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Loyalty Shares with Tenure Voting - a Coasian Bargain? Evidence from the Loi Florange Experiment

Discussion – Conference on Differential Voting Shares
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Motivation

- Loyalty shares:
  - Voting rights double after a minimum holding period
  - Idea: Give more power to long-term shareholders
  - Natural experiment: French Loi Florange, effective April 3, 2016
    - Introduces mandatory loyalty shares unless shareholder meeting opts out with two-thirds majority
    - Loyalty shares become default: previously OSOV was default

- This paper
  - Study 104 companies included in SBF 120 index (why not more?) that are incorporated in France and have been publicly traded since the introduction of the law (March 29, 2014).
  - Hypothesis (Coase theorem): If the previous ownership structure was optimal, shareholders should decide to revert to OSOV
Key results

→ Most companies that opted for OSOV before loyalty shares became the default chose to revert to OSOV

→ *Exception*: Companies where the largest shareholder has more than one-third but less than two-thirds before the vote (usually the state)
  - Is it blockholder status or the identity of the state that counts?
  - Probably difficult to disentangle (7 observations, LDV estimation in Table 7)

→ More IPO firms have loyalty shares after passing of *Loi Florange*
Interesting paper on an interesting experiment

Comments:
1. Which problem are loyalty shares supposed to address? → Short-termism
2. Within which framework should we interpret the results?
3. How should we interpret the empirical results? – Comments on Tobin’s Q
Short termism – the conceptual backdrop
A popular (populist?) argument

➔ Argument in the press, not so much in academia (Economist Jan 12, Mar 10 2017)

➔ Somehow the following steps seem to be involved:
  - Turnover in capital markets is increasing, holding periods decreasing
  - Short-term investors focus on short-term earnings and cash flows
  - Managers catering to these short-term investors sacrifice long-term investments
    - in particular R&D and innovation

➔ No systematic evidence to support how length of holding periods, corporate objectives, and investment policies are connected
  - …but the opposite: Kaplan (2017); Roe (2018);
  - Also: Lerner, Sorensen, Strömberg (2011) on patenting activity of LBOs

➔ Some recent models of “optimal short termism”
  - Hackbarth, Rivera, Wong (2018); Gryglewicz, Mayer, Morellec (2018)
  - Heaton (2017): maximizing value or maximizing the likelihood of survival?
How much short-termism is optimal?

→ Trade-off between
  - Discipline to ward off entrenchment → requires that governance intervenes, reacts to early (imprecise, imperfectly reliable) signals – the “short leash”
  - Tolerance for failure (Tian & Wang, 2014) → incentives for innovation (Manso, 2011) → credible commitment not to react to some signals – the “long leash”
  - Optimal governance has to trade off agency costs from the ‘long leash’ against inefficient investment from ‘short leash’ – best done by initial shareholders

→ Empirics: Short-termism may be a good thing – Giannetti & Yu (2016) find firms with more short-termist investors adapt better to competitive shocks, but have more agency costs

→ Models of “exit:” early incorporation of information
  - …but then more trading in response to short-term information in stock prices makes prices more efficient → improves long-term investment (Edmans, 2009)
Interpreting the consequences of Loi Florange

→ **Backdrop:** What if investors and entrepreneurs have differences of opinion rather than just different information? (e.g., Varian, 1985; Harris & Raviv, 1993; Kandel & Pearson, 1995)

→ Important if individuals have to interpret ambiguous, complex information, e.g., assessing new technologies (Allen & Gale, 1999; Coval & Thakor, 2005)

→ **Optimal ownership structure:**
  - Stay private as protection against investors with misaligned beliefs (Boot, Gopalan, Thakor, 2006)
  - Entrepreneur needs to find the “right” shareholders

→ **Loyalty shares**
  - Temporary dual-class shares (difference: cannot sell them at a premium)
  - Provide entrepreneurs with limited protection from “volatility of shareholder base“ (Boot, Gopalan, Thakor, 2008)

→ **Loi Florange:** Some firms go public that otherwise would have stayed private?
Tobin’s Q

→ Tobin’s Q has three drivers:
   1. operational efficiency
   2. growth opportunities
   3. on the extent to which these growth opportunities are realized

→ Assume:
   - Managers always prefer projects with higher NPV/investment (=marginal Q)
     ▪ may implement too many (overinvestment, empire building)
     ▪ or too few (underinvestment, e.g., b/c of risk aversion, financial constraints)

→ Higher average Q may indicate
   - Higher risk aversion
   - Higher financial constraints
   - More growth opportunities
Tobin’s Q and under/overinvestment
My favorite interpretation of Table 3

![Graph showing Tobin’s Q and under/overinvestment]

- **Family**: 1.77
- **Average**: 1.51
- **State**: 1.20

### Table 3:

<table>
<thead>
<tr>
<th>State</th>
<th>Marginal / Avg. Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family</td>
<td>1.77</td>
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Source: © 2018 Ernst Maug

Discussion of Becht et al., Loyalty Shares with Tenure Voting
Summary

→ Great paper on interesting economic experiment

→ Q-results may be interpreted differently

→ Recommendation: Work on big picture
  - Short-termism
  - Protection from volatility of shareholder base