Dual Class Shares – Empirical Evidence

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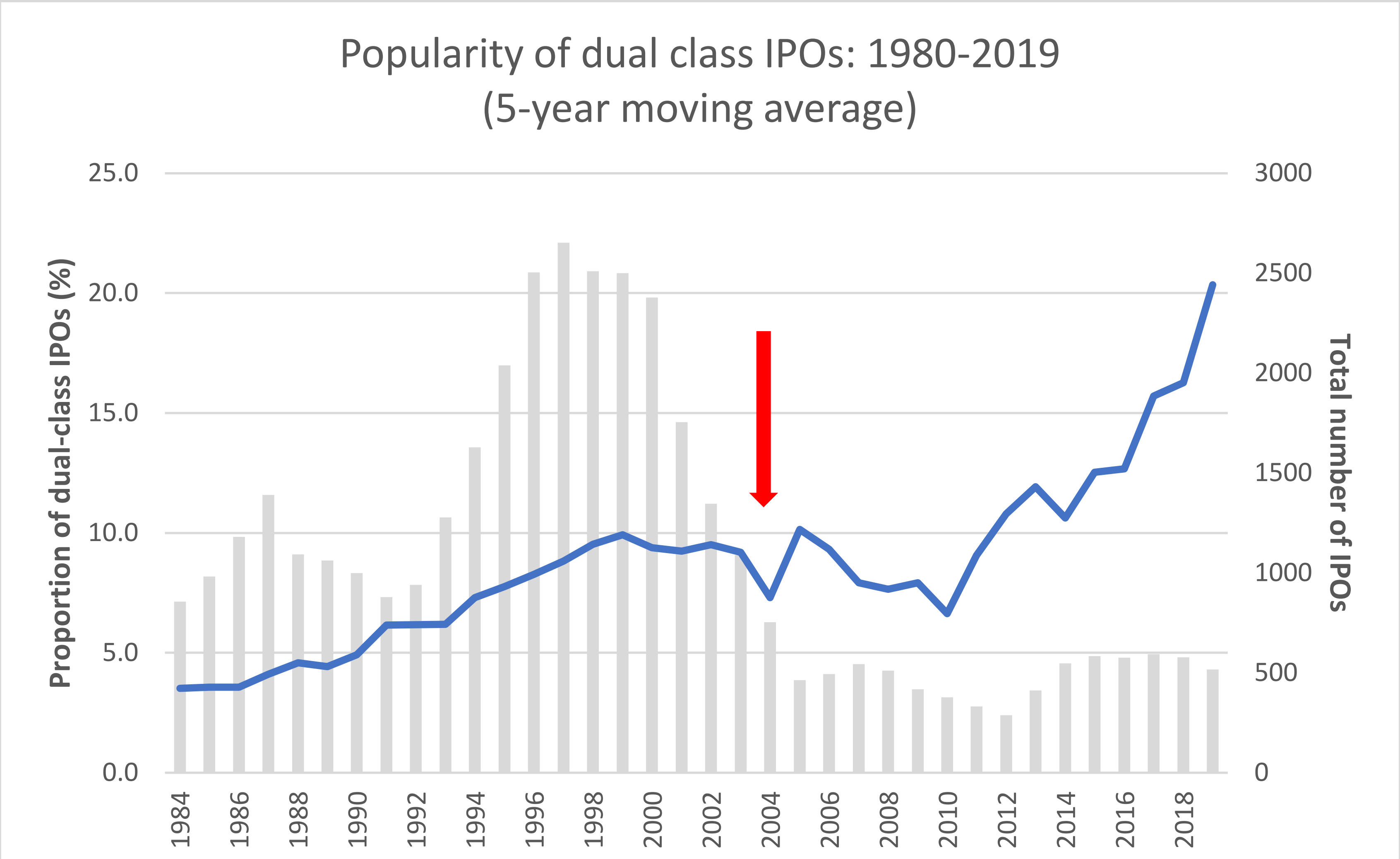
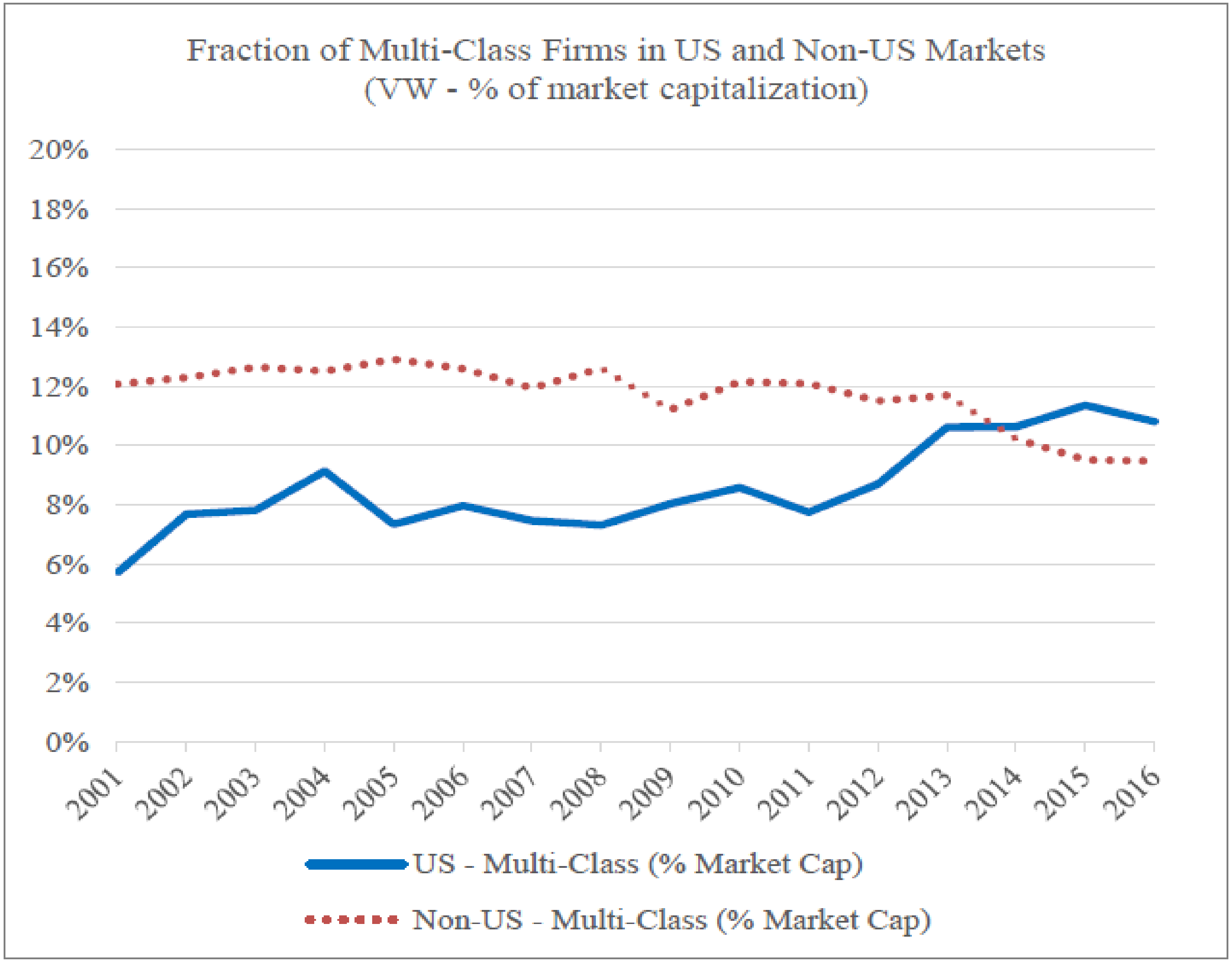
Dual class IPOs are on the rise in the U.S.



Source: Cremers, Lauterbach, Pajuste (2018, updated)

Stock of dual class firms around the world



Source: Kim, Matos. Xu (2018)

Classics

- The golden “**one share-one vote**“ principle…
- …but no robust empirical evidence that disproportional ownership destroys value (Adams and Ferreira, 2008)

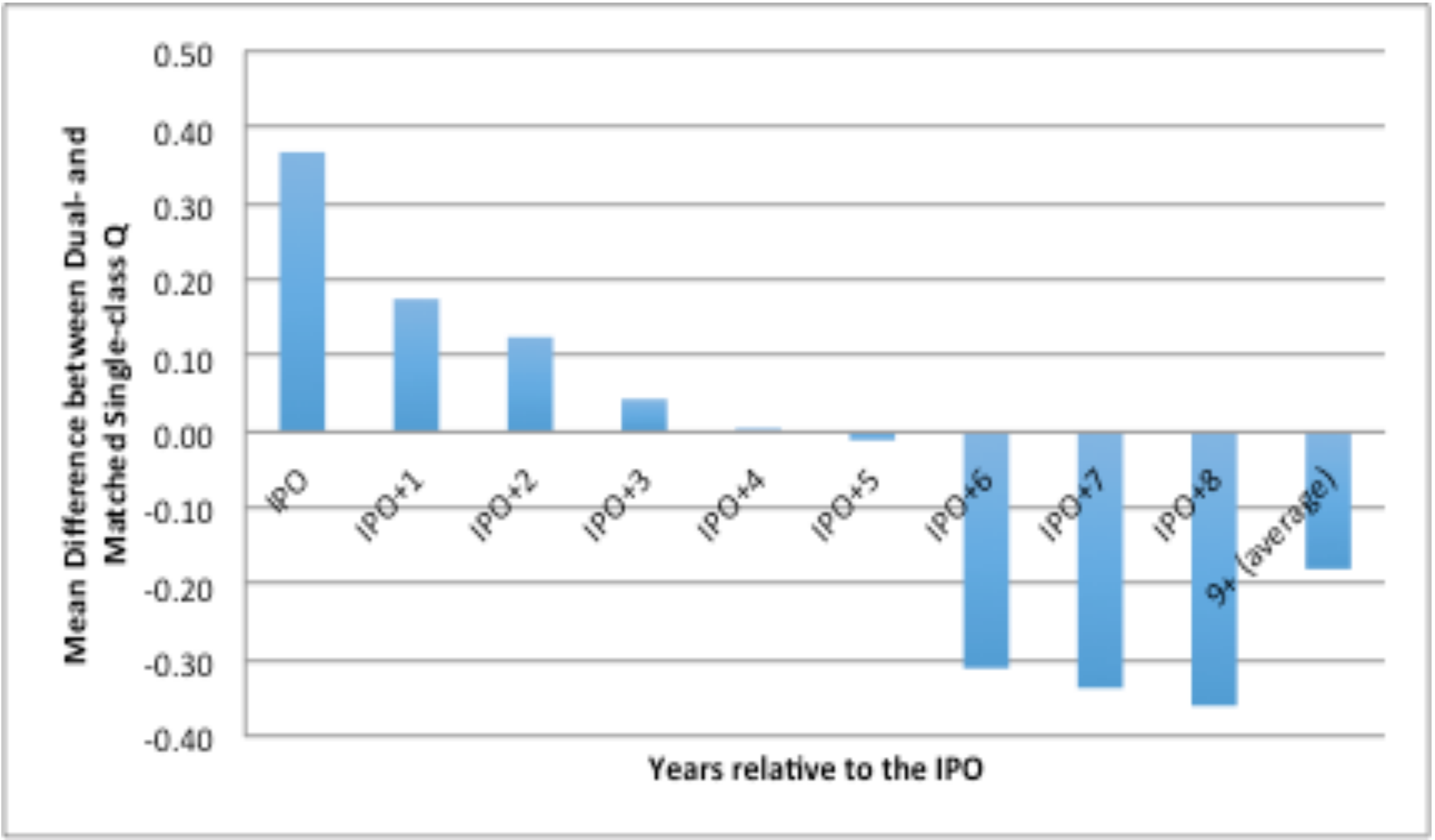
- Lower valuations of dual class firms relative to single class firms (Masulis, Wang and Xie, 2009; Gompers, Ishii and Metrick, 2010)…
- … but dual class firms have similar returns to single class firms (Smart, Thirumalai and Zutter, 2008), or even outperform (MSCI, 2018).

Recent evidence

- Bebchuk and Kastiel (2017) theoretically argue against the perpetual nature of dual class structures. Any special value a dual class structure may offer on its IPO, dissipates over time.
- The costs and benefits of dual class structures vary along the **life cycle** of these firms.

- Recent studies find strong empirical evidence for the life-cycle effect (Cremers, Lauterbach, Pajuste, 2018 (CLP 2018); Kim and Michaely, 2018).
- Dual class firms exhibit a valuation (Tobin's Q) premium over **comparable** single class firms at the IPO. However, this valuation premium gradually dissipates within 6 to 9 years after the IPO; dual class firms drop into lower valuations than comparable single-class firm. (CLP 2018)

Life-cycle effect

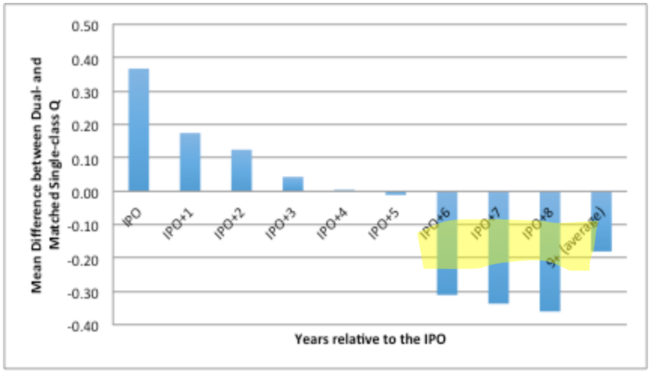


Source: CLP 2018

"Apples and oranges"

- Dual class firms (compared to single-class firms) at IPO are
  - More mature (years from founding): 13 years vs. 23 years
  - Bigger (total assets): 265 MUSD vs. 1198 MUSD
- …and they live longer (publicly)

- Therefore, a simple cross-section of dual- and single-class firms compares firms in a different stage of their life-cycle → lower valuation on dual-class structures
- Maturity discount (Loderer, Stulz, and Waelchli, 2017)



Dual-class benefits

- Dual-class structure may help **visionary entrepreneurs** take their companies public, protecting them from premature loss of control.

- Particularly young founders may be disruptive in their ideas, making their firm's success more dependent on their vision and leadership.

- Founder-CEOs are value enhancing for the firm (Fahlenbrach, 2009).

BOSS Founder-Run Companies ETF

- Founders idiosyncratic vision (measured by media coverage of firms' founders prior to their IPO) predicts the use of dual-class share structure among technology firms (Grinapel, 2020).

Founders

	Dual-class firms		Single-class firms		Differen ce
	Mean	N	Mean	N	p-value
All sample firms	100%	384	100%	384	
Founder is a director/officer at the IPO	53.4%	205	42.7%	164	*** *0.003*
incl. Founder is Chief Executive Officer (CEO)		156		107	
Founder is Chairman of the Board (but not CEO)		31		29	
Founder is Director/Officer (but not CEO or COB)		18		28	
At least one founder-insider at IPO+5	91%	115	81%	90	** *0.032*

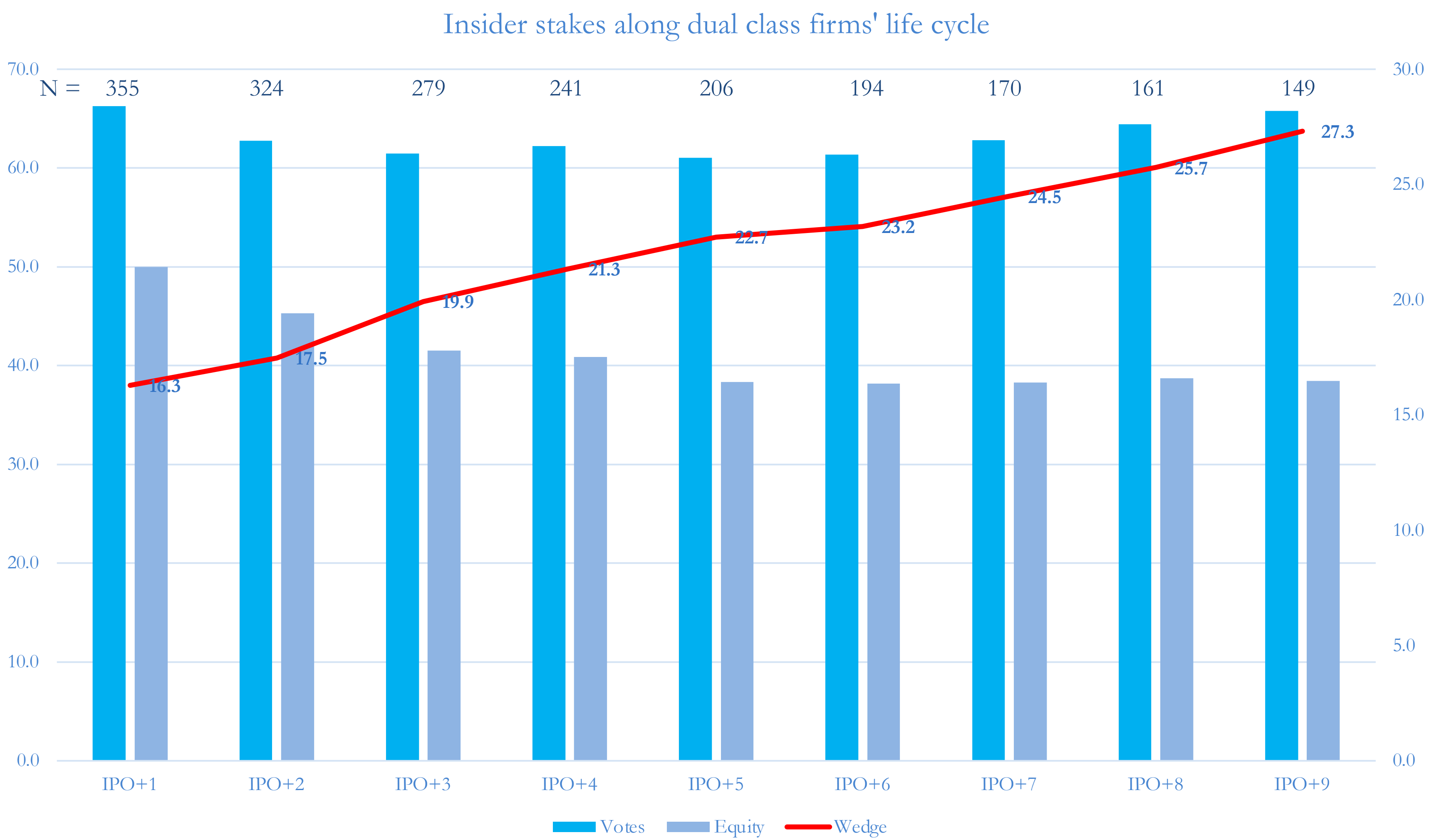
Source: CLP 2018 (updated)

- A positive founder-insider value effect in dual-class firms at the IPO (similar result found in Aggarwal et al., 2021).
- The effect dissipates over time as founders' interest in the firm decreases and s/he departs from the leadership team and/or sells shares.

Dual-class costs

- Controlling shareholders may extract some private benefits that in the pre-IPO period often are restrained by close monitoring from venture capitalists.
- In the years after the IPO, venture capitalists tend to exit and founders may become entrenched as sole controlling shareholders.
- Additionally, in dual class firms founders can cash out, meanwhile preserving tight control over vote, creating a wedge that may induce worse **agency behavior**.

Wedge



Source: CLP 2018 (updated)

Wedge Can Increase for Different Reasons

			Issue of new A shares	Other Class B sell	Founders sell
		t=1	t=2		
Founders # Class A shares	1 vote	0	0	0	0
Founders # Class B shares	10 votes	100	100	100	80
Total # Class A shares		100	200	150	120
Total # Class B shares		150	150	100	130
Voting rights (Founders)		62.5%	58.8%	87.0%	56.3%
Cash flow rights (Founders)		40.0%	28.6%	40.0%	32.0%
Wedge (Founders)		**22.5%**	**30.3%**	**47.0%**	**24.3%**

Google case

Applicable percentage ownership is based on 298,652,030 shares of Class A common stock and 46,940,340 shares of Class B common stock outstanding at March 29, 2018.

On the Record Date, we had 345,596,538 shares of Class A common stock and Class B common stock issued and outstanding, consisting of 298,656,198 shares of Class A common stock and 46,940,340 shares of Class B common stock. On the Record Date, we had 348,952,225 shares of Class C capital stock issued and outstanding.

	Voting Shares Beneficially Owned				
	Class A Common Stock		Class B Common Stock		% Total Voting Power[1]
Name of Beneficial Owner	Shares	%	Shares	%	
Executive Officers and Directors					
Larry Page	–	–	19,952,558	42.5	25.9
Sergey Brin	–	–	19,290,366	41.1	25.1

Approval of the Adoption of Google's Fourth Amended and Restated Certificate of Incorporation

In April 2012, our board of directors, after receiving the unanimous recommendation of a special committee of our board of directors (Special Committee), unanimously determined that it is advisable and in our best interests, and in the best interests of our stockholders (other than the stockholders who will enter into transfer restriction agreements, as to whom no determination is made), to adjust our capital structure by establishing a new class of capital stock and potentially declaring and paying a dividend of one share of this new class of capital stock for each outstanding share of Class A common stock and Class B common stock. This new capital stock, which will be known as Class C capital stock, will be available for use for, among other things, stock-based acquisitions and equity-based employee compensation.

As part of the approval of the adoption of the New Charter, Larry, Sergey, Eric, and certain of their respective affiliates have agreed to enter into transfer restriction agreements with Google (Transfer Restriction Agreements). Pursuant to the Transfer Restriction Agreements, these stockholders will agree, among other things, not to sell or transfer any shares of Class C capital stock that they receive at any time if, as a result of such sale or transfer, they would own more shares of Class B common stock than Class C capital stock. These restrictions are intended to limit the ability of these stockholders to sell their Google stock in a manner that does not reduce their voting power. See "Transfer Restriction Agreements" below.

Google case

		2005	2012	2018
Class A shares held by Larry Page & Sergey Brin (M)	1 vote	0.00	0.08	0.00
Class B shares held by Larry Page & Sergey Brin (M)	10 votes	72.86	51.86	39.24
Class C shares held by Larry Page & Sergey Brin (M)	0 votes	0	0	39.24
Total Class A shares (M)		162.55	259.98	298.65
Total Class B shares (M)		114.73	66.05	46.94
Total Class C shares (M)		0	0	348.95
Voting rights (Page & Brin)		55.6%	56.3%	51.1%
Cash flow rights (Page & Brin)		26.3%	15.9%	11.3%
Wedge (Page & Brin)		29.3%	40.4%	39.8%

Wedge over time

- Increase in the wedge is an important reason for the decrease in Tobin's Q over dual class firms' life-cycle (CLP 2018).

- Aggarwal et al. (2021) find that the initial wedge has increased in the post-Google IPO period, which can be explained by founders having stronger bargaining power (versus venture capitalists), a reduced need for external financing in cloud industries, and higher prevalence of foreign firm IPOs, particularly from China.

Policy and other responses (1)

- A self-correct mechanism: Unifications
  - By year IPO+9 only about 20% of firms unify, and a higher wedge significantly reduces the probability of a unification (CLP 2018)

- Mandatory sunset provisions: mandate a shareholders' vote beyond a certain listing age
  - Pros: Benefits of dual class structures tend to decrease and costs increase over the life-cycle of dual class shares (Bebchuk and Kastiel (2017)
  - Cons: One size does not fit all; perverse incentives prior to the sunset date (Fisch and Solomon, 2019)

Policy and other responses (2)

- Index exclusion (see Committee on Capital Markets Regulation, 2020)
  - Exclusion approach (UK Premium listing; S&P 500 for new entrants)
  - Hurdle approach, e.g. at least 5% of voting rights held by public investors (Russel 1000)
  - Inclusion (MSCI; DUAL)

- Country-specific responses
  - One size does not fit all. Three primary regulatory models (Gurrea-Martinez, 2020): (i) prohibitions (the United Kingdom, Germany, Spain, Colombia, or Argentina); (ii) the permissive model (Canada, Sweden, the Netherlands, the United States); and (iii) the restrictive approach (Hong Kong and Singapore).
  - Default rules (e.g. loyalty shares in France); menu options; or stickiness of historically determined patterns (Tallarita, 2021, this workshop)

Policy and other responses (3)

- Enhanced Disclosure
  - "The concern that public shareholders are not adequately informed of the risks associated with dual class shares is a better argument for additional disclosure than against dual class share structures." (Committee on Capital Markets Regulation, 2020)

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Thank you!