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Sebastian Schilling

Does Corporate Governance Affect Firm Value?

Evidence from Europe

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Abstract

This thesis provides evidence that companies showing stronger corporate governance performance are on average also valued higher in terms of Tobin's q. This evidence is found using a dataset of 242 of Europe's largest corporations listed in the FTSE Eurotop 300 index. For each of these corporations, a dataset of over 300 corporate governance rating variables is provided by Deminor Rating to establish a detailed overview of a firm's corporate governance performance. These 300 rating variables result out of a corporate governance standard established by Deminor in cooperation with the largest European institutional investors and in reference to the respective national corporate governance codes of the companies in the sample. The standard produces four rating pillars representing the elements of corporate governance which institutional investors perceived as most crucial for high governance performance. Aggregation of the four pillars to a single governance rating variable is avoided to assess the specific effect of each pillar on firm value as well and because of the risk of subjective weighting. The statistical analysis provides evidence for a highly significant positive correlation between three of the four governance factors with Tobin's q as well as strong correlations amongst the governance factors themselves. The variable 'Rights and Duties of Shareholders' is the sole variable to show no correlation with both the dependent and the independent variables. Employing a Factor Analysis to account for multicollinearity between the independent variables leads to the creation of one component representing a firm's corporate governance performance. This component is highly significant, displays a positive coefficient and creates a model presenting an R square adjusted of over 12 per cent. The subsequent addition of the independent score component ROA increases the R square adjusted of the model to approximately 42 per cent, thereby making the resulting model and the inherent coefficients highly representative. Whereas an initial analysis shows that company corporate governance performance is strongly dependent on the country it is situated in, this interdependence no longer exists with the created score components, thereby establishing a corporate governance measurement variable which shows no systematic linkage to either country or industry sector affiliation. The coefficient of the corporate governance score component suggests that, ceteris paribus, a one point increase in the value of the score component leads on average to a 0.3 point increase in Tobin's q. The created model therefore provides the necessary evidence for a statistical linkage between corporate governance and firm value.

Chapter 1 Introduction

In the late 1980s, numerous US enterprises began implementing protection mechanisms as a response to a vast array of hostile takeovers largely initiated by corporate raiders. Whereas these mechanisms were designed to protect companies against hostile attacks that were not in their best interest, they simultaneously protected management from direct influence of shareholders. This evolution led to the discussion about the roles and responsibilities of management and their shareholders, with a strong emphasis on the question of how the interests of these two parties could best be aligned so as to strive for the same goals. Whereas the issue of corporate governance began as a purely North American problem, it reached Europe in the early 1990s after several prominent bankruptcies and fraud occurred as for example the Metallgesellschaft in Germany or Barings in the UK. With the boom of global stock markets in the late 1990s, Continental Europe experienced a tremendous change in the nature of its capital markets, with the entrance of a large amount of private investors attempting to reap short-term gains off companies of which they had only limited structural knowledge. It was only after the crash of global stock markets and the recent spectacular bankruptcy cases of Enron and WorldCom that corporate governance has reached the prominence it enjoys today.

Today, there is general agreement by investors that effective corporate governance is crucial for the long-run success of a company. Institutional investors today agree that corporate governance must play a prominent role in investment decisions. As James Wolfensohn, president of the World Bank states: “The governance of the corporation is now as important in the world economy as the government of countries.”

According to a vast array of conducted surveys in recent years, an increasing number of institutional investors are including corporate governance standards and practices by the companies they invest in into their investment decisions so as to protect their rights and interests as owners. These investors realize that the financial risk they face may be strongly reduced by the governance structures implemented by companies. This remains especially valid in times of volatile financial markets, as shown by the US examples of Enron and WorldCom mentioned above. Furthermore, as an increasing amount of investors are stocking up on foreign shares, the need for a

detailed corporate governance analysis has reached a global scale. In Europe, this development has been accelerated by the introduction of the Euro, providing a strong incentive for European instead of national investment strategies. Nevertheless, governance practice varies strongly between European countries and companies, making it considerably difficult for investors to compare European companies in terms of governance practice.

Another feature of corporate governance in which investors are strongly interested is its effect on value creation. Even though corporate governance is not the sole contributor to value creation, its presence may reduce the downside risk linked to the above problems. According to several surveys performed by McKinsey & Co. (Three Surveys on Corporate Governance, The McKinsey Quarterly, 2000), investors are willing to pay more for companies they perceive as well governed, especially in emerging markets. Even in Europe and the United States investors are apparently willing to pay premiums of up to 22 per cent[1]. As Paul Coombes, a co-author of these surveys states: "First and foremost is the notion that the real value of corporate governance lies not in satisfying some code of best-practice principles, but rather in actually achieving a lower cost of equity. If you can establish a degree of confidence in the investing community that the way you're conducting your affairs is appropriate and sensible, it's likely that they will value your shares more highly, which thereby reduces your cost of equity" (McKinsey & Co. Website, 26.11.2002). The question whether companies understand that the value for good governance is a reduced cost of equity remains very much alive.

Whereas much research has been performed on the link between corporate governance and firm value, mainly weak or non-existent relationships have been established. However, recent research conducted by Gompers, Ishii, and Metrick (2001) establishes a significant negative correlation between the amount of takeover defenses implemented by US companies and firm value. Research by Byrd and Hickman (1992), Weisbach (1988), and Borokhovich, Parrino, and Trapani (1996), to name just a few, attempt to link board membership and structure to agency costs, with which they succeed. However, a direct relationship with firm value is either mixed or goes in the opposite direction of the agency problems. Whereas these studies have all attempted to iso-

[1] This is the average premium investors stated they were willing to pay for well-governed companies in Italy. The average premium for the remaining countries lies at 19 per cent.

late the effect of certain governance criteria on firm value, there has been no research so far that investigates overall governance performance in this respect. This aspiration would have represented an insurmountable project due to the existence of varying and numerous governance criteria across nations. However, due to the increased amount of publications by institutional investors stating clearly their governance criteria for companies on an international basis, it is possible to create a benchmark today that is both complete and internationally applicable.

This thesis therefore attempts to engage in answering the following thesis statement:
Does 'good' corporate governance positively influence the value of European firms? Good corporate governance is defined based on a rating standard developed by Deminor International, a Brussels based consultancy firm, in cooperation with leading institutional investors and also taking into account national governance codes. The four key pillars by which corporate governance is defined are:

- Rights and Duties of Shareholders
- Range of Takeover Defenses
- Disclosure on Corporate Governance
- Board Structure and Functioning

The thesis will be structured as follows:
Chapter 2 will begin by providing a general overview of what is inherent in the corporate governance definition. Part one will discuss the foundation of corporate governance, namely the agency problem[2] arising out of the separation of ownership and control by looking at transaction conditions, incentive mechanisms and by looking at the economic importance of the subject. Part two of the chapter will then focus on the definition of stakeholders and describe their relationship with management through the concepts of corporate-, contractual-, and work governance. Part three will investigate the impacts of a nation's cultural and legal history on corporate governance practice as well as the effects of ownership structure.

[2] In the course of this thesis, the terms agency problem, principal-agent problem as well as principle-agency theory will be used interchangeably. All three terms refer to the same phenomenon, namely the problem arising between principles and agents through the separation between ownership and control of the company.

Chapter 3 will deal with the construction of a governance standard on the basis of which all companies in the sample are rated in their corporate governance performance. Each of the four pillars mentioned above are assessed in terms of what they consist of, why they are relevant for the standard and what recommendations companies must comply with to obtain a high rating concerning these standards. For this purpose, the description of every pillar is divided into three sections: first, a review of the academic literature concerning the topic addressed by the pillar is provided. Next, the description of the pillar and the underlying best-practice recommendations are discussed. Finally, the third section compares the rating basis of every pillar with several national and pan-national codes to explore whether significant differences exist.

Chapter 4 will then undertake a statistical analysis of the relationship between the established corporate governance elements and firm value. More specifically, the objective of the chapter will be to provide a statistically significant answer to the thesis statement on whether or not European companies can influence their firm value by improving corporate governance performance.
Therefore, the first section will give an overview of the financial and corporate governance-related data that will be employed in the statistical analysis. This overview will include a description of the sources as well as the relevance of the employed data. Then research questions will be formulated presenting gradual steps in the analysis of the overall thesis question. After the data has been investigated and specific research steps have been established, an OLS regression analysis testing the thesis statement will be conducted. In this analysis, four null- and alternative hypotheses will be formulated and tested. Both regression analysis and further statistical procedures will be employed to determine the statistical influence of corporate governance on firm value. The focus of the analysis will also include an overview of the interdependence amongst the independent variables themselves. Finally, additional variables are added to the regression model besides corporate governance determinants to increase the overall explanatory power of the model.

Finally, chapter 5 will give insights on how corporate governance is dealt with in practice. More specifically, a case study of Deutsche Wertpapier Spezialisten Investment Group (DWS), Europe's largest Mutual Fund, will address strategic and financial issues concerning corporate