

Ownership Structure, Corporate Governance & Company Performance¹

There is a general wisdom that ownership concentration in a company may actually improve its performance as having a large controlling shareholder (with majority voting) would ultimately decrease the company's monitoring costs.

There is also an assumption that managers are imperfect agents of shareholders, as they could attempt to pursue their own goals rather than work on optimizing the shareholders' wealth.

This is the reason why many families tend to entrust their business operations to family members who are also co-owners.

I will try in the short time allocated to me to analyze the effect of ownership structure on a company's performance and on its ability to comply with corporate governance standards.

Let us presume from the outset that a conflict of interests between shareholders and managers of a company is one of the main reasons for a company's poor performance.

One approach that may control this conflict, applied by many successful companies around the globe, is to increase the equity ownership of managers, therefore encouraging executives to work more efficiently to maximize their wealth as shareholders.

However, such approach may also work in the opposite direction, as large manager shareholders may use their ultimate control rights to achieve private benefits.

For this reason there has been a surge in many jurisdictions around the world in the drive to strengthen corporate governance regimes in an attempt to ensure protection to small shareholders whilst optimizing corporate performance.

"Corporate Governance" as defined by the International Finance Corporation (IFC), refers to the structures and processes for the direction and control of companies.

Corporate governance concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders.

Good corporate governance, IFC adds, contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

¹

Fadi B. Nader – Partner, Levant Law Practice
Speech given at BMG Family Business Forum – Thursday 17th June 2010
Institute of Directors, Waterloo Room, 116 Pall Mall, London

Corporate governance finds or implements a system to monitor and control the Company's management in order to ensure value maximization in the interest of shareholders. Finally, it also helps in resolving the "conflict of interest" dilemma between controlling shareholders and other shareholders of the company.

Such perspective on corporate governance implies the existence of an intrinsic relationship between corporate performance and the ownership structure (family or other) in a single company.

Good corporate governance, thus, consists of a set of various mechanisms; however it is important to determine the most suitable model and whether the governance system should be market-based (like in the US or in the UK) or control-based (as applied in Japan, continental Europe and emerging economies)?

The **market-based model** relies on independent corporate boards, dispersed share ownership, transparent information disclosure, active take-over markets and others.

The **control-based system**, on the other hand, emphasizes the values of insider corporate board, concentrated share ownership structure, limited disclosure, reliance on family finance and other sources of funding (banks, financial institutions).

The resolution of conflict between owners and managers relies on internal mechanisms such as ownership structure, executive compensation, board of directors, financial disclosure, and other methods.

On the other hand, the resolution of conflict between controlling shareholders and minority shareholders seeks remedies outside the company, like finding an external counter balance (through take-over or buy out), or relying on the available legal infrastructure to provide protection to minority shareholders.

Recent studies of corporate governance systems have revealed that (i) geographical location, (ii) tax systems, (iii) industrial development and (iv) cultural characteristics; are four key factors in determining the ownership structure of a company which in turn impacts the company's performance.

Besides market or economic condition, one of the main reasons for a company's bad performance, distress or bankruptcy lies in its poor management.

The inefficiency that might lead companies to failure or to poor performance could be well rooted in the existence of a conflict of interest or priorities between the Company's managers and its shareholders.

In any case, institutional shareholders are more profit-oriented than government ownership and may have more incentives to monitor corporate performance.

Government ownership, for example, is supposed to negatively affect a company's performance, as the main government focus in general is on securing political, social and economic benefits rather than on realizing corporate profits.

A government's priorities may not necessarily coincide with the objectives of other shareholders in the company who would look for higher returns. For instance, a government may care more about unemployment or would aim to maintain control over certain strategic economic sectors over the value of its shares in a company.

Therefore, it is likely that government would support distressed companies irrespective of the companies' performances. Such attitude could affect a company's performance negatively and, at the same time, decrease the likelihood of its default.

It is assumed that companies with institutional ownership will have a lower risk of failure as institutional shareholders would monitor their investment more closely and their prime objective is to maximize their profit in the company.

The possible impact of ownership structure on a company's performance is therefore essential to determine its corporate governance standards, but evidence on the nature of this relationship has been mixed.

While some theories and academic researchers suggest that ownership structure affects a company's performance, others suggest the irrelevance of the relationship between ownership structure and a company's performance.

Furthermore, most of the studies are conducted in developed countries where the characteristics of ownership structure are different from countries like Saudi Arabia or other countries in the Middle East region.

However, we know that ownership structure and its concentration in the hand of one family holding majority control plays an important role in the performance and value of large Saudi companies.

A certain degree of ownership concentration is in fact needed to increase the company's performance and also to decrease the company's risk of default.

Therefore, I believe that corporate governance problems do not arise from the separation of managerial control from ownership structure per se but from the existence of multiple or diversified and some time conflicting ownerships in a company.

In case of a single non-managing owner, the shareholder-manager (or agency) problem can be solved by the implementation of efficient management monitoring systems and incentive schemes that could influence managers to pursue shareholders' interests.

However, the existence of such monitoring systems would depend on their real costs to the shareholder.

In this case, the separation of ownership from management is even more likely to optimize corporate performance than in the case of owner-managed companies, as owner-managers could be more satisfied with self-achievement or with family legacy that might be traded off against company profits.

In companies in which ownership is shared between several individuals with different perceptions of non-monetary ownership values or of the timing of profit payoffs, conflicts may arise if the transferability of ownership rights is restricted either by law, as with partnerships or by an inefficient stock market.

This is the reason why, at the beginning, most family owned businesses are formed as partnerships or as individual establishments.

Publicly listed companies that are the result of the transformation of medium and large family enterprises are characterized both by the delegation of managerial functions to professional executives and by allowing multiple and diversified ownership.

However, these companies could be negatively affected by an important corporate governance problem: securing the control of key shareholders over managerial discretion while ensuring that management are not biased or influenced by the private interests of a particular group of shareholders.

One solution to this corporate governance dilemma is provided by a well-regulated and functioning capital market which would force both management and shareholders to abide by a well defined set of corporate governance rules that would ultimately enhance corporate performance while safeguarding shareholders' rights.

In Saudi Arabia (as well in many other countries of the MENA region), the largest 20 companies are not listed on the stock exchange.

This reveals the need to improve corporate governance in Saudi non-listed companies by improving transparency in the decision-making processes and increasing awareness and providing suitable education and training to managers and shareholders.

In addition, given the pivotal economic role of Saudi non-listed and often family/founder-owned companies in Saudi, it is critical to examine these companies' specific governance problems and the impact of any recommended solutions on their performance.

It should be noted in this regard that the IFC has established a corporate governance methodology for family-owned or founder-owned non-listed companies.

According to the IFC , family members' duty should not only be limited to the governance of their company, they should also be responsible for the governance of their family and its relationship with the business.

Setting up a solid family governance system early in the lifecycle of a family business will help anticipate and resolve potential conflicts among family members about business issues.

This will make it possible for family members to concentrate on other key issues such as growing and expanding their business activities.

In addition to their own governance, family members should establish an adequate and flexible structure for their company's board of directors and senior management.

A skilled, predominantly independent, and well organized board of directors would make it possible to set the right strategy of the company and to properly oversee its management's performance.

Also, professional and motivated management is essential to running the day-to-day activities of the company.

The choice of directors and senior managers should be based on their qualifications and performance and not on their ties or "allegiance" to the family.

Finally, it is very important that families become aware of the importance of these issues and start building an adequate corporate governance structure for their business as soon as possible.

Waiting until the size of the family is very large, and its business operations more complex would make it more difficult to address the already existing conflicts between family members.

A timely and clear governance structure would make it easier to maintain family cohesion and strengthen the family's members' interest in a common business.

Many of the world's greatest corporations are family dynasties, which have successfully evolved and adapted to changing business and corporate governance environment.

Irrespective of its ownership structure, a performing and lasting company should be able to ensure an equitable treatment to all its shareholders who should be provided with the right tools to effectively monitor the company's management through a competent Board of Directors who, in its turn, is directly accountable to the Company and its shareholders.

Once these basic corporate governance standards are observed, family businesses can aspire towards becoming listed companies with the intent to gain another source for raising funds to expand their operations while maintaining their entrepreneurial drive and control over companies' directions.

Thank you.