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Ownership, Control and Shareholder Value in Italy: Olivetti's Hostile Takeover of Telecom Italia

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Abstract

I examine ownership structures, minority shareholder rights, and shareholder activism in the context of Olivetti's successful hostile acquisition of Telecom Italia in 1999. Events surrounding the takeover provide mixed evidence of improvements in minority shareholder protections. The story, which gives a fascinating picture of the evolution of Italian corporate governance, is unusual, in that minority shareholders were more willing to stand up for their rights. Moreover, privatization and the introduction of the euro have resulted in shifts in ownership and financing patterns. However, due to the concentration of ownership of listed companies, hostile takeovers in Italy will remain rare.

Keywords: Ownership Structure; Shareholder Value; Mergers and Acquisitions; Investor Protection; Path Dependence

JEL Classifications: G32, G34, G38, F21

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1. Introduction

"Yet that Olivetti is taking on a company more than five times its size shows that Europe's business mores are changing quickly. The traditional reluctance to attack corporate giants, political interventionism and closing of the ranks among national business elites appear to be falling by the wayside as Anglo-Saxon notions of shareholder value and corporate governance take hold in Europe. That means Telecom Italia can't take too much comfort in history, even if Olivetti still has many obstacles to overcome." (*Wall Street Journal,* March 8, 1999, p. A15).

"In the end, greed won." (An unmanned Olivetti advisor quoted in *Euromoney,* July 1999).

In February 1999, Olivetti made an unprecedented €53 billion ($58 billion) hostile takeover bid for Telecom Italia. In May, Olivetti's chief executive, Roberto Colaninno, sent a champagne cork flying out of a window at Mediobanca, the Milan investment bank. He was celebrating the receipt of 51.02% of Telecom Italia's voting shares, including those belonging to six of Telecom Italia's seven core shareholders.

Commentators rushed to proclaim a new era in Italian business practice, one with a fresh emphasis on shareholder value and the rights of minority shareholders. For example, the *Financial Times* proclaimed "By launching a Lire102,000 billion bid for a privatized group on Saturday, Roberto Colaninno, chief executive of Olivetti, has provoked what is tantamount to an earthquake in the traditionally closed and incestuous world of Italian capitalism dominated by a few big influential players and their political sponsors." (February 22, 1999, p. 23).

In this paper I describe the takeover, both in its specifics and in the broader context of ownership structures and shareholder value. I consider the likelihood of future takeover battles, the potential enhancement of minority shareholder rights, and the possibility of shareholder activism. I also investigate whether the enthusiastic comments quoted above are justified.

I find that despite the success of Olivetti's bid, the limited number of listed companies and current ownership structures preclude the possibility of frequent hostile takeovers. Unlike Telecom Italia, which had a wide shareholder base in the wake of its privatization, the ownership of most Italian companies is highly concentrated (Bianchi, Bianco, and Enriques, 2001; Faccio and Lang 2002; and La Porta, Lopez-de-Silanes, and Shleifer, 1999). Furthermore, controlling shareholders enhance their power through the use of pyramids and nonvoting savings shares.

I also find that in Italy, as in much of Europe, a primary agency problem is the expropriation of minority shareholders by controlling shareholders. Examples of expropriation include asset sales and transfer pricing favorable to the controlling shareholder, entrenchment, excessive executive compensation, and targeted share issues and repurchases. Such practices are frequently referred to as "tunneling" (Johnson, La Porta, Lopez-de-Silanes, and Shleifer, 2000). The Telecom Italia/Olivetti affair provides several examples of this behavior. What is less typical is the manner in which minority shareholders fought some of the more unpopular schemes.

I also note several remarkable aspects of the Olivetti takeover story. It was the largest hostile takeover offer to that date, paving the way for Vodafone's even more expensive hostile takeover of Mannesmann the following year. The syndicated loan package put together by Olivetti's advisors was the largest up to 1999. These events illustrate at least two points: that the introduction of the euro created new opportunities to raise large amounts of cash quickly, and that in Europe, size alone no longer is a sufficient takeover defense.

Reforms in the law enacted just prior to the Olivetti takeover have made shareholder activism somewhat easier. Bianchi and Enriques (2001) analyze the 1998 Consolidation Act on Finance and conclude that although obstacles remain, the legal environment is now more conducive to activism. Even so, widespread activism similar to that experienced by Telecom Italia remains unlikely. Minority shareholder attendance at annual meetings is low and the primary sponsors of mutual funds are banks and insurance companies. These institutions are unlikely to jeopardize their other business dealings with corporate clients by pushing unpopular shareholder initiatives.

While corporate affairs in Italy are still in the process of transformation, a complete break with established practices will be difficult. Under a theory of path dependence (Bebchuk and Roe, 1999), an economy might maintain a potentially inefficient ownership structure if there are sufficient internal rents or private benefits of control. Given these rents, parties in power will seek to impede reform, and any new laws will tend to perpetuate ownership structures in place at the time of adoption. Exogenous shocks, such as pressure from international investors and the changes in markets brought about by the introduction of the European single market and the euro, might be sufficient to push Italy onto a new path. The question is whether the changes will be fundamental or merely cosmetic. Olivetti's hostile acquisition of Telecom Italia and its aftermath suggest that the end point of the transformation is not yet clear.

The paper is organized as follows. Section 2 provides some relevant background on the two companies and Mediobanca prior to 1999. Section 3 presents the history of the takeover. Section 4 discusses the entrenchment effects of ownership structures in Italy. Section 5 discusses the treatment of Telecom Italia's minority shareholders and minority shareholders more generally and some consequences of this treatment. Section 6 addresses the ongoing evolution of ownership structures, minority shareholder treatment, and investor activism. Section 7 discusses Telecom Italia's performance after the merger and the end of the story. Section 8 concludes.

2. History and performance prior to the takeover

2.1 Events and performance at Olivetti prior to its bid

One remarkable aspect of Olivetti's offer is that it even occurred. The company had been losing money since 1990, and by 1996, Olivetti was on the brink of collapse. In particular, its personal computer division was losing market share.

Beginning in late 1995, several events provoked a change in strategy which ultimately led to Olivetti's recovery. In December 1995, Olivetti made a huge rights issue, raising 2,257 billion lire ($1.42 billion). After the rights offering, approximately 70% of Olivetti's shares were in foreign hands. In January 1996, Olivetti announced greater than expected losses for 1995. Over the next few days Olivetti's share price tumbled 14%.

Olivetti's voting syndicate of core shareholders dissolved in January. Not all of the syndicate members participated in the offering and total syndicate holdings declined to 20%. With the syndicate's dissolution and the unusually large stake of foreign investors, Olivetti was open to pressure from investors. After Olivetti failed to improve its performance during the first half of 1996, Carlo De Benedetti resigned as chief executive in July. On September 4, after a meeting with international shareholders, he also relinquished his position as chairman, becoming honorary chairman. At the time, the move was hailed as a victory for shareholder activism.

However, the investors underestimated De Benedetti's cleverness. Following whispered allegations that Olivetti's first half reports were misleading, Francesco Caio, De Benedetti's successor as chief executive, was replaced with Roberto Colaninno, a De Benedetti protégé who was then serving as the chief executive of another company controlled by De Benedetti. Olivetti's year-to-date return was -50% by the time Colaninno assumed control in October.

As chief executive, Colaninno quickly undertook a major restructuring program that was intended to put Olivetti back on the path to profitability. The central strategy of the plan was to concentrate on telecoms through Olivetti's Omnitel mobile and Infostrada fixed-lines operations.

To accomplish that goal, Colaninno sold the personal computing and other small businesses in early 1997 and the Olsy computer services business in March 1998. In September 1997, he entered into an alliance with Mannesmann, providing joint ownership of Omnitel. It was the new focus on the telecoms business that led to the decision to bid for Telecom Italia.

Table 1 presents summary statistics of Olivetti's financial health prior to the merger.

2.2 Telecom Italia's privatization

At the end of 1996, the state had ultimate control of 10.34% of Italian companies (Faccio and Lang, 2002). This frequency is the fourth highest frequency among the 13 countries they study. The government maintained control via the *Istituto per la Ricostruzione Industriale* (IRI), which owned nearly 500 companies in the early 1990s. Between 1993 and 2001, the government privatized approximately 30 companies, raising €85 billion (Pagano and Trento, 2002).

Telecom Italia completed its privatization in October 1997. The offering was one of the largest in Europe that year and created Italy's largest company in terms of market capitalization. At the time, the government struggled to create a group of 14 core shareholders controlling 9% (*Financial Times,* October 1, 1997, p. 31). The initial goal was to create core holdings of 15% to ensure stability and promote global alliances. The government retained a 5% stake as well as a "golden" share with veto power over major decisions such as mergers, acquisitions, disposals, and the choice of core shareholders. Following a struggle for control among top management, the Agnelli family made its presence felt at the new privatized company despite its tiny 0.62% stake. The first president following the initial shake-up was Gian Mario Rossignolo, who had extensive ties with the Agnelli family. This degree of influence was possible because of the use of core shareholder groups and ownership pyramids (discussed below).

The privatization program created a new group of companies without a dominant shareholder and aimed to broaden the investor base by encouraging the participation of small savers. Italian retail investors could buy shares in Telecom Italia for a three percent discount. The offering attracted 2.1 million applications to buy shares. These investors ultimately were allocated 1.45 billion shares against only 55 million to institutional investors (*Financial Times,* October 27, 1997, p. 21). Moreover, many of these shareholders were not Italian; 37% of Telecom Italia voting shares were held by foreigners at the time of Olivetti's tender offer. As a result, the company was more vulnerable to takeover than the typical Italian company.

2.3 Mediobanca and family capitalism

Corporate affairs have long been decided in what is commonly called the *salotto buono* or "good drawing room." The *salotto buono* refers to a way of doing business in which decisions are made out of the view of minority shareholders and the public, often in the drawing rooms of Mediobanca, the Milan merchant/investment bank founded by Enrico Cuccia in 1946. Mediobanca historically lies at the center of a network of pyramid ownership structures and strong personal ties cemented by voting agreements and cross-shareholdings.[1]

Since its founding, Mediobanca has been the dominant provider of capital to the large firms of Italy. Its greatest assets are Cuccia's many contacts and its stakes in nearly every important company. Mediobanca uses these stakes to place friends on the boards of nearly every large corporation and protect them from hostile takeovers. The whole system is summarized in one comment by Leopoldo Pirelli, another denizen of the *salotto buono,* "What Cuccia wants, God wants." One aspect of the system is that shareholder value and the concerns of minority

[1] See Pagano and Trento (2002) and Amatori and Colli (2000) for in-depth discussions of the system's evolution.

shareholders are of secondary importance. However, even Mediobanca's many critics acknowledge it has played a valuable role in the growth of Italy's post-war economy.[2]

Further, until 1993, Mediobanca was the only bank permitted to own shares in industrial companies (Bianchi et al., 2001). Moreover, Italy does not have the "main bank" system that prevails in countries such as Germany (Melis, 2000), and until recently non-state banks could only offer short-term credit to industry (Amatori and Colli, 2000). This situation allowed (and still allows) Mediobanca to wield power out of proportion with its small size.

Acting as one of Olivetti's advisors was one of the last hurrahs of the Cuccia era at Mediobanca. Its presence contradicted claims that the proposed offer for Telecom Italia was exclusively about improving shareholder value. Some observers speculated that Mediobanca was involved in the deal because Telecom Italia escaped its influence at the time of the privatization.

3. Olivetti's hostile bid for Telecom Italia

The decision to bid for Telecom Italia had its genesis in the summer of 1998.[3] Since Infostrada was having no trouble stealing customers from Telecom Italia, Colaninno concluded there were substantial efficiency gains to be wrung from Telecom Italia's operations. After a series of meetings with a group of investment banks, in December 1998 Colaninno decided to make a bid for Telecom Italia.

3.1 The offer

Olivetti and its advisors, Chase Manhattan, Donaldson Lufkin Jenrette, Lehman Brothers, and Mediobanca, worked feverishly throughout early 1999. Italian law and Telecom Italia's ownership structure affected the extent and timing of the bid. In addition to the government's

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[2] See "The Emperor Strikes Back" in *Euromoney,* December 1999 for a description of Mediobanca's dealings at the time of the takeover.

[3] Much of the following discussion is drawn from an article by Marcus Walker in the July 1999 issue of *Euromoney* titled "The Sack of Telecom Italia."

power arising from its golden share, Italy’s privatization law of 1994 provided for a 3% voting cap in the absence of a tender for 100% of the shares. Moreover, international investors held 37% of Telecom Italia’s shares. The advisors believed these investors would revolt if they suspected Olivetti was attempting to gain control without buying all of the shares. In the end, Olivetti decided to bid for 100% of Telecom Italia’s voting shares.

On Monday, February 15, 1999, articles appeared in Italian newspapers discussing rumors that Olivetti was poised to make a bid for Telecom Italia. Even though Chief Executive Franco Bernabè thought the bid made no sense, Telecom Italia hired Credit Suisse First Boston, Banca IMI, Lazard Frères, and JP Morgan as advisors in the event of an offer.

The two companies set board meetings to discuss their relative positions. Telecom Italia’s goal was to approve its advisors and Olivetti’s was to formalize its bid. Each company, when it heard about the plans of the other, moved its meeting forward. Eventually, Telecom Italia’s board meeting was scheduled for the morning of Saturday, February 20. But Olivetti managed to win the race, holding its meeting late Friday night. With the board’s approval of the proposed offer, Olivetti sent a letter announcing its intention to make a bid for Telecom Italia to the *Commissione Nazionale per le Societa e la Borsa* (Consob), the stock market’s regulatory arm.

Tecnost, a 97% owned Olivetti subsidiary, would be the acquisition vehicle. The offer price was €10 per share, to comprise €6 in cash, €1.40 in Tecnost stock, and €2.60 in Tecnost bonds. The offer price represented a 10.5% premium over Telecom Italia’s share price. Throughout the battle, Olivetti stressed that it was working with its bankers to ensure that there would be a highly liquid market for the Tecnost bonds after completing the deal. The total value of the offer was €52.6 billion.

A feature of Italy's new takeover law provided the incentive to hold the first board meeting. Under the law, once a bid is in place, the target can no longer adopt defensive moves without the approval of at least 30% of its shareholders. Olivetti's fear was that Telecom Italia would erect defenses sufficient to put the price out of reach.

Olivetti suffered a temporary setback when Consob declared that the letter of intention was invalid. Consob wanted a guarantee that Olivetti's planned sale of its existing telecoms businesses to Mannesmann would be completed. It took four days for Olivetti to achieve the guarantee. Surprisingly, Telecom Italia did not use the four days to erect defenses. Consob declared Olivetti's offer valid on February 26, perhaps succumbing to pressure from Prime Minister D'Alema (Amatori and Colli, 2000).

3.2 The financing

Olivetti, with a market capitalization of €9.4 billion, faced the task of financing a €52.6 billion bid. The biggest component was to be a syndicated loan package expected to total €20.7 billion. Other sources included €7.6 billion from the Mannesmann sale, a rights offering for €2.6 billion in Olivetti equity, €13.7 billion in new Tecnost bonds, €7.4 billion in new Tecnost equity, and €0.6 billion in cash on hand.

Chase organized the syndicated loan, which was later increased to €22.5 billion. Olivetti stimulated interest by offering 225 basis points above Libor, a very generous spread for a company with a single-A credit rating at a time when the typical prevailing spreads were 75 basis points. Despite a steep €1 billion entry level, nearly 50 banks expressed an interest in participating. Ultimately, Olivetti received 26 offers totaling more than €30 billion.

3.3 Telecom Italia's defense

Telecom Italia's advisors presented defensive options on Sunday, February 21. The preferred approach entailed altering Telecom Italia's ownership structure so that the company would become too expensive for Olivetti to purchase. The proposals included converting 2.2 million savings shares to voting shares and the purchase of the 40% of Telecom Italia Mobile (TIM) not already owned. Other strategies focused on providing Telecom Italia shareholders quick cash alternatives to Olivetti's bid, such as a leveraged offer, payment of a special dividend, or a share repurchase. The advisors also suggested finding a "white knight," tying up the offer with lawsuits, or making a retaliatory offer for Olivetti – the so-called "pac-man" defense.

Chief Executive Bernabè rejected almost all of the defenses, as he did not want to do anything he would not consider good strategy in the normal course of business. After days of debate, he agreed to three defenses designed to make Telecom Italia too expensive for Olivetti: converting the savings shares into voting shares, repurchasing 10% of the voting shares using cash on hand, and a stock offer for the TIM shares. The offer for the TIM shares was switched to a cash offer after Telecom Italia shareholders said they wanted to avoid the dilutive effect of a share offer. Telecom Italia's voting shares total value would have exceeded €90 billion following completion of the plan.

One effect of the debate was that Telecom Italia missed its best opportunity to put its defenses into place. Because Telecom Italia did not act quickly following Consob's initial rejection of Olivetti's bid, the defensive plan had to be put to a shareholder vote. However, only 22% of the shareholders attended the April 10 meeting. The turnout was far short of the 30% quorum required to permit voting on defensive proposals. Additional shareholders sufficient to achieve quorum milled around the meeting place, but never entered the hall. Olivetti had increased its offer to €11.50 per share or €60.4 billion in total by the time of the meeting. The end result was that the shareholders faced the following decision: Should they take Olivetti's up-front offer of cash and securities, or should they stick with Telecom Italia and hope for long-term gains?

3.4 Enter Deutsche Telekom

Bernabè secretly decided to pursue the idea of a white knight following the disaster at the shareholders meeting. On April 15 he told his advisors he had been meeting with Ron Sommer, the chief executive of Deutsche Telekom. On April 22 Telecom Italia and Deutsche Telekom announced that they were merging via a share swap to create Deutsche Telecom Italia. The combined company would be worth nearly €200 billion. The major sticking point was the German government's 72% stake in Deutsche Telekom, which would translate into 40% of the merged company. The Italian government was not thrilled with the idea of a foreign government having such a large stake in Italy's largest listed company. After Prime Minister Massimo D'Alema and Chancellor Gerhard Schröder were unable to reach an agreement on the German government's quick disposal of its shares, D'Alema threatened to use the government's golden share in Telecom Italia to block the deal.

The proposed merger did not impress commentators. According to *Euromoney,* "It's even harder to see what value Telecom Italia's proposed merger with Deutsche Telekom offers to shareholders. It brings little hope that either company will be transformed into a leaner, more efficient competitor. Worse, it raises the prospect that politicians and civil servants will decide the fate of these deals, not markets." (*Euromoney*, May 1999, p. 5). In the end, pressure from the Italian government and a lack of enthusiasm on the part of investors doomed the deal.

3.5 The shareholders vote and the aftermath

Shareholders began to submit their shares to Olivetti on April 30. The contest ended late on May 21 when six of seven of Telecom Italia's remaining core shareholders tendered, pushing the acceptances over 50%. Since the final count was not completed until several hours after the market closed, the core shareholders did not know that their shares would prove decisive. By the end of the day, Olivetti had received 51.02% of the voting shares. Telecom Italia's board met on May 25, and Bernabè and the non-executive directors resigned effective June 28.

Olivetti ultimately purchased 52.12% of Telecom Italia's voting shares at a cost of €31.35 billion. The funding comprised €18.86 billion in cash, €4.58 billion in Tecnost equity, and €7.91 billion in Tecnost notes (later increased to €9.41 billion). The cash came from €6.86 billion in syndicated loan borrowings, €2.6 billion from Olivetti's reserves, €1.47 billion from Tecnost's cash reserves, and €7.93 billion from the Mannesmann sale.

The audacity of Olivetti's bid prompted many observers to proclaim a fundamental shift in attitude. The *Financial Times* stated the "takeover marks a historic turning point for both corporate Italy and the political culture and marks the beginning of an even greater financial shakeout in the country. An important point is that the core shareholders, except one, sold their shares. This is unprecedented and suggests an end for 'crony capitalism.'" (May 24, 1999, p. 17). See also, the *Wall Street Journal* quote at the start of the paper. As subsequent events have shown, this optimism was misplaced, in part due to the strength of the *salotto buono*.

4. Ownership and control of listed Italian companies

In this section I explore the ownership of listed companies and the methods companies use to protect themselves from Telecom Italia's fate.

A common perception is that even if hostile takeover attempts are rare, the mere possibility forces managers to minimize the consumption of perquisites and to focus on increasing shareholder value. However, a necessary condition is for companies to be vulnerable to attack. As shown by Bianchi et al. (2001), Faccio and Lang (2002), and La Porta et al. (1999), most continental European firms are less vulnerable than those in the U.S. and U.K.

Although the data and analyses differ across the three studies, the conclusions are similar. As it is in much of continental Europe, in Italy ownership is highly concentrated and there is a limited number of potential takeover targets For example, according to Bianchi et al., as of 1996 the largest blockholder controls an average (median) of 48.02% (50.97%) of the votes of listed companies. All three studies report that only 10% to 20% of the firms lack a shareholder with a 20% stake. Also, according to Faccio and Lang (2002) and La Porta et al. (1999), the dominant shareholders are families and the government.

Concentrated ownership has been the rule in Italy for a long time (Aganin and Volpin, 2003). Only 10%, 4.35%, and 12.99% of listed companies did not have a controlling shareholder at the 20% level in 1947, 1987, and 2000, respectively.

Controlling shareholders further entrench their positions via the creation of ownership pyramids and the issuance of savings shares. The goal is to increase outside capital while maintaining control over broad portions of the economy. In fact, a typical feature of the *salotto buono* system is the ability to maintain control of many companies using the smallest capital investment possible.

The structure of an ownership pyramid is that A owns a controlling stake in B, which in turn owns a controlling stake in C. So, A still is able to maintain control of C, even though A's direct stake in C is small. According to Bianchi et al. (2001), 53% of Italian industrial firms belong to a pyramid.

Olivetti provides a good example of the efficacy of using a pyramid (Amatori and Colli, 2000). At the top were Colaninno and his family, who owned 15.7% of Fingruppo Holding and 5.66% of HOPA Holding. Fingruppo also held 30% of HOPA, resulting in a total Colaninno stake of 0.0566 plus 0.157*0.3, or 10.37% in HOPA. HOPA in turn owned 51.63% of Bell of Luxembourg, which owned 14% of Olivetti. As a result, Colaninno had effective voting control of Olivetti via the intermediate stakes in each level of the pyramid. However, he had only a 0.75% (0.1037*0.5163*0.14) direct stake. Although the individual stakes fell far short of the 50% level necessary to guarantee undisputed control, low attendance by other shareholders at annual meetings made it unlikely that managerial initiatives would be contested. Following the takeover, the Olivetti pyramid was even taller, encompassing Tecnost, Telecom Italia, and TIM.

Moreover, Olivetti did not tender for Telecom Italia's savings shares, which represented 29% of the outstanding shares. By law, savings shares receive higher dividends than voting shares and their total par value cannot exceed that of voting shares. According to Faccio and Lang (2002), 41.35% of Italian companies have savings shares. Bianchi et al. (2001) report that saving shares account for 13.8% of the market capitalization of companies that have them.

Worldwide, voting shares trade at a premium to non-voting shares. The premium in Italy of 82% (Zingales, 1994) is much higher than those reported in other countries. Zingales suggests a likely reason for this higher private benefit of control is that it is easy to dilute the property rights of minority shareholders.

On top of everything else, in Italy voting syndicates are fairly common. These arrangements allow a shareholder to maintain control even if he does not own a sufficiently large controlling stake himself. Volpin (2002) reports that 15% of Italian listed companies, excluding banking and insurance firms, have voting syndicates. As mentioned earlier, a voting syndicate at Olivetti collapsed a few months prior to the ouster of Carlo De Benedetti as Olivetti's chairman.

In the end, the highly concentrated ownership structures mean the primary agency problem is not between shareholders and managers. Instead, the conflict is typically between controlling and minority shareholders.

5. The expropriation of minority shareholders

Because many people viewed the success of Olivetti's bid as an important step towards fostering improvements in shareholder value, an interesting question is whether events actually panned out as predicted. A primary problem with the ownership structures just discussed is the likelihood of poor treatment of minority shareholders.

5.1 Poor treatment of Telecom Italia's minority shareholders

At the time of Olivetti's offer, Colaninno emphasized that his plan for Telecom Italia would enhance shareholder value. However, it is not clear that his actions accorded with his promises. On June 9, 1999, the day the government formally cleared Olivetti's purchase of Telecom Italia, Colaninno announced he was assembling a new group of core shareholders to protect the company from "sneak attacks" (*Financial Times,* June 9, 1999, p. 36). His plan was to increase the core holdings to just shy of 30%, the level at which the group would have to make an offer for all of Olivetti.

Next, the first of two revealing attempts to alter the group in his favor began on September 28, 1999. Following the change in control, Telecom Italia had to distribute 90% of its income as dividends so that Tecnost could meet its interest expenses. Olivetti decided to transfer Telecom Italia's 60% stake in TIM directly to Tecnost. The primary benefit would be to reduce the overall group dividend expense, because the group would no longer have to distribute a portion of the dividends paid by TIM to Telecom Italia's minority shareholders. Olivetti justified the action in terms of increased efficiency, but outsiders viewed the plan as an effort to increase the cash flows available to service Tecnost's debt. The lower portion of the group's post-merger ownership structure appears in Figure 1.

New Tecnost shares would be used to compensate Telecom Italia's minority shareholders for the loss of their indirect TIM stake. Because issuing the new Tecnost shares would have a major dilutive effect on Olivetti's existing 70% Tecnost stake, a key issue would be the number of new Tecnost shares paid for each Telecom Italia share. Colaninno and Olivetti did not want that link in the pyramid weakened too much. Colaninno was well aware that Telecom Italia's minority shareholders had already passed up one opportunity to receive Tecnost shares during the original tender offer.

Olivetti settled on an exchange ratio of between 1.5 and 1.65 Tecnost shares for each Telecom Italia share, which would reduce Olivetti's Tecnost stake to approximately 42%. Olivetti simultaneously announced plans to spend €4.5 billion to repurchase 34% of Telecom Italia's savings shares for €6 per share (*Financial Times*, September 29, 1999, p. 32).

Telecom Italia's minority shareholders were furious. Over the next two days, its shares dropped 8.7% on a volume of 234 million shares against an average daily volume of 19 million shares during the previous three weeks. Over the period, the MIB 30 fell by only 2.2%.

There were calls for the Italian government to use its golden share to block the deal. In particular, institutional investors were livid. "When we met with Mr. Colaninno during the takeover, he promised us to focus on shareholder value, this has all turned out to be a hoax," said one London fund manager. (*Wall Street Journal,* November 4, 1999, p. A25). In a letter to the *Financial Times*, Mr. Colaninno defended the plan as "sound and logical," adding that the aim of the plan was to "simplify the ownership structure of the Telecom Italia group, to facilitate the efficient servicing of our debt, to make clear to all the discount currently attaching to Telecom Italia's fixed-line business, to increase our flexibility to negotiate value-enhancing alliances and, above all, to help us identify and address the huge cost of inefficiency under which Telecom Italia still labours." (September 30, 1999, p. 22).

After a month of bickering, Olivetti increased its Tecnost stake to 72.8% and agreed to commission an independent analysis. Following analysts' recommendations of 2.2 to 2.5 Tecnost shares for each Telecom Italia share, on November 21 Olivetti abandoned the whole idea. By this time, Telecom Italia's share price had rebounded to a price 17% above its level of September 28.

The second Olivetti action to rile Telecom Italia's minority shareholders began on February 5, 2001. This time, Olivetti announced its intention to convert Telecom Italia's savings shares into voting shares and then repurchase some of them. The goal of the conversion was to raise €12.8 billion to fund the repurchase and reduce Olivetti's debt. In turn, TIM would be able to reduce its dividend and have the resources to pursue new alliances.

The plan had two components. First, the savings shareholders would turn in their shares and receive rights to purchase voting shares for 48% of their market value, with a minimum price set at €6.25 per share. Next, Telecom Italia would repurchase up to 10% of the voting shares at a 15% premium or for €17.50 per share, whichever was higher. Olivetti planned to participate proportionally in the repurchase, reducing its Telecom Italia stake from 55% to approximately 40%. Olivetti expected to receive from €4.3 billion to €5.1 billion, depending on the tendering rates and share prices at the time of the transaction, for its debt reduction program.

As before, shareholders were unhappy with the terms on offer. Previous share conversions by TIM and Olivetti subsidiary SEAT Pagine Gialle allowed the purchase of voting shares at only 38% and 30% of their market prices, respectively. Moreover, based on prevailing share prices, it would be more expensive for the savings shareholders to convert their shares than to sell them and purchase voting shares on the open market.

Both Olivetti's and Telecom Italia's share prices fell at the announcement. As Olivetti announced it would only pursue the plan if over 80% of savings shareholders tendered and a majority of Telecom Italia's voting shares not held by Olivetti approved, a group of investors banded together to try to block the plan. Bowing to shareholder pressure on April 1, Olivetti reduced the conversion premium to the higher of €5.25 or 42% of the voting share price. Even so, Gordon Singer, a manager at the hedge fund Liverpool Partners stated the plan was "the most devious of any of the operations discussed so far." (*Financial Times,* May 4, 2001, page 19). Although investors approved the plan on May 3, it was never completed, in part because Telecom Italia's declining share price reduced the amount that could be raised.

The willingness of institutional shareholders to fight back again did not sit well with Colaninno. As reported in *The Economist,* "As companies are exposed to international markets, they attract attention from interventionist-minded foreign investors. Some of this attention is unwelcome. Roberto Colaninno, boss of Telecom Italia, made clear at a shareholders' meeting on May 3rd that he is furious with Liverpool Partners, a Bermuda-based hedge fund that is trying to block a proposed €10.8 billion plan to convert special savings shares into ordinary (voting) shares and buy some of them back. Liverpool Partners argues that the plan benefits Olivetti, Telecom Italia's biggest shareholder, more than anybody else. It has persuaded a group of similar funds to campaign for better terms. Mr. Colaninno considers such interference utterly unwarranted." (May 12, 2001, p. 63). Actually, Colaninno said "The interventions were either banal, provocative, even aggressive, or attempting to pass I don't know what message. None of them worry me, none of them scare me." (*Financial Times,* May 4, 2001, p. 19).[4]

5.2 One instance in which minority shareholders were treated fairly

Olivetti did learn one lesson, at least for a short time, during the unsuccessful attempt to merge Tecnost and TIM. In their next attempt to streamline operations, the boards of Olivetti and Tecnost agreed to merge the two companies. Based on prevailing share prices, Olivetti proposed to offer 1.12 Olivetti voting shares per Tecnost share. Between board approval on May 27, 2000 and the extraordinary shareholder meeting in early October, Olivetti frequently stressed its "commitment to a ***market-friendly transaction***" which required the majority vote of Tecnost's minority shareholders (Olivetti press release, May 27, 2000, emphasis in original). Olivetti also took steps to protect Tecnost's bondholders as part of a public relations campaign emphasizing the fairness of the transaction to Tecnost's investors. Specifically, they promised to increase the coupon rate in the event of a downgrade by either Moody's or Standard & Poor. Following almost unanimous approval of the Tecnost minority shareholders and bondholders, the two companies merged on December 31, 2000.

5.3 Broader evidence concerning entrenchment and the treatment of minority shareholders

There is an extensive Italy-specific literature that studies the effects of its ownership structure. Volpin (2002) relates managerial turnover to firm performance while controlling for ownership structure. He reports that management in Italy is entrenched. The relation between turnover and performance is lower when the executive is a member of the controlling shareholder's family. In contrast, the relation between turnover and performance increases when the controlling shareholder also holds substantial cash flow rights. Also, the presence of a voting

[4] Olivetti's actions were hardly unique. See Macey (1998) for additional examples of expropriation of minority shareholder value.

syndicate enhances the relation between performance and turnover. Volpin suggests this is evidence of a monitoring role for outside blockholders.

One reason for a lack of trust among minority shareholders arises from the practice of tunneling. According to Johnson et al. (2000), tunneling encompasses both legal and illegal activities. Examples of tunneling include asset sales and transfer pricing favorable to the controlling shareholder, excessive executive compensation, loan guarantees, dilutive share issues, minority freeze-outs, and insider trading. Johnson et al. notes that tunneling is a worldwide phenomenon and provides examples of legal tunneling in Italy, France, and Belgium.

Bigelli and Mengoli (2001) provide evidence of expropriation of minority shareholders. They report an inverse relation between the market reaction to acquisition announcements and acquiring firms' separation of ownership and control, measured as cash flow to voting rights. Among firms with both voting and savings shares, the market reaction for voting shares is slightly positive and the reaction to savings shares is significantly negative. Since voting shares have both cash-flow and control components, but savings shares only have a cash-flow component, the difference can be attributed to higher control rights. Also, they examine 19 mergers of companies within the same pyramid for evidence of tunneling. If the acquiring firm is nearer the top of the pyramid, the reaction is significantly positive, suggesting underpayment. When the acquiring firm is lower in the pyramid the reaction is significantly negative, suggesting overpayment. Bigelli and Mengoli conclude that acquisitions do not create value for all shareholders. Instead, the acquisitions tend to "increase the majority shareholder's private benefits of control." Recall, the offer price in the proposed Tecnost/Telecom Italia merger was widely considered to be insufficient. Bajo, Bigelli, and Sandri (1998) provide broadly similar results for a sample of investment decisions.

Barontini and Siciliano (2003) examine the relation between the risk of expropriation of minority shareholders and equity returns and firm value. They classify a firm as having a high risk of expropriation if the firm is closely held (i.e., the ultimate owner at the top of the pyramid controls more than 30% of the firm's voting rights), the second shareholder has less than 10% of the voting rights, and there is a significant wedge between cash flow and voting rights. Firms with a high risk of expropriation and in which the ultimate shareholder is either the state or a family have Tobin's Qs which are 15% to 17% lower than those of other firms. In contrast, they report the risk of expropriation is not related to equity returns.

Bianco and Casavola (1999) present evidence suggesting that investors fear expropriation more when the degree of vertical integration within a pyramid is greater. On the other hand, they also present evidence of internal capital markets within groups.

Overall, the papers discussed in this section indicate a disturbing lack of both minority shareholder protections and accountability for managers of family-controlled firms. Fortunately, Consob and the government have worked hard to improve the situation. The passage of a market reform law in 1998, discussed in Section 6.3, improved the lot of minority shareholders. Consob (2002, 2003a) also discusses other important changes in regulations.

6. Evolution of ownership and minority shareholder protection

6.1 Evidence on minority shareholder protection and market development

A major factor affecting minority shareholder rights is a country's legal structure. According to La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998), Italy primarily uses the French-civil-law structure, which is characterized by the weakest protection afforded to minority shareholders and quality of accounting of the four systems they study. At the time of the study, Italy scored only one of six on La Porta et. al.'s Antidirector Rights index. Poor law enforcement in French-civil-law countries exacerbates the potential for abuse. Overall, they find a strong negative relation between ownership concentration and the quality of legal protection afforded to investors. The need for more concentrated ownership arises from a need for investors to protect themselves, given the poor minority protections.

La Porta et al. (1998) and Bebchuk, Kraakman, and Triantis (2000) discuss the costs of high ownership concentration: core investors are not diversified, firms find it difficult to raise external equity due to a fear of expropriation, firms are insulated from the disciplinary pressures of the threat of takeover, and firms might pursue inefficient investment policies. Several studies support their argument. Giannetti and Koskinen (2004) report minimal stock market participation among small and foreign investors in countries with poor investor protection. Lins and Warnock (2004) report U.S. investors have smaller holdings of family controlled firms in countries with poor legal protection. A McKinsey (2002) survey of global investment decision makers concurs. Decision makers place strong emphasis on factors such as shareholder equality, property rights, and accounting disclosure when allocating capital. Moreover, Wurgler (2000) reports the correlation between industries' investment opportunities and actual investment is higher in countries with stronger minority investor rights.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) examine the effects of a lack of investor protection on market development. French-civil-law countries typically have lower market capitalizations to GDP, fewer traded companies, and fewer initial public offerings. The evidence on the number of listed companies is striking. Italy has only 3.91 listed companies per million people, compared to 30.11 per million in the U.S. and 35.68 per million in the U.K.

Pagano, Panetta, and Zingales (1998) examine Italian companies' decisions to go public. They report that the typical Italian IPO is eight times as large and six times as old as those in the

U.S., and that borrowing costs decrease following the IPO. Pagano et al. suggest the lack of protections offered to minority shareholders makes it more difficult for firms to gain investors' trust. The end result is many Italian firms find it difficult to gain access to capital markets. In fact, Consob (2003b) reports that privatized firms account for 73% of the market value of companies listed since 1990. As discussed earlier, Barontini and Siciliano (2003) report that firms with a high risk of expropriation are worth less than other firms.

In assessing the effect of high ownership concentration and poor investor protections, Becht and Mayer (2001) are blunt: "By preventing increasingly sophisticated investors from identifying – with certainty and ease – the ownership and control structure of European corporations and the group structures these corporations might be embedded in, the lack of disclosure seriously undermines Europe's ability to compete for globally mobile capital. International fund managers, who are administrating a rising share of the World's and Europe's savings, deplore obscurity. When disclosure standards are low they demand a high-risk premium. When they are very low they do not invest at all."

An alternative, but not necessarily mutually exclusive, method of viewing existing market structure and development is what Aganin and Volpin (2003) term the "political economy" view, based on Rajan and Zingales' (2003) contention that market development is influenced by the balance of power between pressure groups. In the context of the political economy view, established Italian firms did not have to worry about overall financial development. Instead, they used internal funds, which were quite high immediately following WWII due to low wages and protected markets (Amatori and Colli, 2000). Building on this idea, Pagano and Volpin (2004) show that incumbent firms pressure the government to stifle market development to limit potential competitors' access to capital. The greater the state involvement, the greater is the need for political clout. Finally, to achieve the political clout, the groups maximize the number of firms under their control. As noted earlier, a successful method of controlling many companies with minimal capital outlay is to create pyramidal groups with ownership concentrated at the top of the pyramid.

Once the ownership structures are in place, path dependence (Bebchuk and Roe, 1999) makes far-reaching reform difficult. However, a shock to the system might bring about some changes. For example, globalization and market integration forced by the euro might cause internal funds to dry up. According to Rajan and Zingales (2003) "Incumbent incentives are powerfully affected by competition, especially that emanating from outside their political borders, which they cannot control. The degree to which a country's borders are open to both the flow of trade and capital is thus likely to matter." In response, the Italian government, like many others, is trying to foster the creation of national champions and blocking the acquisition of candidates for the position by foreign companies (explaining, in part, the failure of the proposed Telecom Italia/Deutsche Telekom merger).

Whether the Law and Finance or Political Economy view more completely portrays reality is a topic of ongoing debate. For example, in his annual speech to the financial market, Consob's chairman, Luigi Spaventa, calls the La Porta et al. (1998) measure "highly questionable" (Consob, 2002). Regardless, the end result is that Italy has highly concentrated ownership and relatively few publicly traded companies. Moreover, these companies are tied together via pyramidal groups and voting pacts.

6.2 The Draghi Law and the enhancement of minority rights

The government enacted the Consolidation Act on Finance, a major reform of the law regulating financial services, stock exchanges, and listed companies in February 1998. The law is frequently called the Draghi Law or Draghi Reform, as many of its provisions resulted from the work of a commission on corporate governance headed by Mario Draghi, the director general of the Italian Treasury. The 30% threshold required to implement defensive tactics discussed in Section 3.3 is a feature of the Draghi Law. Other aspects of the law aim to improve minority shareholder rights. For example, the law reduced the threshold required to convene a shareholder meeting to 10% from 20%. Minority shareholders now have the right to name one of three or two of five members of the board of auditors. The new rules requiring that the compensation of board members and auditors must be made public are among the strictest in Europe. Lastly, minorities with 5% stakes can sue directors for damages. Aganin and Volpin (2003) argue the provisions improve Italy's score from one of six to five of six on the La Porta et al. (1998) Antidirector Rights index. Other aspects of the law call for more transparent balance sheets, half-yearly reporting of financial results, meetings with analysts, and stricter insider trading rules.

Linciano (2002) examines voting premiums from 1989 to 2000 and provides evidence that voting premiums steadily diminished over the period that the Draghi commission was in operation, culminating in a drop of 7% in the premium at the time of passage of the law. Linciano argues the declining premium is evidence of a reduction in the private benefits of control, at least in terms of investor perceptions.

Bianchi and Enriques (2001) provide an in-depth discussion of the law and its effects. They examine whether the law encourages shareholder activism, and whether such activism is likely or even possible. These questions are important, because, as Macey (1998) notes, prior to the reform, active monitoring of management was highly unlikely due to the lack of an active market for control and the lack of institutional investors willing or able to do so.

Bianchi and Enriques (2001) address their second question first by examining whether a sufficient number of institutional investors exist to successfully engage in shareholder activism. Overall, the data is mixed. As shown in Section 6.4, there has been an increase in the number and value of Italian mutual funds. However, Bianchi and Enriques note that as of the end of 1998, the mutual funds held only 221 stakes greater than 1% (the threshold for reporting under the Draghi Law). International investors held an additional 71 stakes greater than 2% (the threshold for other block holdings). The holdings affect 119 of 218 listed sample companies. Individual Italian mutual funds hold relatively few positions. The top five positions at each fund average 43.1% of total fund holdings. Also, banks and insurance companies manage most mutual funds. These entities are unlikely to risk other business dealings by pushing too hard on the activism front. Plus, as noted earlier, individual shareholders or shareholder groups have voting control of the majority of Italian companies. These firms will not be affected by shareholder initiatives. In spite of the impediments to activism, Bianchi and Enriques conclude that institutional investors are in position to play a role in the governance of Italian companies, especially in the case for international investors less likely to be affected by conflict of interest concerns.

Bianchi and Enriques (2001) then investigate whether the Draghi Law creates a legal environment friendlier towards shareholder activism. In addition to the minority rights mentioned previously, the solicitation of proxies by 1% shareholders is now permitted. Even so, the rules governing the solicitation of proxies remain strict. The right to present shareholder proposals outside of a shareholder meeting does not exist and only shareholders representing 10% of the shares can call for meetings. Even then, directors retain the right to refuse to submit any proposals to a vote. Bianchi and Enriques conclude that while the legal environment is now more conducive to shareholder activism, its implementation remains difficult and costly.

Although mechanisms facilitating increased activism are in place, formal activism remains on a small scale. Voting on a controversial merger of Olivetti and Telecom Italia in July 2003, discussed in Section 7.2 below, supports this view. While many foreign investors voted against the merger, members of Assogestioni, Italy's investment manager association merely abstained (*The Economist,* July 5, 2003, page 66). Broader evidence from (Consob, 2003b) concurs, reporting Italian financial companies represent less than 2.5% of the shares participating at the annual meetings of large companies. Moreover, absentee rates approaching 90% of small shareholder capital at annual meetings lowers ownership thresholds necessary to exercise control (Consob, 2002).

6.3 Changes in ownership structures

There is limited evidence that ownership patterns are changing. Bianchi et al. (2001) report a tendency towards simplification in the pyramid groups' structures driven by financial distress and a desire to focus on core operations. Between 1996 and 1998, the mean market capitalization weighted top stake fell from over 50% to 35%. They also report a rise in institutional ownership. The percentage of companies with institutional investors owning shares at the 2% reporting threshold increased from 33% in 1996 to 84% in 1998.

Consob (2003b) reports a reversal of the trend, with a mean 40.7% stake held by the largest shareholder in 2002. Also 15.4% of firms have no controlling shareholder(s), falling from a peak of 38.6% in 1998.

Aganin and Volpin (2003) trace the ten largest groups by market capitalization from 1930 to 2000 at ten-year intervals. As might be expected, the Olivetti group was the largest in 2000, accounting for 24.07% of total market capitalization. There are only two family-controlled groups as of 2000 compared to five in both 1980 and 1990. Moreover, reflecting the desire of many groups to simplify their structures, the average number of companies per group has fallen to 3.9 in 2000 from 6.1 and 8.7 in 1980 and 1990, respectively.

6.4 Changes in financial markets

The introduction of the euro and the requisite changes in the laws governing markets made in preparation for its arrival have had far reaching consequences in terms of corporate financing and attitudes towards shareholder value. Some of the consequences have been unintended. In fact, it is highly unlikely that Olivetti's bid for Telecom Italia would have occurred had it not been for the advent of the euro. Olivetti never would have been able to fund the offer as individual national debt markets were too small and fragmented and tracking tranches offered in the multiple European currencies would have been a major hurdle. Pricing the loans in euros solved the problem at a stroke.

The big Tecnost debt issue was not an isolated case among countries adopting the euro. Santos and Tsatsaronis (2002) provide evidence that bond underwriting quickly changed from a segmented market into a single market.

There are two primary effects for corporate borrowers. First, the fees paid to underwriters on bonds issued in euros fell dramatically and are now similar to those on bonds issued in U.S. dollars. Second, the underwriting business has gravitated from local institutions towards the larger banks that able to provide broad marketing and placement support. Bris, Koskinen, and Nilsson (2003, 2004) examine changes in valuation and investment surrounding the adoption of the euro. They find greater increases in valuation and investment for companies in adopting countries than for companies in non-adopting EU countries, Switzerland, and Norway. The authors conclude the results are consistent with a decrease in the cost of capital following the introduction of the euro.

Another way in which the introduction of the euro affected Olivetti and the Italian stock market was through the Stability and Growth Pact. In order to qualify for membership in the euro, the Italian government needed to reduce interest rates and government debt. The latter was reduced in part via the privatization program discussed earlier. The reduction in interest rates allowed Olivetti access to cheaper financing. Generally, investment opportunities in newly privatized companies and reduced interest rates encouraged "a large entry of individual investors" in the equities markets looking for higher returns and allowed institutional investors to become a "massive presence" (Consob, 2001).

The growth in open-ended mutual funds illustrates the enhancement of Italy's equity culture. As shown in Figure 1, mutual fund assets increased from \$49 billion to almost \$500 billion over 1991 to 2003. This growth reflects a new awareness of the importance of shareholder value. It has also created a new class of institutional investors willing to fight the traditional Italian way of doing business. As noted by Bianchi et al. (2001), financial institutions such as pension funds or investment funds historically did not own large blocks of shares in non-financial companies, partly because of the generous unfunded, pay-as-you-go public pension system. However, it is not clear that investor enthusiasm for equities will survive the collapse of the equity bubble and, more recently, fallout from the Parmalat scandal. The aggregate household exposure to risky assets recently returned to 1995 levels after quadrupling during the late 1990s (Consob, 2003b).

Concern for shareholder value was prevalent enough by the time of Olivetti's offer for Telecom Italian that both chief executives felt compelled to present industrial plans for the improvement of Telecom Italia's operations. The plans had many similarities. Olivetti's Colaninno presented his plan to investors in Milan on March 17 and in London on March 18.

The primary goal was to cut costs by €2.3 billion per year. Highlights included 13,000 job cuts in Telecom Italia's core business and 6,500 elsewhere, the sale of Telecom Italia's Latin American assets, the reduction of international and domestic long distance call charges by 70%, maintenance of the dividend to Telecom Italia's savings shareholders at current levels, and the repurchase of up to 30% of the savings shares. At the same presentation, Colaninno described Bernabè's plan to merge Telecom Italia and TIM as "a great stupidity." (*Financial Times,* March 18, 1999, p. 23). Later, shareholders played a role in the defeat of the plan to merge Tecnost and TIM and in forcing better terms on the proposed conversion of Telecom Italia savings shares.

Generally, concern for shareholder value can be assessed by changes at many of Italy's largest companies. Bianco and Casavola (1999) state that market pressures forced companies to shorten their pyramids and simplify their ownership structures. Even the Agnelli family has simplified the structure of its vast empire by streamlining its pyramid structure and improving focus. Moreover, according to *The Economist,* "There is a new emphasis on profitability, and on the use of sophisticated investment-appraisal techniques, such as 'economic value added', which take into account the interests of all shareholders, not just a few. Managers are being held account for their company results, and the use of performance-related pay and stock options is spreading rapidly." (November, 18, 1997, Italy Survey p. 17). Ironically, Bernabè was among the young managers cited as being behind the movement. Market pressures received an assist in the form of the financial crises experienced by many of the groups.

Euromoney expressed a more cynical view the same month that Olivetti gained control of Telecom Italia: "It helps to woo fund managers based in London and New York, and – perhaps more effectively – makes politicians feel they shouldn't intervene as much as in the past." (May 1999, p. 42). Melis (2000) concurs, arguing that when managers say they are concerned about shareholder value, they are specifically referring to blockholder value. Of course, it is not surprising that the entrenched powers want to maintain their privileged positions. In the end, this view might be seen to have been remarkably prescient.

6.5 Other governance issues

A detailed examination of Italian corporate governance is beyond the scope of this paper. However, a couple of issues are worth noting. According to Melis (2000, 2004) and Hopt and Leyens (2004), Italian boards are a mix of the unitary board system used in the U.S. and U.K. and Germany's two-tier board system. That is, they have a typical board of directors (*Consiglio di Amministrazione*) with a supplemental board of statutory auditors (*Collegio sindacale*). Unlike German supervisory boards, members of the board of statutory auditors cannot be employees of the company and they must meet certain professional qualifications.

The board of statutory auditors might be the best avenue for minority shareholders to protect their rights, as minorities have the right to elect one of three or two of five members. While the board of directors manages the company on a daily basis, the board of statutory auditors ensures that the board of directors is acting in compliance with the law and that the firm's internal control system is adequate. It also has the right to call a shareholder or board meeting if it deems management is acting incorrectly. However, because the call for a meeting must come from two statutory auditors acting jointly, the majority of boards of statutory auditors only have three members, with only one elected by minority shareholders (Melis, 2004).

Consob (2003b) and Melis (2000) report that the average board consists of a majority of non-executive directors. However, neither paper discusses the independence of these directors. Consob (2003b) reports that interlocking directorships are common even outside the pyramid groups. A recent voluntary code of conduct, the Preda Code of 2002, recommends that a reasonable number of the non-executive directors be independent. A new company law, the Vietti-Reform of 2003, gives companies a choice between three board models. In addition to the traditional model, companies may adopt a unitary board or a German two-tier model (Hopt and Leyens, 2004).

7. Post-merger performance and events

7.1 Accounting and share price performance following the merger

During the takeover battle, Colaninno promised to improve performance at Telecom Italia. I report Telecom Italia's post-merger performance figures in Table 2. For comparison, I create a sample of privatized telecom companies. The adjusted figures (reported in parentheses) are the Telecom Italia figure minus the median figure for the control firms. The control firms are Deutsche Telekom, Telefonica, Swisscom, France Telecom, and Koninklijke KPN.

Telecom Italia's performance has been mixed since the merger. Its unadjusted EBIT to total assets was relatively consistent beginning at 13.1% in 1999. Even so, the adjusted performance improved over the period. While Telecom Italia's had negative net income in 2001 and 2002, it outperformed the other telecom companies in 2002.

Telecom Italia's declining unadjusted bottom line performance is, in part, due to the huge debt load the company assumed in the course of the acquisition. Both the unadjusted and adjusted total liabilities to total assets increased over the 1999 to 2002 period. As shown in panel C, Telecom Italia did become more efficient following the merger. Although their employment continued to increase, reaching a peak in 2001, unadjusted and adjusted revenues per employee increased steadily over the post-merger period.

The market based figures presented in panel D are mixed. The unadjusted price-to-sales and market-to-book figures decreased following the collapse in share prices in 2000. However, Telecom Italia was not hurt as badly as the other companies. I report price to sales as both Telecom Italia and some of the control firms had negative net earnings and even EBIT in one or more years.

Figure 2 illustrates the share price performance of Telecom Italia, Olivetti, the broad Mibtel index of listed Italian companies, and the telecoms section of the Dow Jones Euro Stoxx index over four years, beginning with Olivetti assumption of control of Telecom Italia at the end of June 1999. All four measures show signs of frothiness at the peak of the bubble with the DJ Telecom index experiencing the greatest increase in value. By July 2001, when Pirelli acquired control of Olivetti, its value had fallen by approximately 19%. In contrast, the Mibtel and Telecom Italia were up by 6.3% and 8.4%, respectively. By the May 2003 shareholder approval of the merger of Telecom Italia and Olivetti, the shares had fallen to only 81.8% and 46.4% of their beginning values, respectively.

7.2 The End of the Story – The more things change…

Following the failure of the savings share conversion plan, Colaninno sold his controlling stake in Olivetti to Pirelli and the Benetton family's Edizione Holdings on July 27, 2001 for €7 billion. At €4.17 per share, the price represented an 80% premium over recent prices. As usual, minority shareholders could not participate in the transaction.

After the purchase, Pirelli and Edizione had a 27% stake, just short of the 30% threshold requiring an offer to all shareholders. As before, Pirelli's chairman Marco Tronchetti Provera established control of Telecom Italia via a pyramid. In Tronchetti Provera's case, his investment company GPI was at the top of a pyramid with eight levels, including Pirelli and Telecom Italia (*Financial Times,* August 1, 2001, p. 1).

The purchase and the way in which it was consummated suggest Italy remains a country in which the *salotto buono* continues to dominate and minority shareholder rights do not matter. It is ironic that one of Franco Bernabè's defenses in the spring of 1999 was that Olivetti's offer was unfair to minority shareholders for this very reason. In contrast, while admitting that institutional investors in the U.K. would have fought the deal and that many of Italy's companies are controlled by families with minority stakes, Tronchetti Provera defended Italy's system by commenting "I'd like to remind people that (the UK) has an excellent financial market, but it has lost its industries." (*Financial Times,* August 3, 2001, p. 21).

Ultimately, Italy's market has a ways to go before it can be considered transparent. Until it does so, few Italian companies will be capable of competing on a global level. "These features help to explain why there are so few world class large Italian companies. Without more transparent and stringent corporate governance, Italy's businesses will struggle to tap into essential foreign capital." (*Financial Times,* July 31, 2001, p. 18). *The Economist* added "If they behave like Pirelli, Italian firms will increasingly lose access to foreign capital. And foreigners will become increasingly leery of investing in Italy for fear of being hoodwinked by better-informed insiders." (August 4, 2001, p. 13).

Tronchetti Provera ultimately succeeded in one area that Colaninno could not. In the summer of 2003, following yet another battle filled with claims of unfairness. Telecom Italia's minority shareholders approved the merger of Telecom Italia and Olivetti. Tronchetti Provera also has improved governance at the company, perhaps under pressure, by instituting a truly independent board (ten of nineteen members, including four chosen by minority shareholders), a new auditing structure, and new disclosure and remuneration committees (*Business Week Online,* May 10, 2004).

8. Conclusion

In 1996, Salvatore Bragantini, a commissioner of Consob, wrote “It is quite absurd to think that in the western world’s fifth or sixth industrial power you can continue operating a capitalist system without a real capital market. The choice is simple. Either we develop an open market or our industrial prospects are doomed.”[5] In this paper I examine the success of the effort to become a more open market in the context of Olivetti’s hostile takeover of Telecom Italia in the spring of 1999. Generally speaking, events to date have mixed implications.

In the course of acquiring control of Telecom Italia, Olivetti and Tecnost, Olivetti’s acquisition vehicle, assumed large amounts of debt. Although it was necessary to take steps to reduce the debt levels, Olivetti’s methods were suspect. First, Olivetti proposed an all-stock merger of Tecnost and TIM to gain direct access to the latter’s rich cash flows. Olivetti angered Telecom Italia’s minority shareholders by offering to pay only 1.5 to 1.65 Tecnost shares for each Telecom Italia share. Olivetti was forced to give up on the idea only after much vocal campaigning and a series of independent reports suggesting that TIM was worth more. In a later effort to raise cash, Olivetti proposed the conversion of Telecom Italia’s savings shares in voting shares. As the voting shares traded at a premium, savings shareholders would be charged 48% of the market value of a voting share, a price widely seen as exorbitant. Once again, Olivetti was forced to revise its offer. Finally, after losing support of his backers, Colaninno sold his controlling stake in Olivetti and, by extension, Telecom Italia and TIM to Pirelli and the Benetton family for only €7 billion. Olivetti’s non-controlling shareholders could not participate in the offer, which represented an 80% premium over prevailing prices.

[5] The quote comes from a pamphlet entitled *Capitalismo all’Italiano.* It is frequently quoted in the *Financial Times.*

Even so, many groups, including Olivetti, are selling unprofitable divisions and reducing the number of levels in their pyramids. Also, institutional investors are more vocal in standing up for their rights. In this regard, they have been aided by the passage of the Draghi Law, which gives minority shareholders additional rights and requires greater transparency in listed companies. The process has been sped along by the privatization program begun in 1993.

Even Mediobanca has seen its influence wane. The ouster of Vincento Maranghi as chairman in April 2003 marked a rare occasion in which outsiders influenced events inside the bank.

Before the market reforms of the European Union and the onset of globalization, Italy could thrive because its numerous small but strong companies subsidized the mismanagement of the state-owned companies. Most of its family-owned companies remained small due to high taxes, a desire to avoid red tape, and a lack of access to capital markets. Now, however, in a global market there are few Italian companies that are strong enough to be candidates for national champions. So, they are circling the wagons. "'The system here is a dead one,' says Guido Rossi, former chairman of Telecom Italia SpA and former head of stock market regulator Consob. 'Italian companies are closing themselves off in a sort of autarky.'" (*Wall Street Journal,* August 7, 2000, p. A8).

At this time, it is unclear how events will turn out. Will Italian companies truly turn inward, or will they adapt a more Anglo-Saxon approach towards managerial capitalism? While progress towards reform and openness has been slow, it has been occurring. Moreover, as Aganin and Volpin (2003) argue, there was little difference between Italian firms of the early twentieth century and Anglo-Saxon firms today.

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Table 1
Summary statistics for Olivetti prior to its takeover of Telecom Italia
This table presents selected financial ratios for Olivetti for the period 1995 to 1998, which I obtain from Olivetti's Annual Reports. The table reports revenue per employee and net earnings per employee figures in billions of lire.

	1995	1996	1997	1998
Panel A: Return figures				
EBITDA before non-recurring items/Assets	0.009	-0.022	-0.005	0.093
EBIT/Assets	-0.093	-0.029	0.034	0.077
Net earnings/Assets	-0.132	-0.089	0.002	0.017
Net earnings/Equity	-0.597	-0.510	0.008	0.066
Panel B: Financial ratios				
Current ratio	1.467	1.274	1.420	1.509
Total liabilities/Equity	3.528	4.700	3.666	2.985
Medium & long-term liabilities/Equity	1.318	1.548	1.334	1.479
Panel C: Employment				
Number of employees	31711	29153	22659	16742
Revenue/Employee	0.310	0.285	0.292	0.426
Net earnings/Employee	-0.050	-0.031	0.001	0.015

Table 2
Performance of Telecom Italia following its acquisition by Olivetti
This table presents selected adjusted and unadjusted financial ratios for Telecom Italia for the period 1999 to 2002. In each block of entries the adjusted figure appears in parentheses below the unadjusted figure. The adjusted figure is the Telecom Italia figure less the median of a group of control firms. The control firms are Deutsche Telekom, Telefonica, Swisscom, France Telecom, and Koninklijke KPN. Source: Individual company annual reports. The table reports revenue per employee and net earnings per employee figures in millions of euros. Where necessary, I convert amounts into euros using end of the year exchange rates.

	1999	2000	2001	2002
Panel A: Return figures				
EBIT/Assets	0.131	0.105	0.106	0.140
	(0.073)	(0.054)	(0.085)	(0.116)
Net earnings/Assets	0.038	0.031	-0.033	-0.006
	(-0.008)	(-0.004)	(-0.012)	(0.188)
Net earnings/Sales	0.064	0.070	-0.067	-0.011
	(-0.027)	(-0.042)	(-0.004)	(0.412)
Panel B: Financial ratios				
Current ratio	0.734	0.620	0.763	0.892
	(-0.080)	(-0.276)	(-0.331)	(0.035)
Total liabilities/Assets	0.560	0.610	0.692	0.757
	(-0.090)	(-0.109)	(-0.009)	(0.007)
Panel C: Employment				
Number of employees	127,193	148,707	161,527	152,845
	(-4,531)	(-34,038)	(-51,571)	(-51,687)
Revenue/Employee	0.221	0.252	0.280	0.301
	(0.026)	(0.020)	(0.067)	(0.073)
Net earnings/Employee	0.014	0.018	-0.019	-0.003
	(-0.001)	(-0.008)	(-0.005)	(0.083)
Panel D: Market based measures				
Price to Sales	3.072	2.581	1.962	1.579
	(-1.868)	(0.396)	(0.487)	(0.371)
Market to book	2.368	1.759	1.657	1.666
	(-0.575)	(0.220)	(0.415)	(0.307)

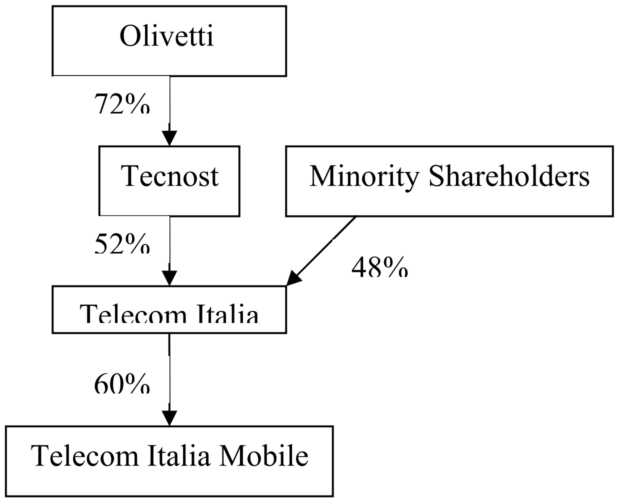

Fig. 1. Post-acquisition ownership structure of the Olivetti group. The figure illustrates the ownership structure of the Olivetti group at the time of the proposed merger of Tecnost and Telecom Italia Mobile, which was announced on September 28, 1999. On October 28, 1999, the Olivetti Group announced that Olivetti had increased its Tecnost stake to 72.8% and that Tecnost had increased its Telecom Italia stake to 55%. All ownership percentages represent ownership of ordinary voting shares.

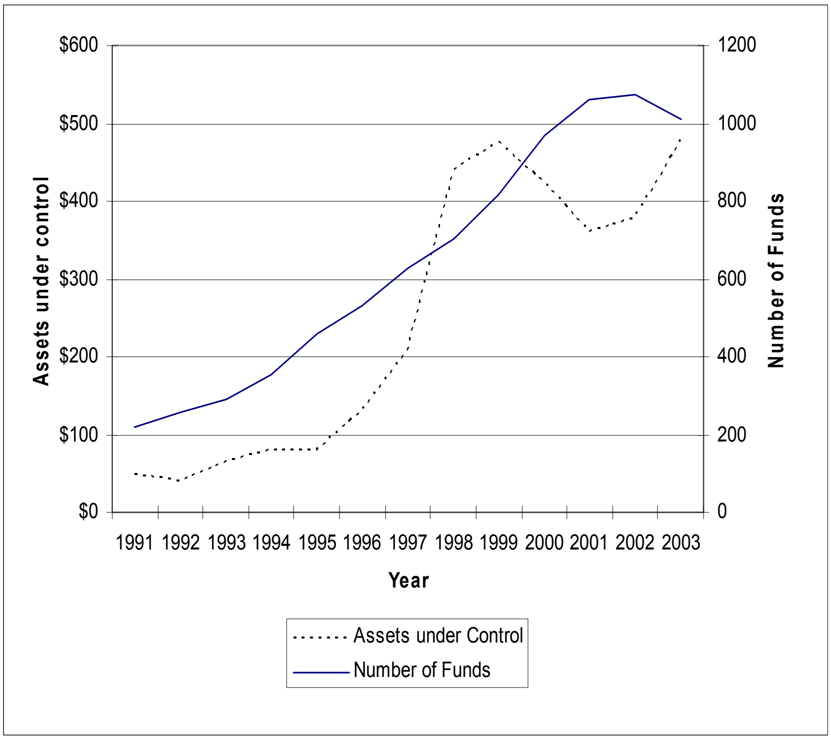

Fig. 2. Italian Mutual Fund Industry. This figure illustrates the growth in the number of Italian mutual funds and the assets under control (in billions of dollars) for 1991 to 2003. The data are reported by the Investment Company Institute.

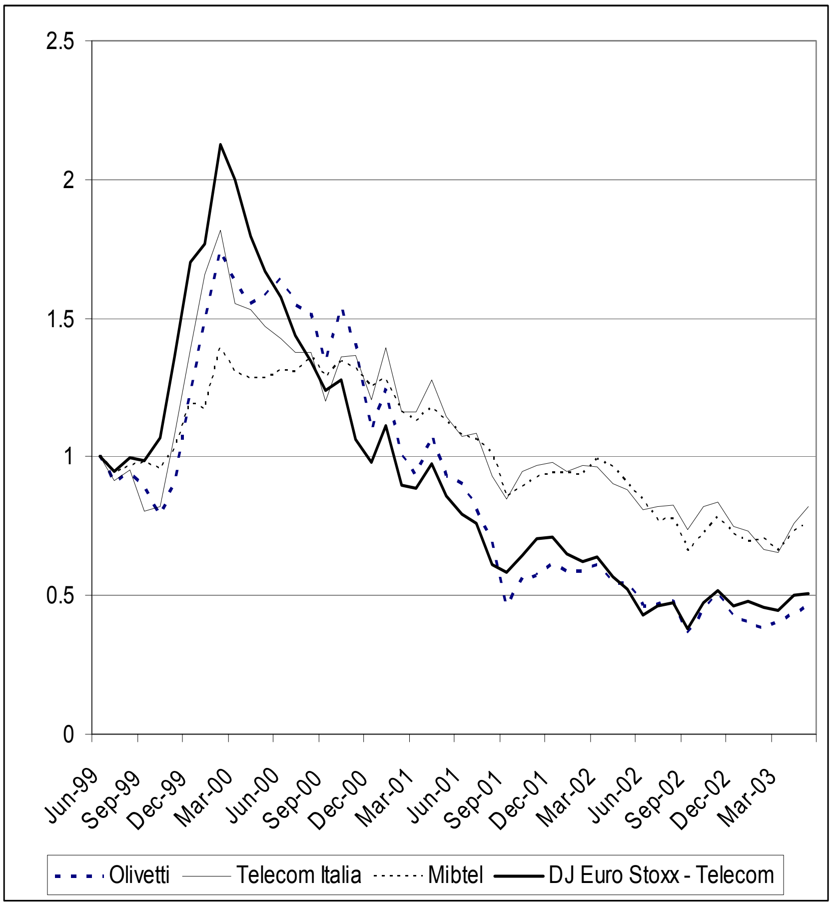

Fig. 3. Value of €1 invested at the end of June 1999. This figure shows the value of €1 invested at the end of June 1999, the date that Olivetti completed its acquisition of control of Telecom Italia.

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