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Politických vězňů 7, P. O. Box 882, 111 21 Prague 1, Czech Republic ▪ phone (+420) 224 005 123, fax (+420) 224 211 374 ▪ www.cerge-ei.cz, office@cerge-ei.cz

Rent Extraction by Large Shareholders: Evidence Using Dividend Policy in the Czech Republic

JAN BENA, LSE AND CERGE-EI (JAN.BENA@CERGE-EI.CZ)
JAN HANOUSEK, CERGE-EI (JAN.HANOUSEK@CERGE-EI.CZ)

Failures in corporate governance have recently attracted wide attention around the world. In the US, where most corporations have dispersed ownership, corporate governance researchers and practitioners concentrate predominantly on how to align incentives of management with those of atomistic shareholders; these efforts are aimed at addressing the recent well publicized scandals. For example, Enron became most famous when it was revealed that it was sustained mostly by institutionalized, systematic, and well-planned accounting fraud organized by its management. Similarly, the former CEO of Tyco International resigned and was under investigation for stealing hundreds of millions from the company. In contrast to the US, the predominant form of ownership in Europe and East Asia is control by a large shareholder, which often supplies top management. Reflecting such very different ownership structure, the attention of corporate governance is shifted from solving management-shareholder conflict to solving the one amongst shareholders themselves. Governance by dominant owners hasn't proved faultless either. For instance, it is widely believed that the East Asian financial crisis in the late 1990s was to a large extent due to the presence of malfunctioning corporate governance structures based on a concentration of ownership with features of "crony capitalism".

Our research tries to uncover the functioning of corporate governance in the Czech Republic—an emerging market economy in Central Europe. Similarly to Western Europe, the ownership structure of most Czech firms is highly concentrated. The specificity of the Czech Republic is that, after privatization which allocated fundamental ownership rights, the evolution of institutional structures was slow and corporate law was completely novel and only weakly enforced. In other words, corporate governance mechanisms which are present in developed European economies and which were documented to play a key role in governing the relationship between corporate insiders and outsiders and among outsiders themselves were emerging from scratch. In this unique institutional framework, we study the behavior of large shareholders and try to see how the conflict between controlling owners and minority shareholders is resolved.

> *As controlling shareholders are in power to decide whether and how firm's profits are distributed, the corporate governance mechanism in concentrated ownership structures should predominantly ensure that all shareholders are equally treated per unit of stake in the firm.*

We document the decisions taken by large shareholders about how corporate profits are distributed by analyzing the dividend policy of more than 1,500 large Czech firms in the period 1993-2003. Our analysis is the first comprehensive empirical study of dividends from a transition country in Central and Eastern Europe. We follow the literature by arguing that large shareholders can have a dual impact on firms. On the one hand, significant owners have a strong incentive to monitor management to ensure that a firm's value is maximized, while on the other, their behavior is motivated by the possibility to extract rents and enjoy the private benefits of control. Legally, all shareholders have the same cash flow rights in the Czech Republic. Paying dividends follows this principle as distributed cash reaches all shareholders proportionally, but a dominant shareholder exerting effort to seek private benefits associated with ownership does not. As controlling shareholders are in power to decide whether and how firm's profits are distributed, the corporate governance mechanism in concentrated ownership structures should predominantly ensure that all shareholders are equally treated per unit of stake in the firm. The key question we answer is whether rent extraction by large shareholders takes place in the Czech Republic and how substantial it is. Also, we investigate whether minority shareholders are able to monitor large shareholders in order to preclude significant rent extraction.

We find that corporate dividend policy in the Czech Republic depends on concentration and domicile of ownership. We consider several levels of ownership concentration, several types of the single largest owner, and investigate the difference between domestic and foreign owners. The Czech largest owner has a positive but small effect on the probability to pay a dividend, 0.11. In contrast, if the largest owner is foreign, the probability to pay a dividend is positive and very large, 0.35. In line with these findings, the target dividend payout ratio (long-term annual dividend payout as a fraction of profit) for foreign-owned firms of 0.46 is substantially higher than for Czech-owned firms at 0.12. Overall, foreigners use dividends to distribute profits more often and aim at a higher target payout ratio than Czechs. These results are summarized in the following table:

Table 1: Probability of paying out dividends and the target payout ratio (long-term annual dividend payout as a fraction of profit) associated with Czech and foreign ownership.

	Probability the ownership structure pays dividends	Target payout ratio associated with the ownership structure
Czech owned firms	0.11	0.12
Foreign owned firms	0.35	0.46

Dominant shareholders extract rents from firms and do enjoy private benefits of control. Significant minority shareholders limit rent extraction by increasing dividend payout. Rent extraction and dilution of minority shareholders seems to be associated predominantly with Czech owners as foreigners pay higher dividends relative to Czechs.

The most interesting results are for the concentration of ownership: Firms with a dominant majority owner pay dividends less often and their target payout ratio is small. In contrast, firms with a majority owner and at least one strong minority owner (monitored majority) pay dividends more often and the target payout ratio is large. The probability that a firm with a dominant Czech majority owner pays a dividend is 0.09. If the Czech majority owner is accompanied by a significant minority shareholder (Czech monitored majority) the probability increases to 0.16. The same pattern holds for foreigners. The probability that a firm with a dominant foreign majority owner pays a dividend of 0.26 is a lot lower than the same probability if the majority owner is accompanied by a significant minority shareholder 0.58 (foreign monitored majority). The associated target payout ratios for these ownership structures are as follows: positive but very close to zero for the dominant Czech majority ownership structure; 0.82 for the Czech monitored majority ownership structure; 0.61 for the dominant foreign majority ownership structure; and 0.86 for the foreign monitored majority ownership structure. These results are summarized in Table 2.

The above set of results for ownership concentration supports our hypothesis that, first, dominant shareholders extract rents from firms and do enjoy private benefits of control and, second, significant minority shareholders limit rent extraction by increasing the probability that a dividend is paid and increasing the target payout ratio. The presence of strong minorities shifts the dividend policy in the same direction both for Czech as well as for foreign largest owners and we highlight that minority shareholders play a key role in determining dividend policy in the Czech Republic. Our results indicate that rent extraction and dilution of minority shareholders seems to be associated predominantly with Czech owners as foreigners pay higher dividends relative to Czechs in all cases. All results are robust to alternative definitions of key ownership variables, the way we control for corporate capital budgeting and financing policy, and use of alternative econometric techniques.

Regulators should support the development of sound and transparent financial markets prevalent in Western Europe as they seem to police dominant owners most effectively.

Our analysis of expropriation from the perspective of dividends, while narrow in scope, does provide quantitative evidence on the expropriation that takes place within Czech companies. Expropriation by large owners or corporate insiders in general is not simply a matter of redistribution amongst shareholders only. It is damaging more generally as corporate insiders might choose to invest in projects with low or negative returns just because they create opportunities for expropriation. Investment decisions are hence distorted and corporate growth is slower than it could be. Such inefficient investment behavior, if undertaken by a large number of firms, has adverse effects on the whole economy. This is of an exceptional interest in countries like the Czech Republic which struggle to catch up with the developed economies of Western

Table 2: Probability of paying out dividends and the target payout ratio (long-term annual dividend payout as a fraction of profit) according to concentration of ownership.

	Probability the ownership structure pays dividends	Target payout ratio associated with the ownership structure
Majority controled firms & the largest owner is Czech	0.09	Positive but close to zero
Firms owned by a majority shareholder accompanied by a strong second largest owner & the largest owner is Czech	0.16	0.82
Majority controled firms & the largest owner is foreign	0.26	0.61
Firms owned by a majority shareholder accompanied by a strong second largest owner & the largest owner is foreign	0.58	0.86

Europe. Each dollar available for investing should be allocated to growth opportunities with the highest returns and should not be invested based on what projects make expropriation easy. To address these problems regulators should, first, strengthen the rights of minority shareholders to enable them to limit expropriation. Second, and more importantly, regulators should support the development of sound and transparent financial markets prevalent in Western Europe as they seem, based on extensive both anecdotal and research evidence, to police dominant owners most effectively. We believe that our findings based on data from the Czech Republic and conclusions we make may to a large extent be valid for other CEE countries as they underwent a similarly quick transition from a state-directed to a market economy and face similar challenges.

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Principal Investigators:

Jan Bena
jan.bena@cerge-ei.cz
LSE and CERGE-EI

Jan Hanousek
jan.hanousek@cerge-ei.cz
CERGE-EI