Insiders Ownership and Firm Performance. Empirical Evidence

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Abstract

Despite the prevalence of family firms throughout the world, the evidence on the effect of family ownership on corporate performance is still scarce. This study provides new evidence of the influence of the insider ownership on non-listed firm's performance, differentiating the behaviour of family and non-family firms using data on 586 Spanish non-listed firms. Our evidence supports both the convergence of interest and the entrenchment effects, and suggests that Spanish family firms' insiders become entrenched at higher ownership levels. The empirical evidence shows also that for family firms the relationship between insider ownership and firm performance differs depending on which generation manages the firms

Keywords: Insider ownership, non-listed firms, family firms

1. Introduction

The relevant literature suggests that ownership structure is one of the main corporate governance mechanisms influencing the scope of a firm's agency cost. Berle and Means (1932) suggest that ownership concentration should have a positive effect on performance because it alleviates the conflict of interests between owners and managers. In this sense, concentrated ownership structures leave aside the classic agency problem between managers and shareholders, but lead to a conflict between majority and minority shareholders (Shleifer and Vishny, 1997, La Porta et al., 1999).

In this context, this study focuses on non-listed firms with concentrated ownership structures whose principal shareholders are, in many cases, families. Most studies focus on listed firms, so we

considered it is very important to focus on non-listed companies to fill this gap. It is interesting to check whether the results obtained on the behaviour of internal control mechanisms of non-listed firms, could be compared with findings from numerous studies investigating listed firms.

This study seeks to make a new contribution with a highly representative sample of non-listed family and non-family Spanish companies. The limitations identifying non-listed family firms imply that the detailed analysis of the information in databases and the survey are the only ways to do so. This paper uses a combination of these two forms to categorize family firms.

Our aim is to examine the effect of ownership structure of non-listed firms on firm performance, using the insider ownership as corporate governance mechanisms. Besides, verifying whether the family nature of the company generates a different behaviour in the action of this mechanism.

The results show a difference in the behaviour of family and non-family firms when we take into account the insiders ownership. For family businesses, the results show an existence of a cubic relationship between insiders ownership and firm performance. The family firm performance increases with low and high levels of insider property and falls in the intermediate levels. These results are consistent both with the hypothesis of convergence and the entrenchment hypothesis. Also, we found the existence of a quadratic relationship between insiders ownership and firm performance for first generation family firms. In particular, for insiders ownership levels below 55% in first generation family firms, the hypothesis of convergence of interests between shareholders and managers is true. However, for ownership levels above this percentage, the prevailing hypothesis is the entrenchment one.

The rest of the article is organized as follows. Section 2 contains a review of the literature regarding the ownership structure as a control mechanism and presents the hypothesis. Section 3 presents the data and the analysis procedure used to conduct the empirical study and the results of the investigation. Finally, Section 4 sets out the principal conclusions, and the paper ends with a list of bibliographical references.

2. Theoretical Base

Non-listed companies are characterized by concentrated ownership and the main agency problem is between the majority and minority shareholders. The origin of conflicts in concentrated ownership firms can be found in the tendency of majority shareholders to use their power to gain benefits that harm the private wealth of minority shareholders (La Porta et al., 1999; Francis et al., 2005). A greater concentration of voting rights can therefore lead to greater incentives for controlling shareholders to obtain private benefits. This trend may be exacerbated in the case of family firms because those benefits remain in the controlling family, whereas in non-family firms they are distributed among a large number of shareholders (Villalonga and Amit, 2006).

Founding families represent a special type of shareholders in firms. Anderson et al. (2003) say that founding families differ from other shareholders in two main aspects: the interest of the family in the long-term survival of the company, and the concern of the family for the reputation of the company and the family itself. This may suggest that the aim of these companies is not to maximize shareholder value, but to maximize the value of the firm when the two are in conflict. Families have concerns and interests of their own, such as stability and capital preservation, which may not align with the interests of other investors of the firm.

Focusing on the relevant literature, it should be noted that various studies that have considered the ownership structure as an internal control mechanism, have analyzed three distinct aspects: the ownership concentration (Demsetz and Lehn, 1985; Shleifer and Vishny, 1986; McConnell and Servaes, 1990; Leech and Leahy, 1991; Morck et al., 2000), insider ownership (Stulz, 1988; Morck, et al., 1988; McConnell and Servaes, 1990; Faccio and Lasfar , 1999), and the identity of the owner (Galve and Salas, 1992; Pedersen and Thomsen, 1997).

In this study we discuss one of these three areas: insider ownership, and look at its validity as internal control mechanisms for non-listed firms, following the principles of Agency Theory. In this regard, we need to fill the gap and check whether ownership structure acts as an internal control mechanism in non-listed firms, distinguishing the behaviour of family firms.

Jensen and Meckling (1976) and Fama and Jensen (1983) argue that insider ownership can cause two types of fully differentiated behaviour: convergence of interests with shareholders and the entrenchment effect.

Jensen and Meckling (1976) assert that as insider ownership grows, the tendency of owners to consume company resources decreases, and therefore their interests and those of shareholders are aligned. In this way, conflicts between owners and managers tend to disappear, and the hypothesis of convergence of interests prevails. However, they also argue that the natural tendency of managers is to use company resources in their own interests, which may conflict with those of external shareholders. These authors note that with increasing insider ownership, conflicts of interest between shareholders and managers disappear because their interests tend to converge. However, Demsetz (1983) and Fama and Jensen (1983) argue that significant percentages of insider ownership generate compensation costs. They argue that even when the levels of insider ownership are low, market discipline may induce managers to seek to maximize value, despite scant personal incentives to do so. Conversely, when insiders hold a percentage of the capital of the company that is large enough to give them voting power or influence, they can achieve their own objectives other than the maximization of value without compromising either their jobs or their salaries.

These arguments show an entrenchment effect on the part of insiders, which means that too high a percentage of insider ownership has a negative impact on business performance. The entrenchment effect is based on the idea that concentrated ownership creates incentives for the controlling shareholder to expropriate wealth from minority shareholders (Fama and Jensen, 1983; Morck et al., 1988; Shleifer and Vishny, 1997). If family members occupy important positions both in management and on the board of directors, worse governance mechanisms may result, since the supervisory body may not operate efficiently.

The existence of these two widely different effects suggests a nonlinear relationship between insider ownership and the value of the company, which has been already shown up in several studies (McConnell and Servaes, 1990; Gedajlovic Shapiro, 1998). Various studies have also shown a nonlinear relationship between firm value and insider ownership (Morck et al, 1988; Wruck, 1989; Hermalin and Weisbach, 1991; Cho, 1998). Several authors have also addressed the entrenchment hypothesis, although their findings have not been conclusive (Morck et al., 1988; McConnell and Servaes, 1990; Leech and Leahy, 1994; Mudambi and Nicosia, 1998; Lasfar and Faccio, 1999; Lehmann and Weigand, 2000; Miguel et al., 2004).

The evidence on this matter for non-listed companies is limited, and that is what led us to test the hypothesis outlined above. It would be interesting to know whether this behaviour occurs more in family firms than in non-family firms, due to the greater power attributed to insiders. Also, as Gómez-Mejía et al. (2001) say, if ownership and family control are associated with greater entrenchment of managers, it is necessary to determine whether this behaviour is stronger in family firms than in non-family ones.

At this point, it seems necessary to include three hypotheses to check whether entrenchment and alignment of the interests of managers also appear in non-listed family firms, drawing a distinction for family firms managed by the first generation.

H1: *Family firms' performance increases with low and high levels of insider ownership and falls in the intermediate levels.*

To test this hypothesis we suggest the following model:

$$Y = \beta_0 + \beta_1 FINSOWN + \beta_2 FINSOWN2 + \beta_3 FINSOWN3 + \beta_4 OUTSIDERS + \beta_5 GROWTHOP + \beta_6 LEV + \beta_7 SIZE + \beta_8 AGE + \beta_9 SECT + \varepsilon \qquad \text{(model 1)}$$

The information asymmetry between the founding family and other shareholders can increase the entrenchment effect due to a lower flow of information and less transparency, all leading to a loss of performance (Wang , 2006). Faccio et al. (2001) suggest that founding families have strong incentives to expropriate wealth from minority shareholders, and note that such incentives are greatest when the influence of the family extends beyond their ownership rights. Families can exercise control or influence in two ways: through the position of chief executive or through a disproportionate representation on the board of directors. Consequently, expropriation by families is expected to be greatest when the board's family control exceeds family rights, or when a family member is the chief executive officer.

These arguments suggest that the presence of the family in the firm generates a consolidation and greater alignment of interests in family firms than in non-family ones and this relationship could be stronger in first generation family firms.

H2: *Performance increases more with low and high levels of insider ownership and decreases more at intermediate levels in family firms than in non-family firms.*

This relationship is analyzed using the following model:

$$Y = \beta_0 + (\beta_1 + \beta_2 FD)\, INSOWN + (\beta_3 + \beta_4 FD)\, INSOWN2 + (\beta_5 + \beta_6 FD)\, INSOWN3 + \beta_7 OUTSIDERS + \beta_8 GROWTHOP + \beta9 LEV + \beta_{10} SIZE + \beta_{11} AGE + \beta_{12} SECT + \varepsilon \quad \text{(model 2)}$$

H3: *If the firm is managed by the first generation of the family, performance may increase more with high and low levels of insider ownership and fall more at intermediate levels than in other family firms.*

This model is used to make the comparison:

$$Y = \beta_0 + (\beta_1 + \beta_2 GEN1)\, FINSOWN + (\beta_3 + \beta_4 GEN1)\, FINSOWN^2 + (\beta_5 + \beta_6 GEN1)\, FINSOWN^3 + \beta_7 OUTSIDERS + \beta_8 GROWTHOP + \beta_9 LEV + \beta_{10} SIZE + \beta_{11} AGE + \beta_{12} SECT + \varepsilon \quad \text{(model 3)}$$

3. Empirical Research: Method, Data and Analysis
3.1. Population and Sample

We conducted this study on Spanish firms included in the SABI (Iberian Balance Sheet Analysis System) database for 2006 (the latest year for which full data are available). We imposed certain restrictions on this group of companies in order to reach a representative set of the population. First, we eliminated companies affected by special situations such as insolvency, winding-up, liquidation or zero activity. Second, restrictions concerning the legal form of companies were imposed: we focused on limited companies and private limited companies as they have a legal obligation to establish boards of directors. Third, we eliminated listed companies. Fourth, we studied only Spanish firms with more than 50 employees, i.e. companies large enough for us to ensure the existence of a suitable management team and a controlling board to monitor their performance. Finally, companies were required to have provided financial information in 2006. With this condition, the sample under study comprised 3723 non-listed Spanish firms.

There is no official database of family firms, so there is no way to directly identify family firms. Also, the lack of an agreed definition of family firm leads to the use of samples of convenience, or to firms being identified as family firms after the sample is preselected (Daily and Dollinger, 1993; Schulze et al. 2001, 2003; Chua et al., 2003). Given these limitations, the detailed analysis of the information in databases and the survey are the only way to identify family and non-family non-listed firms. This study has chosen a combination of these two methods of identification.

In this study, family firm means a firm who meets two conditions: a) a substantial common stock held by the founder or family members that allow them to exercise control over the firm, and also b) participate actively in monitoring it. As per La Porta et al. (1999), we established 50% as the minimum percentage of a firm's equity considered as a controlling interest. To find compliance with these two conditions, we conducted an exhaustive review of shareholding structures (percentage of

common stock) and composition (name and surnames of shareholders), and also examined the composition of the board of directors of each of the 3723 selected companies in the database.

Accordingly, we classified a firm as a family firm if main shareholder is a person or a family with a minimum of 50% of firm equity and there are family relationships between this shareholder and directors, based on coincidence of surnames. The composition of the management was also reviewed in search of family relationships between shareholders and managers.

Of 3723 companies preselected, the original sample used in this study is a 2958 firm random sample. 586 firms responded the questionnaire: 217 non-family firms (37%) and 369 family firms (63%) for which there were data on ownership structures, accounting variables and boards of directors. 1,500 of these 4,699 corporations were sent questionnaires – distributed proportionally according to the populations of the various provinces. A response rate of 14.5% was obtained, i.e. 217 questionnaires were returned. 14% of the corporations that returned the questionnaire are classed as small, 62% as medium and 24% as large.

3.2. Data

Data were collected by means of telephone interviews, a method that ensures a high response rate, and financial reporting information was obtained from the SABI database. To guarantee the highest possible number of replies, managers were made aware of the study in advance by means of a letter indicating the purpose and importance of the research. In cases where they were reluctant to reply or made excuses, a date and time were arranged in advance for the telephone interview. The final response rate was approximately 19.81%, and the interviewees were persons responsible of management at the firms (financial managers in 56.48% of the cases, the chief executive officer in 31.06%, the president in 1.54% of the cases, and others in 10.92%).

The questionnaire collects information on the variables required for the study that could not be obtained from the SABI database and that it was considered would be captured more reliably through a survey. In particular, information regarding the ownership structure, the composition of the board of directors and company management.

Table I: Definition and calculation of variables

| PANEL A VARIABLES OBTAINED FROM THE QUESTIONNAIRE	
VARIABLE	**DEFINITION**
Generation managing the firm (GEN1)	Dummy variable that takes the value of 1 if the company is headed by the first generation and 0 otherwise.
Insider ownership (INSOWN)	Percentage of ownership of insider directors and chief executive officer
Insider ownership in family firms (FINSOWN)	Percentage of ownership of insider directors and chief executive officer in family firms
Board of Director's composition (OUTSIDERS)	Percentage of external directors on the total number of directors
Family Dummy (FD)	Dummy variable that takes the value 1 if the company complies with the definition adopted and 0 otherwise
PANEL B VARIABLES OBTAINED FROM FINANCIAL STATEMENTS	
Firm performance, measured by firm performance (ROA)	EBIT / TA, where EBIT = earnings + financial expenses + tax benefit, and TA = Total Assets
Growth opportunity (GROWTHOP)	Sales0/Sales-1.
Debt (LEV)	Total Debt / Total Assets.
Firm's size (SIZE)	Ln Total Assets.
Firm's age (AGE)	Ln number of years since the establishment of the company.
SECT	Dummy variables to control for sector

3.3. Results

In this section the aim is to analyze whether there is convergence of interests or entrenchment (model 1) in the family firms in the sample.

Taking into account the results of our analysis (Table 2, column I), we can see that in family firms there is evidence of a significant cubic relationship between insider ownership and firm performance. In this sense, the results are consistent with those of Morck et al. (1988) and De Miguel et al. (2004) for listed companies. These authors show a positive coefficient in the case of insider ownership and its cube, and a negative coefficient for the square of insider ownership. We can say that firm performance increases with relatively high and low levels of insider ownership and falls at intermediate levels. These results can be interpreted as consistent with both convergence of interests and the entrenchment hypothesis (hypothesis 1).

Thus, for low levels of ownership, the interests of insiders tend to converge with those of shareholders, resulting in a positive effect on performance. However, as insider ownership grows, the entrenchment hypothesis begins to gain strength, so that insiders use their greater power in the company for their own benefit, without looking to maximize the value of the firm. Performance tends to fall in this case. Despite this, there comes a time when the insiders' level of ownership is so high that they again become concerned for the welfare of all shareholders, which makes performance grow again.

Figure 1: Relation between insider ownership and firm performance
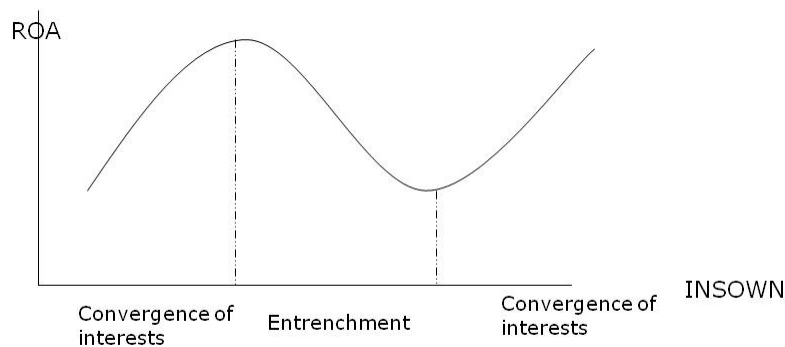
The next step is to calculate the two cut-off points. According to De Miguel et al (2004), they can be calculated by differentiating profit from insider ownership. Equating the partial derivative to zero, the cut-off points are:

$$\text{INSOWN/INSOWN}^2 = -2\beta_1 \pm \sqrt{4\beta_2 - 12\beta_1\beta_3} / 6\beta_3$$

Once the cut-off points are calculated, we note that if insider ownership is between 0 and 35%, increases in ownership will result in higher firm performance. The reason lies in the greater incentives for insiders to maximize performance, as their equity holding grows. On the other hand, if insider ownership is between 35% and 70%, the performance of firms falls when their percentage of ownership increases. Therefore, the entrenchment hypothesis prevails in this case, since most insiders are looking out for their own welfare rather than that of everyone. Finally, for percentages of insider ownership above 70%, the convergence of interest hypothesis appears to prevail again. These results are entirely consistent with those obtained by De Miguel et al. (2004), who analyze a sample of listed Spanish companies, without differentiating whether or not they are family-owned.

Table 2: Relationship between insider ownership and firm performance

	ROA			
	I	**II**	**III**	**IV**
Constant	0.0584 (0.0957)	-0.0148 (0.1053)	0.0815 (0.0934)	0.2194** (0.1024)
FINSOWN	0.2732** (0.1273)		0.1992 (0.1483)	-0.0435 (0.0897)
FINSOWN*GEN1			0.3034 (0.2235)	0.2573* (0.0897)
FINSOWN^2	-0.6966** (0.3389)		-0.6223 (0.4080)	0.0528 (0.0599)
FINSOWN^2*GEN1			-0.4278 (0.6460)	-0.2321** (0.1008)
FINSOWN^3	0.4484** (0.2251)		0.4383 (0.2733)	
FINSOWN3*GEN1			0.1480 (0.4396)	
INSOWN		-0.4854 (0.3906)		
INSOWN*FD		0.7362*** (0.4173)		
INSOWN^2		1.3920 (1.1690)		
INSOWN^2*FD		-2.1237*** (1.2514)		
INSOWN^3		-0.9546 (0.8278)		
INSOWN^3*FD		1.4263*** (0.8818)		
OUTSIDERS	-0.0160 (0.0232)	-0.0145 (0.0168)	-0.0192 (0.0205)	-0.0189 (0.0226)
GROWTHOP	0.0463*** (0.0309)	-0.2239** (0.0984)	0.0518*** (0.0300)	0.0484 (0.0300)
LEV	-0.0991* (0.0321)	-0.1047* (0.0252)	-0.0990* (0.0313)	-0.0976* (0.0312)
SIZE	-0.0025 (0.0054)	0.0070*** (0.0038)	-0.0043 (0.0052)	-0.0049 (0.0052)
AGE	-0.0022 (0.0099)	-0.0103 (0.0078)	-0.0000 (0.0097)	-0.0013 (0.0097)
R^2	0.16	0.16	0.21	0.22

*, ** and *** indicate significance at 1%, 5% and 10% respectively.

Having shown the existence of a cubic relationship between insider ownership and firm performance, we checked whether the effect was stronger in family firms than in non-family ones (model 2). The results, shown in Table 2 (column II), confirm a positive coefficient of the variables that reflect the interaction term of the percentage of ownership and its cube with the family dummy, and a negative coefficient for the interaction term between the square of insider ownership and the family dummy. Conversely, this relationship was not significant in non-family companies. These results indicate that the cubic relationship is found only in the family firms in the sample. Thus, for low and high levels of ownership the prevailing hypothesis is that of convergence of interests, so that insiders place the interests of all shareholders foremost. However, for intermediate levels of insider ownership, the prevailing hypothesis is that of entrenchment, so that their own wealth prevails over the interests of the company, resulting in a loss of performance.

As a result, we can conclude that families have a differential effect in analyzing the behaviour of insiders when their ownership increases. It seems, therefore, that not only the characteristics of the

Spanish corporate governance system but also family ownership affect that relationship. In this regard, La Porta et al. (1998) point out that Spain had higher levels of ownership concentration and a weaker system of legal protection than countries such as the USA, the UK, Japan and Germany, leading to lower investor protection and making expropriation easier. Similarly, the family nature of insiders could also give them more power, as argued by Faccio et al. (2001) and Wang (2006).

Faccio et al. (2001) suggest that incentives for families to expropriate wealth from minority shareholders are larger when the influence of the family extends beyond their ownership rights. In turn, that influence can be measured on the basis of whether a family member holds the position of chief executive or whether there is a disproportionate representation on the board of directors. The family firms in the sample did indeed meet these two premises: in 94% of them the chief executive is a member of the family and the boards of directors are composed mainly of relatives. These two factors may therefore be the cause of a stronger relationship between insider ownership and the performance of family firms in the sample.

Finally, we analyzed whether the aforesaid relationship was stronger in family firms managed by the first generation than in the rest (model 3). In this sense, the characteristics of these family businesses, such as the high ownership concentration and information asymmetry between family members and other shareholders, are aspects that can influence the behaviour of insiders.

The results shown in Table 2 (column III), indicate that we can not accept the hypothesis 3. Although the coefficients of the terms reflecting the interaction term between the insider ownership and its cube and the dummy that denotes the first generation are positive, and the terms for interaction term between the square of insider ownership and the dummy for the first generation are negative, the relationships are not significant. There is therefore no cubic relationship between insider ownership and firm performance in the case of family firms managed by the first generation.

Nevertheless, it is confirmed that there is a non-linear or quadratic relationship between insider ownership and performance in family firms managed by the first generation (Table 2, column IV). Therefore, it seems that the high concentration of insider ownership found in family firms managed by the first generation leads to the entrenchment of family insiders when a certain level of ownership is reached.

This non-linear relationship has also been detected for listed companies, and without analyzing whether firms are family-owned by Jarrell and Poulsen (1988), Stulz (1988), McConnell and Servaes (1990), Mudambi and Nicosia (1998), Fernández et al. (1998) and Hillier and McColgan (2001), among others. They conclude that either the hypothesis of convergence of interests or the hypothesis of entrenchment may prevail depending on the range of ownership.

Specifically, Stulz (1988) proposes a quadratic relationship between insider ownership and firm value. Thus, he says that the value of a firm first increases and then decreases with increasing ownership of insiders. The model suggests that the value of the company reaches a maximum for a certain percentage of insider ownership below fifty percent. McConnell and Servaes (1990, 1995) also find a similar curvilinear relationship between two variables: for ownership levels below 50%, they find a significant positive relationship between insider ownership and company value, but for levels of ownership above that cut-off point they find a significant negative relationship. The results of our analysis are consistent with these findings, indicating that for levels of ownership below 55%, there is a significant positive relationship between insider ownership and the dummy that indicates the first generation. This indicates that the hypothesis of convergence of interests holds for family firms in the sample which are led by the first generation. However, for ownership levels above 55%, the interaction term between the square of insider ownership and the dummy variable for the first generation is negative and significant. This therefore supports the hypothesis of entrenchment for ownership levels that exceed that percentage.

4. Conclusions and Policy Implications

The literature on ownership structure as an internal control mechanism is based, in most cases, in listed firms. The few studies that try to analyze the effect of ownership concentration on firm performance in non-listed firms is what has made us to consider its importance and fill this gap. In this context, this study focuses on Spanish non-listed firms with concentrated ownership structures whose main shareholders are, in many cases, families.

The behaviour of insiders in relation to their percentage of ownership in family firms is different in compare with non-family ones. Our results support the convergence of interest and entrenchment hypothesis on the relationship between firm performance and insider ownership in family firms. The performance of family firms grows with low and high levels of insider ownership and falls in the intermediate levels.

Our results show that if insider ownership is between 0 and 35%, increases in ownership will result in higher firm performance. The reason lies in the greater incentives for insiders to maximize performance, as their equity holding grows. On the other hand, if insider ownership is between 35% and 70%, the performance of firms falls when their percentage of ownership increases. Therefore, the entrenchment hypothesis prevails in this case, since most insiders are looking out for their own welfare rather than that of everyone. Finally, for percentages of insider ownership above 70%, the convergence of interest hypothesis appears to prevail again.

When we analyze the generation managing the firm, it is confirmed that there is a non-linear or quadratic relationship between insider ownership and performance. Therefore, it seems that the high concentration of insider ownership found in family firms managed by the first generation leads to the entrenchment of family insiders when a certain level of ownership is reached. In particular, for levels of ownership below 55% the hypothesis of convergence of interests prevails. However, for ownership levels above 55%, the hypothesis of entrenchment is the one which prevails.

The rules governing the treatment of minority shareholders in a weaker system of legal protection as in Spain can justify the wealth expropriation in Spanish non-listed family firms with a high level of ownership concentration. Similarly, the family nature of insiders could also give them more power, which makes more incentives for families to expropriate wealth from minority shareholders, when the influence of the family extends beyond their ownership rights. This effect is stronger in family firms managed by the first generation.

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