Concentrated Ownership

Various forms of ownership concentration and its implications

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Concentrated ownership

Briefly said, concentrated ownership means that majority of shares is owned by one or few owners

What is concentrated ownership?

- Several definitions
  - Most common is 10%
- When ownership is concentrated, the largest shareholders have control and benefits minority shareholders can't participate to.
- In Finland, the annual general meeting holds power over the board, hence ownership structure is extremely important

"Ownership is at the source of the conflict between owners and managers, a theme that has occupied much of the first wave of corporate governance research" *-Aguilera & Crespi-Cladera*

Recent trends and developments

1. **Moving towards Anglo-American system**

   Based on dispersed corporate ownership and managerial power. Historically controlling ownership has been the norm in continental Europe. This may cause issues because one size doesn't fit all.

2. **Increasing share of active ownership**

   Concentrated ownership might have accelerated activism in owners. It can create dissents between large and minority shareholders, which can lead agreeing parties to be active against each other.

3. **Dual class shares losing its popularity in Finland**

   Earlier a common way to organize power to certain shareholders. Conducted as A- and B-shares where A-shares give for example 10 voting rights as B-shares give 1

Sources: Aguilera & Crespi-Cladera (2015), Connelly et al. (2010), Hamadi and Heinen (2015),) Ikäheimo, Puttonen & Ratilainen (2011), Jakobsson & Korkeamäki (2015),

Concentrated ownership can appear in multiple forms

Main forms of concentrated ownership are ownership by family, state or another firm e.g., pension fund

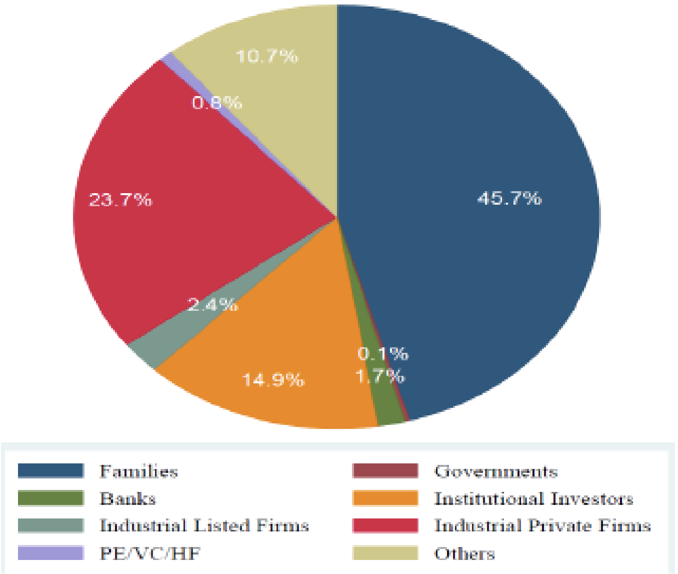
1 Family ownership

- Most common form of ownership around the world
- Around 1/3 of public companies in Europe and in US are family controlled
- **Example definitions**

  - Large proportion of shares in a company is held by family members
  - Firm's strategy is significantly impacted by two or more family members
  - Family member holds a major position in the company
  - There is an internal inheritance mechanisms present

2 State-ownership

- Dominating ownership form in China, common in Finland
- State ownership is rare around the world but government control in firms is more common



3 Ownership by other firms

- Private industrial firms are the second largest owners around the world and institutional investors third
- **Example owners**

  - Private equity firms, for example Venture Capital companies
  - Larger parent company
  - Company with same strategic objectives
  - Pension funds and banks

Sources: Aguilera & Crespi-Cladera (2015), Connelly et al. (2010), Franks & Mayer (2017), Reddy et al. (2017), Villalonga & Amit (2010)

Concentrated ownership leads to multiple positive impacts

Benefits created mainly through better monitoring and alignment of interests

Better alignment of interests

- Controlling owners have superior monitoring power, due to concentrated decision rights
  - Power to have strategic impact
  - Power to set better controlling mechanisms for management
- Closer monitoring leads to better alignment of majority owners' and managers' interests

Long decision-making horizon

- Most majority owners have long-term investment horizon
- Having long-term investment horizon leads to better decisions
  - Owners do not emphasize short-term earnings, but seek sustainable long-term value creation

Sources: Connelly et al. (2010), Gutiérrez & Sáez (2016)

Positive impacts vary between different owner structures

Key impacts include e.g., long-term horizon, secured financing and shared expertise

1 Family ownership

- Stable environment for growth and aligned interests

Empirically:

- Family ownership is associated with higher performance
- Active nature of family ownership has been found to further boost the performance
- Optimal fraction of blockholding between 30% and 40%

2 State-ownership

- State is usually committed for financial and other support
- State support leads to lower probability for financial distress e.g., bankruptcy
- Creates stability to operations and long-term strategic goals

3 Ownership by other firms

- **Institutional** owners provide efficient monitoring and have actively in decision-making
- Ownership by **financial institutions** associated with higher performance
- **Private equity** ownership correlates with higher earnings and returns to shareholders
- In M&A case, **cross-boarder strategic buyers** create value through imported expertise

Sources: Reddy et al. (2017), Villalonga & Amit (2010), Eshafani and Ardakani (2005),

Concentrated ownership has various downsides

Concentrated ownership might lead to misrepresentation of minority shareholders' interests

Concentrated ownership weakens the position of minority owners

- Horizontal corporate governance problem: misalignment of majority owners' and minority owners' interests
- Controlling shareholders may extract private benefits
- Limits investment and growth opportunities

Informational asymmetry

- In countries where high control premiums are paid, there is a negatively correlation with
  - quality of accounting disclosure rules
  - level of protection of minority owners
  - level of product market competition
  - quality of law enforcement
- Highly concentrated ownership argued to lead to inefficient market competition

Sources: Gutiérrez & Sáez (2016), Connelly et al. (2010)

Negative impacts vary among ownership structure

Negative impacts include short-sightedness, dual-agent problems and inefficient decision-making

1 Family ownership

- Misbehavior may occur that violates minority owners' interests
- Putting family benefit ahead of business decisions can also be harmful for outside investors
- Family might be reluctant to take in new investors, which may restrict the availability of financing

2 State-ownership

- In general, state ownership has predominantly been associated with worse performance
- State owned firms tend to put e.g., employment ahead of economic efficiency
- Soft budgetary constraints
- Political motivations may lead to poor management
- Tight media attention can incentivize short-sighted decision making
- Some evidence of increased corruption

3 Ownership by other firms

- Institutional owners: Possible dual-agent problems
- High expected returns may hinder innovation and investments in R&D projects
- Corporate acquisition of shares may precede a takeover

Sources: Reddy et al. (2017), Jakobsson & Korkeamäki (2015) , Connelly et al. (2010)

How to mitigate the negative impacts of concentrated ownership

Scholars debate the question of solving horizontal corporate governance problems

Fostering market competition

- Policies that would foster capital market growth and leveling the playing field would increase capital market growth
- Increased market growth forces efficiency and could lead to stronger position of minority owners
- Some argue that efficient capital markets make corporate governance mechanisms irrelevant

Independent Directors

- Independent Directors, who represent the interests of minority owners could help keep the controlling owners in check
- Independents often aim to maximize the firm value
- Independent directors are not likely to hold a powerful position in the boards of companies with controlling owners

Activism by institutional owners

- May lead to higher representation of minorities' interests
- Evidence of high returns of activism by institutional owners
- Activism is often a very costly strategy
- Regulations needed to enforce the efficiency of activism

Sources: Connelly et al. (2010), Gutiérrez & Sáez (2016)

Assessment through a case company – Finnair

Finnair is majority-owned by the State of Finland

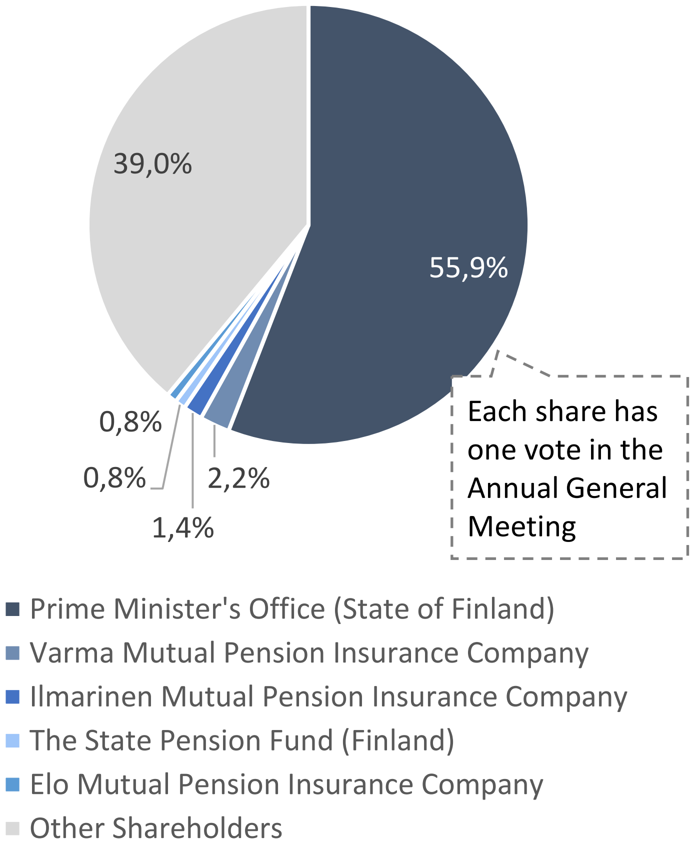
Company facts

- National airline of Finland (flag carrier)
- CEO: Topi Manner
- Listed on NASDAQ Helsinki
- Headquartered in Vantaa, Finland
- Founded in 1923
- Market cap: EUR 710.5m[1]
- Share classes: Ordinary shares only

Overview of ownership

- As the national airline, the State of Finland has a strategic interest in owning the majority of Finnair
- With the Prime Minister's Office (PMO) owning 55.9% of Finnair, very fragmented ownership structure for rest of Finnair – no other shareholder ownership exceeds 3%

Ownership structure



Key insights

- Minority shareholders' voting rights are very fragmented and limited compared to PMO's voting rights
- Due to non-performance related strategic incentives (e.g., ensuring vital airways and fear of competitive market not filling the vacuum) of the majority owner, interests may be misaligned between PMO and minority shareholders
- Maija Strandberg from the Prime Minister's Office is a member of the board at Finnair
- The State of Finland is committed to supporting Finnair in the long term and through economic difficulties, which decreases uncertainty for other shareholders

Notes: 1) Market cap as of Nov 20, 2022
Sources: Company information, Prime Minister's Office, Google Finance

Assessment through a case company – Kone

Herlin family controls the majority of voting rights in Kone

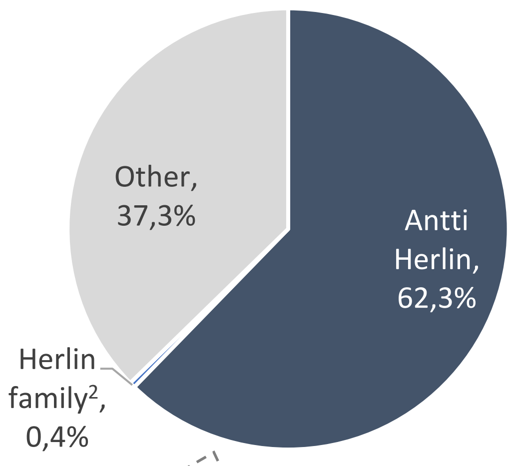
Company facts

- Elevator engineering company
- CEO: Henrik Ehrnrooth
- Listed on NASDAQ Helsinki
- Headquartered in Espoo, Finland
- Founded in 1910
- Market cap: EUR 21.34bn[1]
- Share classes: A and B (dual-class)

Overview of ownership

- Antti Herlin owns 23% of the shares of Kone privately and through two holding companies, and has consequently 62.3% of the voting rights
- Other Herlin family members are also significant (top 100) shareholders in the company

Distribution of voting rights



Antti Herlin and Kone Foundation are the only owners of A-Shares

Each A-Share has one vote while set of ten B-Shares gives owner one vote, which gives Antti Herlin the voting majority

Key insights

- Executive roles are are held by non-family members
- Antti, Iiris, and Jussi Herlin hold positions in the Board of directors – however, they are not independent of the company
- Four generations of family ownership are associated with many benefits such as:
  - Stable environment for growth
  - Long-term goals and incentives
  - Reduced agency costs
- Strategic interests may slightly differ between Herlin family and other investors
- Due to strong ownership and history, Herlin family is likely to continue holding key roles in Kone

Notes: 1) Market cap as of Nov 20, 2022; 2) Includes all major shareholders (top 100) with the surname Herlin
Sources: Company information, Google Finance

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