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Loyalty Shares with Tenure Voting - a Coasian Bargain? Evidence from the Loi Florange Experiment

Discussion – Conference on Differential Voting Shares

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Motivation

- Loyalty shares:
  - Voting rights double after a minimum holding period
  - *Idea*: Give more power to long-term shareholders
  - *Natural experiment*: French *Loi Florange,* effective April 3, 2016
    - Introduces mandatory loyalty shares unless shareholder meeting opts out with two-thirds majority
    - Loyalty shares become default: previously OSOV was default

- This paper
  - Study 104 companies included in SBF 120 index (why not more?) that are incorporated in France and have been publicly traded since the introduction of the law (March 29, 2014).
  - *Hypothesis (Coase theorem)*: If the previous ownership structure was optimal, shareholders should decide to revert to OSOV

Key results

- Most companies that opted for OSOV before loyalty shares became the default chose to revert to OSOV

- *Exception*: Companies where the largest shareholder has more than one-third but less than two-thirds before the vote (usually the state)
  - Is it blockholder status or the identity of the state that counts?
  - Probably difficult to disentangle (7 observations, LDV estimation in Table 7)

- More IPO firms have loyalty shares after passing of *Loi Florange*

Summary and comments

→ Interesting paper on an interesting experiment

→ Comments:

1. Which problem are loyalty shares supposed to address? → Short-termism

2. Within which framework should we interpret the results?

3. How should we interpret the empirical results? – Comments on Tobin's Q

Short termism – the conceptual backdrop

A popular (populist?) argument

- Argument in the press, not so much in academia (Economist Jan 12, Mar 10 2017)
- Somehow the following steps seem to be involved:
  - Turnover in capital markets is increasing, holding periods decreasing
  - Short-term investors focus on short-term earnings and cash flows
  - Managers catering to these short-term investors sacrifice long-term investments
    - in particular R&D and innovation
- No systematic evidence to support how length of holding periods, corporate objectives, and investment policies are connected
  - …but the opposite: Kaplan (2017); Roe (2018);
  - *Also*: Lerner, Sorensen, Strömberg (2011) on patenting activity of LBOs
- Some recent models of "optimal short termism"
  - Hackbarth, Rivera, Wong (2018); Gryglewicz, Mayer, Morellec (2018)
  - Heaton (2017): maximizing value or maximizing the likelihood of survival?

How much short-termism is optimal?

- Trade-off between
  - Discipline to ward off entrenchment → requires that governance intervenes, reacts to early (imprecise, imperfectly reliable) signals – the "short leash"
  - Tolerance for failure (Tian & Wang, 2014) → incentives for innovation (Manso, 2011) → credible commitment *not* to react to some signals – the "long leash"
  - Optimal governance has to trade off agency costs from the 'long leash' against inefficient investment from 'short leash' – best done by initial shareholders
- *Empirics*: Short-termism may be a good thing – Giannetti & Yu (2016) find firms with more short-termist investors adapt better to competitive shocks, but have more agency costs
- Models of "exit:" early incorporation of information
  - …but then more trading in response to short-term information in stock prices makes prices more efficient → improves long-term investment (Edmans, 2009)

Interpreting the consequences of Loi Florange

- *Backdrop*: What if investors and entrepreneurs have differences of opinion rather than just different information? (e.g., Varian, 1985; Harris & Raviv, 1993; Kandel & Pearson, 1995)
- Important if individuals have to interpret ambiguous, complex information, e.g., assessing new technologies (Allen & Gale, 1999; Coval & Thakor, 2005)
- Optimal ownership structure:
  - Stay private as protection against investors with misaligned beliefs (Boot, Gopalan, Thakor, 2006)
  - Entrepreneur needs to find the „right“ shareholders
- Loyalty shares
  - Temporary dual-class shares (difference: cannot sell them at a premium)
  - Provide entrepreneurs with limited protection from „volatility of shareholder base“ (Boot, Gopalan, Thakor, 2008)
- *Loi Florange*: Some firms go public that otherwise would have stayed private?

Tobin‘s Q

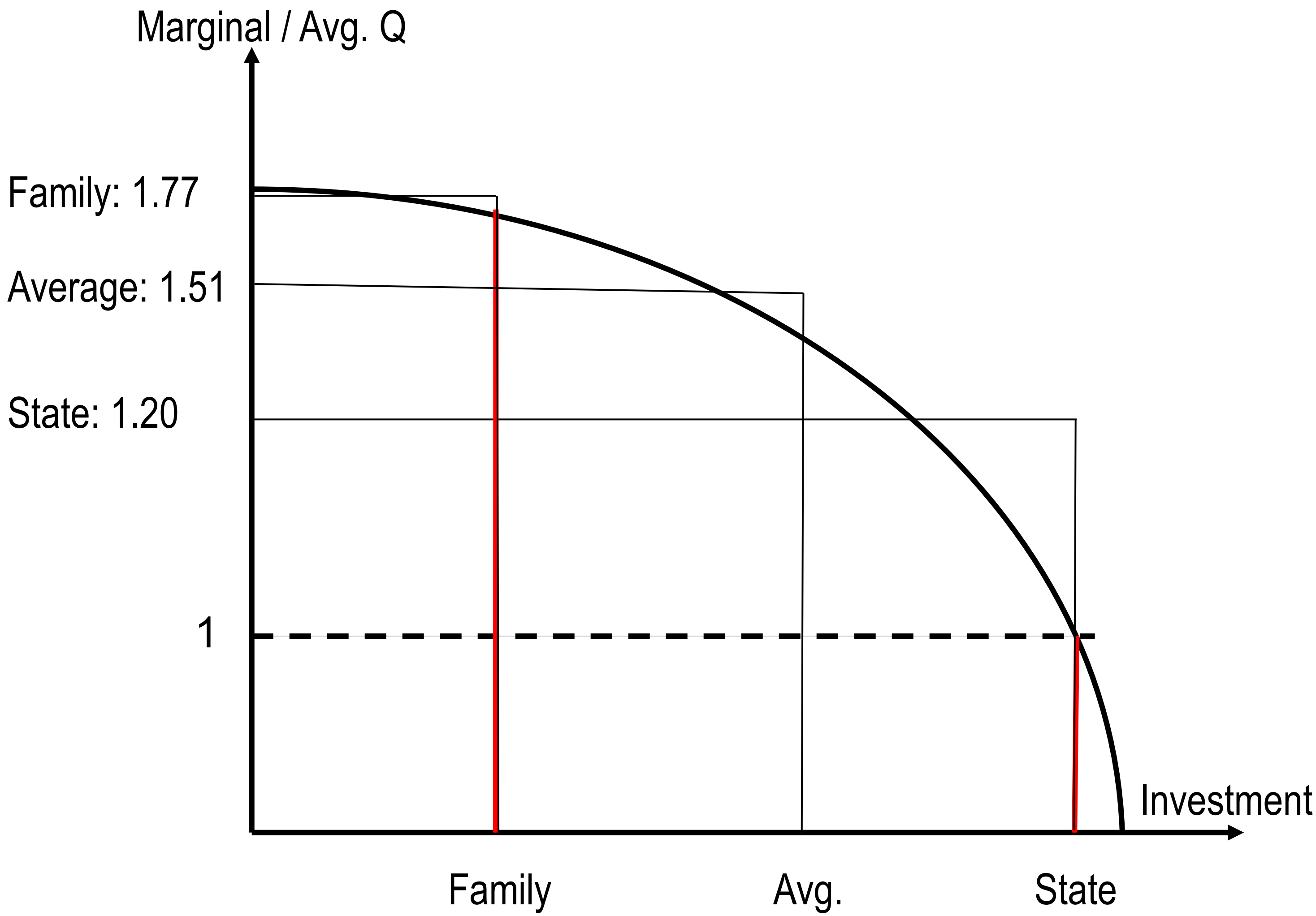
- Tobin's Q has three drivers:
  1. operational efficiency
  2. growth opportunities
  3. on the extent to which these growth opportunities are realized

- Assume:
  - Managers always prefer projects with higher NPV/investment (=marginal Q)
    - may implement too many (overinvestment, empire building)
    - or too few (underinvestment, e.g., b/c of risk aversion, financial constraints)

- Higher average Q may indicate
  - Higher risk aversion
  - Higher financial constraints
  - More growth opportunities

Tobin's Q and under/overinvestment

My favorite interpretation of Table 3



Summary

- Great paper on interesting economic experiment

- Q-results may be interpreted differently

- Recommendation: Work on big picture
  - Short-termism
  - Protection from volatility of shareholder base