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OWNERSHIP STRUCTURE IN CEE COMPANIES AND ITS INFLUENCE ON STOCK PERFORMANCE

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Abstract

Though being part of greater Europe, Central and Eastern European countries are considered emerging markets and, thus, political and economic situation there is to a great extent different from developed Europe, which is also applied to the companies operating there. Investment theories working in Western Europe cannot be applied to CEE equity markets: family owned public companies do not outperform others in CEE, unlike in developed European countries. Both in market downturns and upturns the best turn out to be companies where significant stakes are held by the government. According to the study results, these companies beat second best (companies with significant family ownership): 1044% vs. 523% during the period from April 2000 till November 2009. This phenomenon the authors explain by the CEE investors' wish to be on the safe side in an unstable environment as state owned companies usually pay good dividends, enjoy state indulgence and do not follow risky corporate strategies. Financial performance of the companies with governmental shareholding being at a very high level compared to peers is also adding value to the equity performance.

Keywords: Central and Eastern Europe, ownership structure, major shareholder, share performance, corporate governance

Introduction

A number of Western European investors feel uncomfortable when making decision on investing in emerging Eastern European equity markets, which in most case is explained by the uncertain political situation and, what is more important, intransparent corporate governance and implausible corporate management, which is imposed in most cases by the majority owners. One of the key questions prior to investing definitely is the ownership structure of the corporation, which is especially crucial in rapidly changing political, social and economic environment – typical situation for Central and Eastern Europe located enterprises.

Most of CEE countries' state authorities chose a radical way of privatization upon gaining independence. There have been several stages till the ownership structures of the companies were settled as they are now. When the privatization started, often the control of the company was taken over by the management and employees at the very low expense, significantly below fair values of the companies. In mid 90-s equity markets in Eastern Europe were under rapid development. Later equity markets became mediums in the privatization process as companies went public. At this time local individuals were actively participating in privatization process and, thus, becoming shareholders of the operating companies. It should be noted that with some companies after the first privatization step nothing has changed: e.g. Valerijs Maligins still holds significant part of Latvian pharmaceutical company *Olainfarm* (42% of total capital currently), Ryszard Krauze controls biotechnology company *Bioton*.

Second wave of major changes in shareholding structure of CEE companies was seen relatively recently. This trend can be observed in the context of the significant M&A deals activity in financial years 2005-2007 (Globally, mergers totaled a record $4.38 trillion in 2007, up 21 percent from 2006 according to research firm Thomson Financial). Western European and US companies, which needed to diversify their regional market portfolios for further growth, offered attractive premiums for the strategic targets operating in developing Central and Eastern European markets. This trend was observed across almost every industry: e.g. significant stake of Croatian pharmaceuticals company *Pliva* in 2006 was acquired by US company *Barr Pharmacuticals*; in FY 1998 *Bayerische Hypo- und Vereinsbank AG* bought a stake in Polish *Bank BPH*, which in 2008 was sold to *GE Money Bank*.

Companies operating with country strategic assets such as energy-related, utilities or telecoms (e.g. Russian gas company *Gazprom*, Czech utility *CEZ*) have government as a majority shareholder in their ownership structure.

The above-mentioned processes and factors explain great diversity of corporate ownership structure patterns in CEE countries. The differences are seen both in the percentage of the company owned as well as the type of shareholder. Thus, it can become a problem-solving task for an inexperienced investor in Central and Eastern European companies. The guideline is needed to understand what kind of ownership structure is preferable for a long-term investor; what kind of ownership structure creates the largest value for other minority shareholders. Checking whether ownership matters becomes important as, for instance, authors of the present research in their previous study discovered that fundamental analysis in Baltic States does not help a lot in generating higher performance alpha (Bistrova & Lace, 2009).

Another question arises of whether the situation in CEE countries is similar to the one in developed markets, where it is well-known that companies with family owning the largest are able to generate highest value and, thus, performance alpha in comparison to the companies with different shareholding structure pattern.The aim of the research is to find out what kind of shareholding structure creates highest corporate value within CEE equity markets. The objective of the research is to work out investment policy based on the type of ownership structure of companies located in CEE countries, which would demonstrate highest share price return and, thus, would be the most beneficial. First, the authors present general characteristics of current situation in CEE countries. Second, the share as well as financial performance of companies having different shareholding structure patterns is evaluated. Third, based on the obtained results authors of the research develop guidelines on investing in CEE countries according to the ownership structure. The methods chosen for conducting research are mainly quantitative, which include comparison of the performances based on certain shareholding structures, statistical, descriptive.

Effect of Ownership Structure

Family businesses are more profitable and create more jobs than non-family firms – conclusion made by Jim Lee, an economics professor at Texas A&M-Corpus Christi, who authored the study on S&P 500 and Fortune 500 companies. The comparison was based on net profit margin, employment, revenue, and gross income growth between 1992 and 2002. The researchers found out that average profit margin for family firms was 10%, two points higher than for non-family firms (Lee, 2006).

German researcher Christian Andres analyzed 275 public German companies and concluded in his study that companies with significant family ownership are more profitable and outperform their peers with other type of shareholders. However, this is true under condition that family members are actively represented in corporate management or supervisory board (Andres, 2008).

Spanish economists Kurt A. Desender, Miguel Angel Garcia Cestona, Rafel Crespi Cladera considered the performance of Spanish companies under 2000-2002 crisis conditions. They have found out that ownership structure is one of the most essential factors investor takes into account after adjusting for the sector and size. Their findings show that family controlled firms perform 5.6% better than non-family controlled firms and that firms with dispersed ownership outperform non-family controlled firms with around 7.8%. It has been also proved that founding family controlled firms have on average 11.6% better stock price performance compared to non-family controlled firms (Desender *et al*., 2008).

There have also been a number of studies on emerging markets. Daqing Qi, Woody Wu and Hua Zhang from the Chinese Univeristy of Hong Kong made a research on Chinese companies and found out that the most beneficial for corporate performance is legal-person ownership (institutional holding), while state ownership on the other hand dilutes the performance of the listed companies. It was stated in the study that companies with legal ownership tend to be also more profitable based on ROE figures (Qi *et al*., 2000).

Ukrainian stock market has been relatively well researched on ownership structure relation to corporate stock performance. Iryna Akimova and Gerhard Schwodiauer studied 202 Ukrainian enterprises for period 1998-2000 concluding that insider ownership (employees, managers) is found to have a significant non-linear effect on performance: positive within a lower range but negative from a threshold close to majority ownership onwards, while outside owners do not have a significant effect on performance. It was interesting though that stakeholding ownership by customers affect sale prices and performance negatively. The impact of foreign ownership on performance is significantly non-linear: its effect is positive only up to a level that falls short of majority ownership (Akimova & Schwodiauer, 2004).

Research Methodology

To achieve the main research target authors conducted a study, the corpus of which consisted of fundamental and trading data on 140 largest companies listed in 11 CEE countries: Czech Republic, Croatia, Slovakia, Slovenia, Hungary, Poland, Romania, Russia, Baltic States (Estonia, Latvia, Lithuania). The period examined in the course of the study spanned from April 2000 to November 2009. The data used in the research was originated from corporate annual reports, corporate web-sites and from local stock exchanges.

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All companies researched have been divided into five groups according to their ownership structure patterns. In order to be classified as a certain group the company should have an investor, which holds not less than 15% of the total capital, and it should be the major holding. The groups were the following:

1. Financial: major investor holds the company primarily for financial interest, which is share price appreciation and dividend payments. Usually these are banks, trust accounts, pension funds or investment holdings;
2. Strategic: major stake in company's capital is held by the company, which operates in the same industry, usually headquartered in Western Europe or US. This is very common situation in telecommunication, pharmaceuticals, and financial industry groups.
3. Government: state owns significant part of the company. In this case the shares did not change the hands and state kept its controlling stake (common in industries of strategic importance).
4. Family/private: large stake of the company belongs to the private person, which usually takes active part in company management, being member of the board or management team. Sometimes stake belong to several members of the family, who exert significant influence on corporate management.
5. Mixed: companies with mixed shareholding. The group includes companies, which did not suit any criteria of the above-mentioned groups. These companies tend to have diffused ownership.

The authors tried to find the relationship between the share price performances and the ownership structure patterns mentioned above by using mainly statistical analysis methods such as structure analysis, indexation, comparisons of averages.

Research Results

As it was stated above shareholding structure of CEE companies varies from company to company, but still strategic ownership dominates: 49 out of 140 companies have strategic investor as majority shareholder (Figure 1). It especially dominates in Slovakia (100%), Romania (67%), Czech Republic (67%), Hungary (57%) and Poland (40%). Having strategic investors in ownership capital seem to be very common in financial (55%), communication (50%) as well as energy (44%) industries.

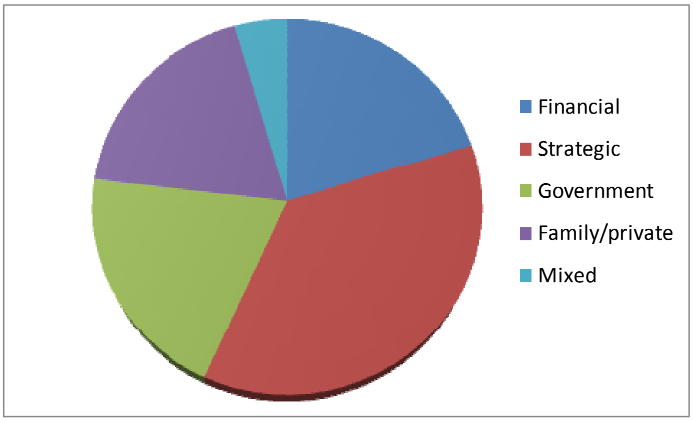

Figure 1. Groups of CEE companies according to their major shareholders

Family, financial institutions and government tend to be equally present in the structures of capital of CEE companies. Government is very active in the sectors, which represent strategic assets, - energy and utilities, having 44% and 60% respectively. Countrywise, government as a major holder is well represented in Russia (42%) and Romania (32%), while in other Central and Eastern European countries government is not so actively taking part in holding local companies (in less than 25% companies in other CEE countries).

Financial institutions (banks as well as investment holdings) are active investors in consumer non-cyclical industry, which is represented mainly by the retail industry group. Basic materials industry is distinguished by great number of companies, where major holder is private person, usually owner or former manager of the company. Same situation is with technology sector, which possesses high degree of innovativeness.

When analyzing the performance of the companies according to the ownership structure, authors created an index for each group starting with April 1, 2000. The chart (figure 2) clearly shows that in the long-term investors, who invested in the company with government being major shareholder, benefited the most as index returned 1044%, compared to the investors in the companies with different capital ownership

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pattern. This is definitely contrasting with generally accepted dogma in Western equity markets, that companies where major holder is family beat the market in the long term. This discrepancy can be logically explained by the unstable political and economic situation in CEE countries. This deal of uncertainty investors are avoiding by investing in the stable and safer companies with governmental holding, which are also usually good dividend payers, thus increasing total shareholders return.

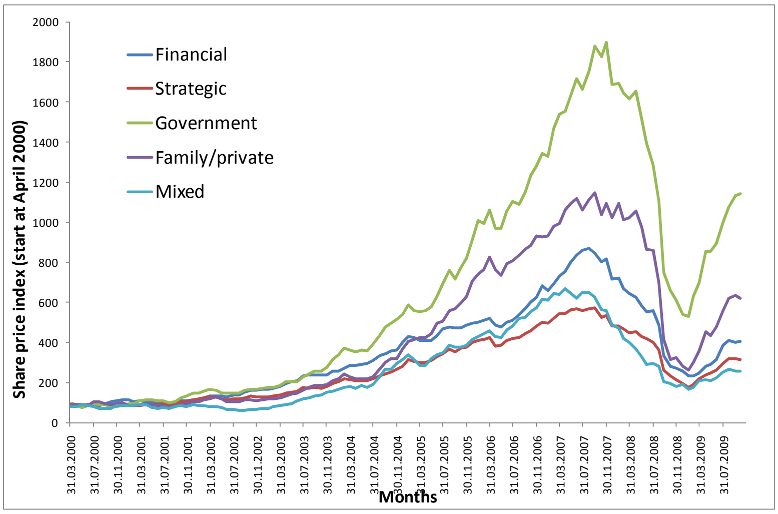

Figure 2. Performance of CEE companies according to their shareholding structure groups

Companies, which can boast of significant family ownership, though are following companies with government as major owner, have returned twice less – 523% since April 2000. The returns of companies with strategic, family and mixed holdings are relatively similar, with financials leading this group.

It is essential for every investor to know how to behave and where to invest during different economic cycles in order to benefit in the end. As study shows (Desender *et al*., 2008) investors under crises conditions make price adjustments for size, sector and the corporate shareholding structure. So, the authors of the study made an analysis on performance character of companies depending on their ownership structure during up-cycles and down-cycles on equity markets.

The charts (figure 3) clearly demonstrate that in both down-phases on equity market companies with significant governmental holding beat the rest of the companies. It is true also in 'no-winner' period in financial years 2007-2009, when companies with this type of shareholding lost 68.2%, while the losses of other companies exceeded 68.7%. Companies with mixed shareholding were the most evident underperformers in the period from 2000 till 2001 and were among major loses during the period from 2007 till 2009.

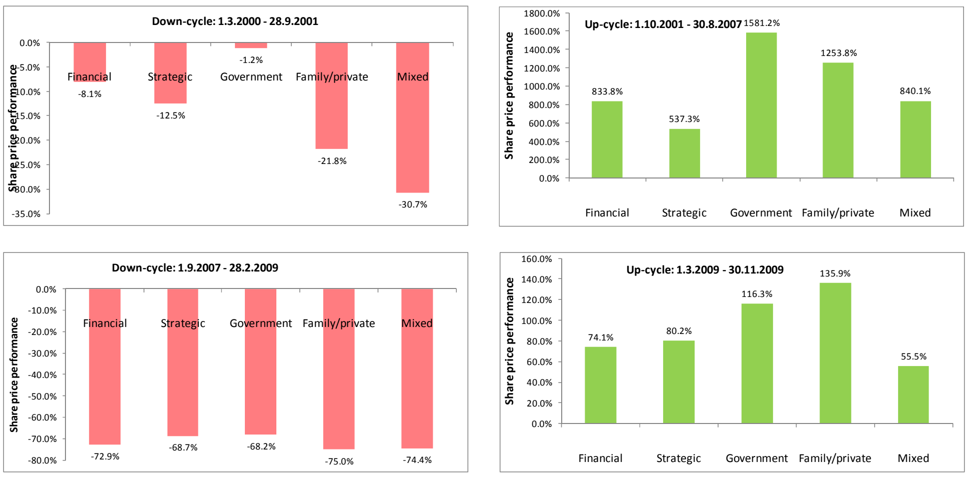

Figure 3. Performance of CEE companies according to their shareholding structure groups during different market phases

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First growing phase under review brought clear leader group, which were companies where government is major shareholder. Though these companies performed well also during the second growth phase (1.3.2009-30.11.2009), they were beaten by the companies where significant influence is exerted by private individuals.

These results point to the fact that investors consider companies with government being major shareholder to be a safe harbor in unstable CEE market environment, which is reinforced under crises conditions. This is contrasted to the companies with diffused shareholding structure, which lose the most during market downturn and are not the favourite ones when markets show strong upwards trend.

Ownership Structure Adds Value to Financial Performance

To understand whether shareholding structure in CEE influences also firm's financial performance, the authors of research analyzed companies of certain shareholding type based on the main fundamental analysis ratios: ROE, ROIC, Net profit margin, OpCF to Equity, Equity ratio.

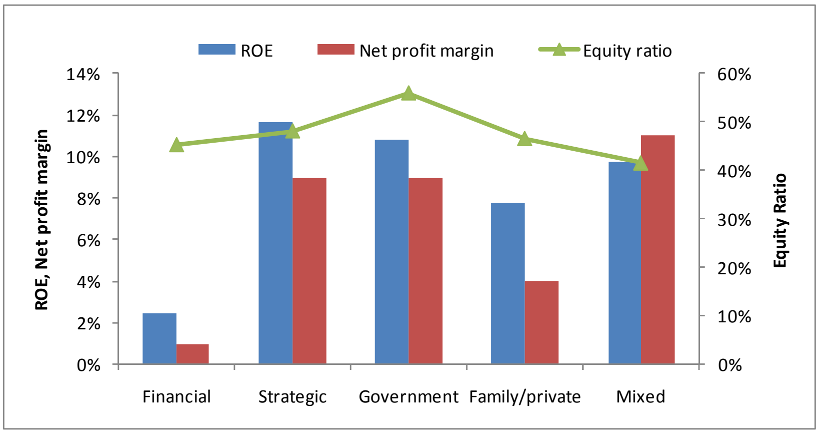

Figure 4. Financial characteristics of CEE companies according to their shareholding structure groups

Companies with strategic shareholding seem to have the highest capital profitability (ROE, ROIC), followed by government and family holdings. Companies with mixed shareholding turned out to have highest net profit margin. Sales profitability is also at the upper end for strategic and governmental majority holding companies. It is worth noticing that companies which are held primarily by investors for financial interest, are of poorest profitability compares to other types of companies.

Equity ratio of all companies under review does not differ a lot. The leaders here are companies with government being major shareholder as they have the most conservative balance sheet management.

Conclusions and Recommendations

Ultimate aim of the research was to discover the influence of type of ownership structure on share price performance in CEE equity markets. The hypothesis set prior to the study was: companies with family ownership majority generate highest performance alpha. Basically, this theory, which is applied in Western European and US markets, is not true within Central and Eastern European emerging markets concepts.

As study results showed ownership structure of CEE companies tends to be very diverse as one can distinguish several types of corporate ownership structure. To a certain extent it resembles situation in Western Europe, where ownership structures are also very diverse – strong presence of family, financial and governmental holdings. US market is characterized by very diffused ownership. It is rare case that a US company has majority ownership whether it is family or strategic holding.

Comparing shareholding of EU companies and CEE companies according to industries, one can find some similarities such as: significant governmental presence in utilities and communications sector, strategic investors are active in financial sector.

When checking the performance of companies with different shareholding structure types, it was discovered that companies with governmental holding outperform all other groups. This is the major discrepancy with authors' hypothesis as well as situation in Western equity markets. Companies with government being major shareholder are regarded by CEE investors as being safe in an uncertain and not yet developed market environment. Besides, this clear leadership can be explained by the promising business models, which have strategic importance for the country, as well as usually high dividend yields. During downturn phases this type of companies outperforms as well, even in 'no-winner' financial crisis of 2008.

The authors of the research analyzed the contribution of ownership structure to the financial performance of the company. High capital profitability was demonstrated by the companies with strategic majority holding as well as governmental majority holding, which is also adding value to the outperformance of the latter group.

The investment strategy, which can be applied to CEE equity markets, worked out basing on the obtained results would be to stick to investing in companies where significant share of capital is owned by the government for the reasons mentioned above. It is especially true during market downturns. However, when markets are moving upwards investors are advised to diversify equity portfolios by including also companies, where great influence on management processes have private person sitting on the board and having significant stake in company capital (personal interest in business flourishing, lack of agency problem, efficient decision-making process).

The authors would seize the opportunity in the future to continue the present research by adding more detailed analysis by countries. Moreover, it would be good to include some more performance analysis such as alpha, beta, Sharpe ratio, correlation analysis data to gain more thorough insight in firms' performance according to their shareholding structure patterns. Besides, the model for evaluating quantitative influence of ownership structure on investors' holdings (losses or gains in capital) can be worked out.

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