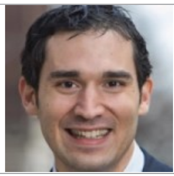

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Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Structures


By Hyunseob Kim and Roni Michaely April 12, 2018

Lawyers and academics generally have a dim view of dual-class share structures. When Snap Inc., a technology-based social media company, was preparing for its initial public offering (IPO) in early 2017, for example, CalPERS and many other prominent institutional investors harshly criticized the company's move to create another share class with no voting rights.[1]

The main drawback of a dual-class share structure is, of course, that insiders who control the firm with voting rights that are disproportionately greater than their cash flow rights can easily take advantage of dispersed outside shareholders. (Co-founders Bobby Murphy and Evan Spiegel, for example, jointly own 45 percent of Snap shares but control more than 70 percent of votes.) Since managers-insiders control more votes relative to their cash flow rights, they may have less incentive to maximize a company's performance and more incentive to collect perks or build an empire that is not in the best interest of other shareholders.

The usual mechanism for protecting against this type of exploitation is monitoring by other shareholders, especially institutional or activist investors. However, under a corporate governance structure that allows insiders to control key corporate decisions through dominating voting power, independent monitoring by the board of directors or intervention by external shareholders is difficult.

Yet the recent IPOs of Google, Facebook, Alibaba, and other prominent companies have included a dual-class share structure. This observation is what led us to look more closely at the potential benefits of that structure. The key benefit is that it allows firms to avoid costly takeover defense and a myopic focus on short-term profits, enabling them to maximize long-term value. Given that outside investors are typically less informed than insiders about the quality of investments for young firms, we argue that this protection from capital market pressure is particularly beneficial for those firms. However, these net benefits will decline as firms mature, growth options dwindle, and the founders are no longer around.

In our paper, "Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Structures," we examine how the benefits of dual-class share structures, net of costs, evolve over a firm's life. We constructed a comprehensive database of more than 900 unique dual-class firms in the United States over almost 50 years, from 1971 through 2015. Using the data, we show first that young dual-class firms (i.e., younger than or equal to the 11-year median age of firms in the sample since their IPOs) have 6 percent to 7 percent greater firm value, measured by Tobin's Q, relative to single-class firms of the same maturity, in the same industry, and with other, similar characteristics. This finding suggests that young dual-class firms have higher value than young single-class firms. However, as they nature, dual-class firms experience 7 percent to 9 percent greater declines in Tobin's Q than do single-class firms. Moreover, we find that, as firms mature, operating margins and labor productivity deteriorate significantly more for dual-class than single-class firms, other things held constant. These findings are consistent with the prediction that adopting a dual-class structure becomes costlier to minority shareholders as firms mature. One implication of the findings is that dual-class firms may not adjust their share structures optimally to changing circumstances over their lives.

We further explore the data to investigate what underlies the dynamics of dual class firms' value and performance. First, we find that the voting premium for superior classes of shares is 2.8 percent higher for mature dual-class firms than young ones. A plausible explanation is that private benefits of control, a cost to minority shareholders, increase over firm maturity at dual-class firms. Second, dividend increases and initiations are associated with more positive market reactions for mature dual-class firms than young ones. This suggests that the agency costs of withholding cash are more acute for mature dual-class firms. Third, we find that firms' pace of innovation declines faster for mature dual-class firms than their single-class counterparts, suggesting that the benefits of adopting a dual-class structure, such as protection of capital market pressure, decrease over a firm's life. Finally, we find evidence that mature dual-class firms make investment and employment decisions that are less sensitive to investment opportunities, making their cash flow riskier and increasing their costs of capital.

Overall, the evidence in our paper suggests that the costs of a dual-class share structure increase significantly as they mature, and the benefits of being shielded from capital markets, which allows firms to invest in long-term projects such as innovation, appear to decrease. Thus, the results in our paper challenge the dominant view that dual-class voting is not optimal. Instead, we argue that one solution to the agency problem at mature dual-class firms could be to create a sunset provision for the dual-class structure, which would set a threshold event that would automatically trigger an end to the structure. This type of provision is supported by legal scholars and practitioners.[2] Thus, one important implication of our research is that, rather than banning dual class structures, as the Hong Kong Exchange has done, firms and investors might be better off allowing these structures as long as they are accompanied by appropriate sunset provisions.

ENDNOTES

[1] For example, see Stephen Foley and Hannah Kuchler, "Snap's offer of voteless shares angers big investors," The Financial Times, February 3, 2017.

[2] See e.g., Bebchuck, Lucian A, and Kobi Kastiel, 2017, The Untenable Case for Perpetual Dual-class Stock, working paper, Harvard Law School, and the Commonsense Corporate Governance Principles (2016).

This post comes to us from professors Hyunseob Kim and Roni Michaely at Cornell University. It is based on their recent paper, "Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Structures," available here.