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Analyzing extractive tactics of institutional investors through levying of management fees in the investees in Malawi

By

Brian Phiri Kampanje

Abstract

Institutional investors usually exert significant influence over the investees through injection of significant cash for organic growth of the investees and have the ability to guide the boards towards pursuing profitable business activities and instill effective monitoring mechanisms to reduce the agency cost. The institutional investors do however sometimes act in bad faith by pursuing extractive behaviour where they establish business relationship with the investees and collect management fees on top of the dividends and have unfair advantage over the other numerous insignificant investors. This study tried to explore the possible existence of the institutional investors' extractive behaviour in Malawi. All the sixteen listed companies were analysed together with four financial holding companies supervised by the Reserve Bank of Malawi. The results indicate use of wholly owned subsidiaries to fleece some of the listed companies through substantial management fees which are excessively higher than dividends thereby shortchanging other investors who either receive lower dividend or none. The management fees transactions fall under the related party transactions but there are inadequate safeguards in the Malawi Stock Exchange Listings Requirements 2023 and the Financial Services (2018). It is recommended that management fees must be capped to 10 percent of the dividend and minority shareholders to enforce it.

Type of Paper: Research Paper

Key words: Extractive, Management Fees, Institutional, Investor

1.0 Introduction

The study tried to investigate the existence of the extractive behaviour of the Malawian institutional shareholders through levying management fees and its impact on the growth of the Malawi Stock Exchange. There is no known study which tried to explore this topic and its findings are therefore of great value to the common body of knowledge for the Malawian economy which can assist the regulators and industrial players come up with the appropriate policies if any malpractices are visible.

1.1 Brief understanding of the Malawi's institutional investors

Kampanje (2012) averred:

[... institutional shareholders in Malawi comprise of pension funds, insurance companies, banks, specialised institutional investors and various financial institutions. The role of the institutional shareholders in Malawi is likely to increase because of the enactment of Financial Services Act 2010 as well as Pension Act 2011.].

The term institutional investor is not defined in the Financial Services Act 2010 but is stated in section 11(2) of the Financial Services (Licensing and Regulatory Requirements for Holding Companies) Directive 2018.

The institutional shareholders possess substantial power of the companies as noted by Holmberg (2018:7):

[The power some shareholders wield to influence corporate strategy is mostly in the hands of institutional shareholders—particularly "activist" hedge funds that aggressively pressure corporations to extract value for their own profit. Even institutional investors that aren't as aggressive—many pension funds, mutual funds, and endowments, for example—are reinforcing the same behavior (with their approval votes) because of their own incentives for high returns. The power structure across the investor class suggests that curbing shareholder primacy will require structural reforms that target the power and incentives of institutional shareholders in order to rewrite the rules that shape corporate behavior.].

1.2 Research objectives

a) Investigate the level of management fees in relation to the profitability of the investee listed on the Malawi Stock Exchange.
b) Analyze any regulatory instruments to limit the amount of the management fees collected by the institutional investors.
c) Explore any remedial actions which can be pursued to address any deficiencies if there is enough evidence that institutional investors undertake extractive behaviour in the investee companies.

2.0 Literature review

Management fees can be collected across the different sectors of the economy and widely used in the principal/agent relationship.

2.1 Definition for management fees

Wright (1930:415) averred:

[Management fees are financial items levied upon and paid by operating utility companies to management companies for services rendered. The services may include engineering, financial, credit, accounting. legal and other advice and help. The managing company may own and control the operating unit; or the relationship may be a purely contractual one, existing between companies in no other way related. The customary practice is for the management company to own its operating companies in order to insure a market for its services and also use such ownership as an investment.].

BDO Canada (2022) postulates:

[For management fees to be allowed as a deduction from taxable income, the following three criteria must be met:

- The amount of the fees charged must be reasonable
- The fees must be incurred for the purpose of earning income
- There must be a legal obligation to pay the fees].

Glenn Graydon Wright (2022) stated:

[Management fees cannot be like dividends at the management's discretion or paid based on the business outcome. There should be a legitimate purpose for charging a management fee for the specific service. It should have the qualities of a business expense – regular, obligatory, and undertaken to generate income.].

Management fees emanate from the management contracts - Hua et al (2020). Hua et al (2020) annotated:

[The management contract, also referred to as an operating agreement, states the area of responsibilities of the owner of the hotel and the management company selected by the owner to operate the hotel. In other words, the owner employs the management company as an agent to assume full responsibility for operating the property and to do so in a professional manner. As an agent, the management company pays, on behalf of the owner, all operating expenses from the cash flow generated by the property, retains a management fee, and passes the remaining cash flow on to the owner.].

2.2 Management fees in connected companies

Management fees can be used as a smoothing profit tool in the corporate group structure. In the case of associated businesses, where one business has prospered and the other has suffered difficult trading conditions, it might be tempting to share profits by making an intercompany management charge, reducing profits in one business and the losses in another - Warren (2021). The principle of the arm's length transaction need not to be proven for example comparing with what a third party would pay for a similar service provided it satisfies to be an economic activity undertaken on commercial basis with a view to making money - Simmons and Simmons (2024).

2.3 Management fees and transfer pricing mechanisms

Management fees are widely used as transfer pricing strategy such that the management fees can be underpriced or overpriced depending on what is beneficial to the reporting entity - Sebele-Mpofu et al (2021). The possibility of manipulating transfer pricing mechanisms is usually on the government's radar but this is complicated by IFRS 8 - Segment Reporting in which the parent company has to disclose the performance of each segment which very often is through the subsidiaries in particular because transfer pricing is not only an accounting technique but also a method of resource allocation and tax avoidance - Demko-Rihter et al (2023). There are varied reasons to justify multinational companies in charging management fees through transfer pricing as noted by Yongjun et al (2020):

[An MNC usually invests in common systems or services or training for the growth of its subsidiaries. For examples, an automobile manufacturer conducts blanket advertisements for some vehicles sold by all dealerships; a hotel installs a reservation system for all chain members; a technology and manufacturing firm provides technical support and personnel training services (e.g., installation and maintenance of the management information systems, training employees for using technical equipment/tools in production and quality management) to its subsidiaries. The expenditures for such common systems or services or training are common costs (also called fixed costs in literature). Each subsidiary bears the common costs by paying a certain percentage to the MNC. As costs are one major element affecting subsidiaries' profits, how to optimize the allocation of common costs among subsidiaries is deemed important for both subsidiaries and

MNCs (Toktay & Wei, 2011). Aiming to shift profits thus reducing corporate tax liability, the MNCs often allocate high/low portions of common costs to the subsidiaries from the countries where the corporate tax rates are high/low (Huizinga & Laeven, 2008).].

Gundelach and Nielsen (2023) noted that there are serious deficiencies in measuring the subsidiary performance using financial indicators so that transfer pricing, management fees or exchange rates all which are uncontrollable factors have been in perpetual use to overcome such limitations.

3.0 Methodology

The study embraced the census by evaluating the Malawian listed companies which are sixteen according to the Malawi Stock Exchange (2024). Additional four out of the six financial holdings as categorised by the Registrar of Financial Institutions (2022) were analysed bringing the total of data subjects to twenty. The other two financial holdings were also listed on the Malawi Stock Exchange.

Document analysis was adopted as it guaranteed independence from the data subjects in view of the sensitivity of the matter. There was no compromise on the findings as there was readily available data as outlined in the annual reports distributed to the shareholders.

4.0 Findings and discussions

4.1 Management fees income for listed companies

Only three out of seventeen listed companies declared to have received management fees from the subsidiaries. These were technically institutional investors. This represents 17.6 percent. A critical review however indicates that a certain listed company has some subsidiaries which levy the management fees from fellow subsidiaries (including those listed on the Malawi Stock Exchange) and therefore the management fees ought to have either appeared in the consolidated or separate financial statements.

The listed companies which levy management fees from their subsidiaries are therefore quantified as four as per the table 1 below.

Table 1: Listed companies which levy management fees from investee

No	Firm	No. of Subsidiaries	No. of Joint Ventures	No. of Associates
1	V	7	1	0
2	X	5	0	0
3	Y	9	2	4
4	Z	9	1	1

Total dividend received to total management fees is presented in Table 2 below:

No	Firm	Dividend received to management fees received	
		2023	2022
1	V	2.3496	2.0956
2	X	0.2999	2.2313
3	Y	50.5135	30.8828
4	Z	N/A	N/A

N/A - means not not available.

While dividends received might include income from other investments under IFRS 9, these were deemed immaterial and inconsequential to affect the results of this study.

4.1.1 Analysis of Firm V' management fees and dividend

Firm V did not disclose how much management fees it charged or collected from its subsidiaries. The management fees were merely mentioned as part of the temporary differences in the calculation of the deferred tax.

The critical look at the consolidated financial statements of Firm V indicate that the management fees are part of the shared services. Further analysis of the financial statements of the material subsidiaries indicate that management fees were also paid to a fellow subsidiary created as a special purpose vehicle exclusively established to provide shared services. The special purpose vehicle is situated at the group head office. The management fees payable to that fellow subsidiary would have reduced the Dividend Received to Management Fees Received of 2.0956 and 2.3496 in 2022 and 2023 respectively. This indicates extractive behaviour as the parent company is able to get substantial management fees when compared to dividend received as shows that for every two parts of a dividend received from the subsidiaries, joint ventures and associates, half of that amount is earned from the management services it offers to such investees which other investors are not capable of enjoying.

4.1.2 Analysis of Firm X' management fees and dividend

Firm X depicts a volatile management fees policy as there was a substantial rise in 2023 from 2022. This shows an inverse relationship in Firm of X in respect of the dividend received from the subsidiaries to management fees charged on the subsidiaries. This possibly indicates income smoothing strategy in which the parent company pursues steady income flows and therefore opted to earn more management fees while the dividend income substantially dwindled. That is a clear sign of the majority shareholder's extractive behaviour.

4.1.3 Analysis of Firm Y' management fees and dividend

Firm Y indicates that management fees are insignificant to the dividend received from the subsidiaries, joint ventures and associates. This could indicate that the majority investors of Firm Y do not practise extractive behaviour and look forward to receiving dividend as compensation for acquiring and maintaining the equity instruments in the investees. There appears to be no extractive behaviour of the majority investors of the parent company.

4.1.4 Analysis of Firm Z' management fees and dividend

Firm Z did not disclose how much management fees it levies from its subsidiaries, joint ventures and associates. A critical review of this firm however reveals that it is very active on the Malawi Stock Exchange so that management fees are levied between or amongst its investees and these are not eliminated during the consolidation process.

Firm Z has a management company as a wholly owned subsidiary which provides management services to some of the parent's (Firm Z) investees. That wholly owned subsidiary is now termed Z_1 and provides management services to several listed companies on the Malawi Stock Exchange. Some of the pertinent information regarding Z_1:

a) Earned substantial management fees in listed company K for the last four years in the company which Z claims to be a mere investment which has not declared dividend during the same period. This indicates extractive behaviour by the institutional shareholder which only acted in the best of itself (self interest) at the expense of the other shareholders.

b) It manages the affairs of listed company L. The management fees it levies are double the dividends which the entire group receives from the listed company L. It would therefore be concluded that management fees are more valuable to the group and might not pursue profitable ventures to increase the profits of the listed Company L as it is already enjoying huge management fees at the expense of other shareholders of the said listed company.

c) It jointly manages a listed company M whose total dividend payout was less than the management fees for both 2022 and 2023. The management fees meant that the group was extracting more value from the listed company M and therefore decisions regarding increasing profitability for the purposes of paying out higher dividends might not have been prioritised. That is the proof of the institution investor's extractive behaviour.

4.2 Financial holding approach to management fees

The four financial holding companies were analysed and had the details as per the table 3 below:

Table 3: Malawi's licenced financial holdings

No	Firm	No. of Subsidiaries	No. of Joint Ventures	No. of Associates
1	R	7*	1	0
2	S	5	0	2
3	T	4	0	0
4	U	3	0	0

*Refers to an unrecognised subsidiary which another financial institution discloses that it is the subsidiary of the subsidiary of the financial holding company R which ought to have increased the number to eight subsidiaries.

4.2.1 Financial holding company R

Six out of the seven subsidiaries of financial holding company R are wholly owned subsidiaries and therefore not subjected to this study as there are no other shareholders to be affected by the decisions regarding the amount, timing and extent of the remittances of the management fees. There is however one subsidiary which meets the criteria of this study. The subsidiary expensed management technical fees equivalent to 20.29 percent of the declared dividend but this was not disclosed in consolidated financial statements. This is a material misstatement of the financial statements and possible indication of the concealment of the additional income. The management fees expensed by the subsidiary did not however indicate extractive behaviour by the majority investors.

4.2.2. Financial holding company S

Four out of the five subsidiaries are wholly owned subsidiaries and therefore excluded from this study. The fifth subsidiary was however partially owned by other investors as it is also listed on the Malawi Stock Exchange. The management fees were levied through a wholly owned subsidiary. The total dividends received by the Financial holding S was merely 11.14 percent and 13.58 percent of the management fees indicating that the Financial holding S collected substantial management fees when compared to dividends received and that is extractive behavior as it earned substantial management fees at the expense of the other shareholders.

4.2.3 Financial holding company T

Three out of the four subsidiaries are wholly owned and the fourth one is listed on the Malawi Stock Exchange and therefore of interest to this study. The listed subsidiary disclosed in its financial statements that it had paid management fees to its fellow subsidiary for services rendered to the entire group. The dividend received to management fees ratio was 505:1 and 326:1 in 2023 and 2022 respectively indicating that there is no extractive behaviour by the majority shareholder in trying to maximize the profits from the publicly listed subsidiary.

4.2.4 Financial holding company U

This holding company has three wholly owned subsidiaries and therefore no possibility of investigating the extractive behaviour in the absence of the outside investors.

4.3 Regulatory instruments to control management fees

4.3.1 The Malawi Stock Exchange Listings Requirements

Section 10.2 (1) of the Malawi Stock Exchange Listings Requirements 2023 stipulates that any listed company is required to consult the Malawi Stock Exchange for any potential related party transaction whose value is in excess of 1 percent of the total book value as per the last audited financial statements. Section 10.5 (i) however stipulates that revenue transaction (revenue in nature in the ordinary course of business) is not a related party. Management fees arise from technical and from the shared services are therefore outside the scope of the monitoring by the Malawi Stock Exchange. This position does not protect the minority shareholders from the extractive behaviour of the majority shareholders who use related party transactions to enhance their income despite dwindling or stunted capital gains and dividends.

4.3.2 Reserve Bank of Malawi Directive on holding companies

Part VIII of the Financial Services (Licensing and Regulatory Requirements for Holding Companies) Directive, 2018 prescribes the permissible and non-permissible activities. Section 21 lists non-permissible activities and section 21 (c) annotates:

[(c) derive or receive income from sources other than the following:-
(i) dividend income;
(ii) income from the shared services where applicable;
(iii) interest earned from idle funds invested in government securities or placements with banks or discount houses;
(iv) profit on disinvestment from subsidiaries or significant minority investments or interests; or
(v) any other sources as may be approved by the Registrar.].

Section 20 (2) of the Financial Services (Licensing and Regulatory Requirements for Holding Companies) Directive, 2018 avers:

[A holding company may with prior approval of the Registrar provide shared services only in the following areas:

(a) human resources;
(b) internal audit;
(c) risk management and compliance;
(d) information communication technology;
(e) legal and company secretarial; and
(f) any other services as may be approved or prescribed by the Registrar.].

These are obviously stringent conditions but financial holding companies are capable of circumventing them through use of other wholly owned subsidiaries so that they are capable of extracting substantial income from the subsidiaries by levying management fees on provision of other services rather than the permitted shared services. This is an area which the Reserve Bank of Malawi must seriously evaluate and put appropriate measures.

5 Conclusion and recommendations

The findings of this study has uncovered evidence of overdependence for the management fees for some institutional investors over their investees resulting in extractive behaviour at the expense of other investors who solely rely on dividend as source of income. There is no evidence that increased oversight through the management services result in increased profits leading to higher dividends. The findings have shown that management fees for a certain company for the past four years were quite substantial while it has persistently made losses such that only one institutional investor with a management contract has been able to extract substantial income while the market share price has stagnated giving no tangible benefit to the other shareholders.

There should be deliberate effort by the Malawi Stock Exchange and the Reserve Bank of Malawi to cap management fees to a maximum of 10 percent of the dividend income received from the investee. This should include management fees earned through fellow subsidiaries. This would lessen the institutional investors' overdependence on the management fees from the investees as that promotes self dealing and self review which distorts the market dynamics in the medium to long term. The institutional investors must spend much of their energy towards directing the financial and operating policies of the investees so as to realise economic benefits in form of high but sustainable dividends and high capital gains instead of considering investees as guaranteed or locked up customers to fleece as much income as possible at the expense of other less powerful minority investors.

It is also recommended that minority shareholders must take keen interest in checking the related party transactions between the companies they invest in and the institutional investors who hold substantial equity stakes therein. The moral persuasion through accountability at the annual general meetings can force the directors representing the institutional shareholders to think deeply about the cost benefit analysis of the management fees at the expense of the rest of the shareholders.

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