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Impact of Corporate Governance on Shareholder Value Creation: Evidence from Tunisian Context

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Abstract

The aim of this study is to examine the impact of corporate governance on shareholder wealth. The emphasis here is placed on the hypothesis that separating ownership from management has a significant effect on shareholder value creation. The empirical analysis is based on a data set of Tunisian listed companies for the period 1997-2006. As predicted by theory, the results show that the presence of institutional investors in ownership structure seems to exercise effective control over the external manager. Capital concentration appears to have a negative effect respectively on performance and value creation. The presence of outside directors has a significant negative impact on value creation and performance of Tunisian firms.

Keywords: ownership structure, board of directors, entrenchment, shareholder value creation

1. Introduction

The difficulties encountered in some companies' management practices led to a great deal of corporate governance research. Starting with the debate initiated by Berle and Means (1932) on the particular organizational form of firms' management, the issue of governance is attached in agency theory where it highlights the existence of conflicts arising from maximizing each player's own utility at the expense of the other. In the early 1990s, defined as a broad concept which covers the various ways in which individuals and groups organize themselves to achieve common goals, corporate governance phenomenon has expanded around the world in order to recommend more transparency and ethics to delineate the responsibilities of leaders. It has been treated as a set of rules and mechanisms put in place to ensure the balance of power between the governing bodies, management, and control. The debate on the ownership structure and value creation of firms is still important for many academics and the empirical results found are often contradictory. Most of the work on this relationship solicits the idea that ownership structure is an effective way to control and manage the company managers (Fama & Jensen, 1983; Shlefier & Vishny, 1997). More recent work; Cho (1998); Himmelberg (1999); Demsetz and Villalonga (2001); found that the impact of ownership on firm value is not significant through the use of simultaneous equation models. In the same context, Denis (1997) suggested by empirical research in the United States context that the concentration of capital strengthens the control of managers and therefore can cause destruction of shareholder value.

Our research focuses on the following main question: What is the impact of the problem of separating ownership from decision on performance and shareholder value creation? In other words, can governance mechanisms as explained by ownership structure and board characteristics contribute to increase wealth of the company? The remainder of this paper is organized as follows: section 2 reviews the literature regarding the relationship between corporate governance and shareholder value creation. Data and methodology are presented in section 3. Our empirical results will be discussed in section 4. Section 5 will analyze the simultaneous effects of ownership structure and Board of directors on value creation. Section 6 concludes.

2. Literature Review and Hypotheses Development

2.1 The Impact of Ownership Structure on Value Creation

Under the agency hypothesis, Shareholders may invest in management control of the firm since they dispose of a non-negligible share of the additional profits and have a significant equity stake in the company. Moreover, they hold voting rights to influence managers and may exercise some level of control or participation in the activities of the firm. Thus, according to Schleifer and Vishny (1989), Hill and Snell (1989; 1997) and Denis et al. (1997), the more concentrated the capital is, the more reinforced control is, where the limitation lies in managers taking unprofitable strategies.

The results of the empirical studies conducted in the last two decades on capital concentration show the positive influence of the presence of controlling shareholders on firm performance (Schleifer & Vishny, 1986; Bethel & Liebeskind, 1993; Agrawal & Knoeber, 1996; La Porta & Vishny, 1997; Kaserer & Moldenhauer, 2005; Boubakri et al., 2005). According to Demsetz (1983), Demsetz and Lehn (1985) , Demsetz and Villalonga (2001), maximizing firm value is not conditioned by capital concentration, but by its environment and its market characteristics. This has been confirmed by studies of Mtanios and Paquerot (1999) who also found no significant relationship between capital concentration and firm performance.

H1: Capital concentration is a positive element to the exercise of effective control by shareholders and therefore has a positive effect on performance and value creation.

Ownership structure is also based on the existence of institutional investors who hold the highest fraction quoted on financial markets namely insurance companies, "Deposits and Consignments Funds", banks securities, collective Organizations Investment in Transferable Securities, pension Funds. Therefore, the assumptions of conflicts of interest and alignment strategies suggest a negative relationship between institutional ownership and corporate value. Bathala et al. (1994) and Seetharaman et al. (2001) suggest that institutional investors have an important impact on management as well as on solving agency problem. Pound (1988), McConnell and Servaes (1990) put forward the idea that institutional ownership serves as a signal for the value of the company. Therefore, the more institutional ownership is, the greater business performance is.

H2: The higher the percentage of participation of institutional investors in the capital is, the higher the value of the company increases.

Furthermore, the increase in managerial ownership should also lead to a positive signal on firm value because the higher the capital share held by managers is, the lower the conflict of interests between shareholders and managers. However, several studies found empirical evidence that shows that, when managers' participation is higher, it is negatively correlated with firm value. According to Morck et al. (1988), Jensen and Ruback (1983), there is a nonlinear relationship between CEO participation and firm value and suggest that the higher managerial ownership is, the lower firm value is.

H3: The higher the percentage of managerial ownership *is, the higher the value of the company increases*

2.2 The Impact of Board of Directors Characteristics on Value Creation

According to Faleye O. (2004), a board is simply a group of individuals working together to accomplish a common goal. Hence, its success depends on the dynamics and interaction of this group. Board size is a very important feature that it may have an impact on this process. By combining board size with measures of firm performance, Yermack (1996) showed that there is a significant negative relationship between board size and firm value as measured by Tobin's Q.

H4: Board size of has a positive impact on firm performance but negative on value creation.

Duality indicates the power structure in the board when the manager occupies at the same time Chairman of the Board of Directors. Fama and Jensen (1983) and Jarrell, Brickley and Netter (1988), suggested that duality is negatively related to firm performance and value creation. Uma and Marsinko (1997) have shown that duality reduces independence of the board and results in costs due to conflicts between the board and the manager. However, Boyd (1994) showed that duality actually translates into a loss of firm performance. *Christine* Panasian (2004) suggests that duality is not a significant factor in explaining firm performance.

H5: The duality has a negative impact on business performance.

An outside director must not have significant contractual relationship with the company. They are supposed to play a greater role in controlling managers since they are neither a shareholder nor former official in the company. According to Fama (1980), an outside director is considered a professional arbitrator whose main task is to stimulate and control competition among senior executives of the company. Thus, they are more efficient than internal directors in monitoring and disciplining managers (Rosenstein & Wyatt, 1990; Byrd & Hickman, 1992). Indeed, Godard and Schatt (2004) put forward the idea that outside directors have an important role in the sustainability of the effectiveness of board performance. In the same vein, Mehran (1995) finds a positive relationship between firm performance and the proportion of outside directors.

H6: The presence of outside directors has a positive effect on firm value creation.

3. Data and Methodology

3.1 Sample Selection

The sample consists of 30 companies listed on the Tunisian Stock Exchange Tunis (TSE) in the period 1997-2006. We choose 1997 because it marks the continuation of the process of consolidation and regulation of the Tunisian financial market. This process began in 1994 through rigorous regulatory, legal and innovative texts inspired by the regulation of Paris Stock Exchange. Moreover, in 1997 Tunisia adopted the new accounting system that seemed more dynamic and adapted to the new ambitions of the Tunisian economy.

3.2 Variables Definition

3.2.1 Dependent Variable

To capture aspects of shareholder value creation we use proxy variables like Tobin's Q, market and economic value added. These standards indicators as supposed to measure firm performance on its economic and financial assets.

- **Tobin's Q** is the ratio calculated by dividing the market value of the company by its replacement value. The numerator is the sum of market value of equity and book value of liabilities, while the denominator is the book value equity and liabilities.
- **Ratio of market value added** (RMVA) is obtained by the following formula: RMVA = MVA/TA = (VM – VC)/TA, Where VM, VC, and TA are respectively market value of the firm including the firm's equity and debt, the book value of invested capital in the firm, and total assets.
- **Ratio of economic added value (REVA)** is calculated by dividend EVA on total assets. Where EVA= NOPAT-WACC*CI. NOPAT is net operating profit after taxes, WACC is weighted average cost of capital and CI is the amount of capital invested.

3.2.2 Independent Variables

The exogenous variables are indicators of ownership structure (internal control mechanism);

- **Capital concentration (SHIFT)**: Measured by the percentage of capital held by the top 3 shareholders.
- **Companies' capital participation (INST)**: Measures the percentage of capital held by firms measured by the ratio: Number of shares held by institutional investors / total number of shares.
- **CEO's capital participation (DIR)**: Is a dummy variable that takes the value 1 if there is participation and 0 otherwise.
- **Board size (TCON)**: Total number of directors within the company.
- **Management duality (DUAL)**: 1 if the CEO and Chairman of the Board positions meet in one person, 0 otherwise.
- **Participation of outside directors (AEXT)** measured by the number of outside directors divided by board size.

3.3 Regression Specification and Estimation Methodology

To estimate the impact of ownership structure (Model 1) and Board characteristics (Model 2) on the shareholders value creation we use the general specifications as follows:

$$SVC_{it} = \lambda_0 + \lambda_1 OWS_{it} + \lambda_2 CV_{it} + \varepsilon_{it} \quad (1)$$

$$SVC_{it} = \mu_0 + \mu_1 BOARD_{it} + \mu_2 CV_{it} + \nu_{it} \quad (2)$$

Where:

- SVC is shareholders value creation as measured by dependant variables: Tobin's Q, RMVA and REVA.
- OWS is ownership structure variable as measured by basic independents variables: ownership concentration (MAJ), Institutional investor participation (INST) and managerial ownership (DIR).
- Board characteristics as measured by Board size (TCON), Management duality(Dual), and participation of outside directors (AEXT).
- CV control variables as measured by: size of the firm (**Size** measured by Log (total assets)), leverage (**Debt** measured by ratio of long term debt to book value of equity), free cash flows (**FCF** measured according to Jensen (1986)), solvability (**SOL** measured by total equity to total assets), age of the firm (**AGE**) and liquidity (**LIQ** measured by liquidity to short term debt).

4. Estimated Results and Discussion

4.1 Study of the Impact of Ownership Structure on Value Creation

Estimates of the previous models using a pooled least squares (the analysis of our panel shows that there is a global homogeneity) are significant. This has encouraged us to use the common effect method (Pooled Least Squares). The used regressions coefficients reflect the structure of our data and are summarized in the tables below:

Table1. Impact of ownership structure on shareholders' value creation (model 1)

Model 1: $SVC_{it} = \lambda_0 + \lambda_1 OWS_{it} + \lambda_2 CV_{it} + \varepsilon_{it}$			
	Regression 1: **Tobin's Q**	Regression 2: **RMVA**	Regression 3: **REVA**
C	**18.19421*** **	**5.860156*** **	**0.082809***
MAJ	**-1.908898** **	-0.321363	0.014556
INST	**1.640993** **	**1.104959*** **	0.005077
DIR	-0.590564	0.183994	3.99^{E}-05
Size	**-1.932090*** **	**-0.725771*** **	**-0.010929***
DEBT	**1.400009***	-0.118876	**-0.034413** **
FCF	**17.65862*** **	**7.050976*** **	**0.460205*** **
SOL	**-5.714065*** **	**-1.929422*** **	**-0.037801** **
AGE	**0.021406*** **	**0.014023*** **	0.000147
LIQ	0.001231	-0.000225	8.34E-05
Adjusted R^2	0.306779	0.268790	0.409010

Where SVC is shareholder value creation or performance as measured by Tobin's Q, RMVA, REVA. OWS is ownership structure as measured by MAJ, INST, DIR. CV is control variables as measured by SIZE, DEBT, FCF, SOL, AGE, LIQ.

Note. *, **, *** respectively significant 10%, 5%, 1% thresholds.

The Table 1 shows that capital concentration variable (MAJ) does not have the same effect in the three regressions. We note that capital concentration is significant and has a negative impact in regressions 1 and 2 which rejects our hypothesis H1 and corroborates, on the one hand, the work of Kirchmaier and Grant (2005), Thomsen, Pedersen and Kvist (2006) who argue that the impact of capital concentration on performance is negative. On the other hand, it confirms the results of the neutrality thesis as developed by Demsetz (1983), Demsetz and Lehn (1985) and Demsetz and Villalonga (2001). Thus, capital concentration represents in fact only one aspect of ownership structure, and seems insufficient to determine the impact of ownership structure on shareholders' value creation.

Moreover, the estimation results show that the variable Institutional investor participation (INST) has a positive and significant effect in regressions 1 and 2. This corroborates our hypothesis H2 and confirms the study by Omri (2002) in Tunisia context, where he showed that institutional investors holding large shares of capital are involved in the control and management of companies. Moreover, these institutional investors influence the modes of business organization through their skills in multiple areas, which consequently improves firm's value creation.

We also note that CEO capital participation (DIR) is insignificant in the three regressions discussed above, and where it has a negative effect on Tobin's Q, which rejects our hypothesis H3 and confirms the study by Morck, Shleifer, and Vishny (1988), Jensen and Ruback (1983), which suggest that manager participation negatively correlates with firm value creation.

Regarding the impact of firm size on performance (SIZE), the relationship is significantly negative on Tobin's Q, which is infirmed by the results of De Miguela et al. (2002). Some authors consider that larger companies often get superior performance, economies of scale, economies of scope, market power, learning effect and experience and they have the means and capabilities to invest in the most efficient and sophisticated systems of governance which is not confirmed Omri (2002) where "performance is not influenced by company size".

Apart from the constant variable (C) which has the largest contribution with a high and significant coefficient of

18.194, the variable (FCF) shows its explanatory power of creating value where it is significant for firm performance models (Tobin's Q) with a positive effect, as well as value creation. For the variable solvability (SOL), it is significant for performance and value creation with a negative effect, while the variable (AGE) is significant and has a positive effect on RMVA value creation ratio. Moreover, value creation (as measured by REVA) is negatively and significantly associated to debt (DEBT), i.e., the less leveraged firms are the less eligible they are to create value in contrast to performance (measured simultaneously by Tobin's Q). This is explained by the fact that Tunisian firms consider debt as a means of financing in the event of insufficient liquidity and thus it is used as a leverage effect which increases firm value. Debt is then considered as a signal of good financial situation of the firm Ross (1973).

4.2 The Impact of Board of Directors Characteristics on Value Creation

For board size variable (TCON), empirical results (Table 2) show a significant positive relationship with Tobin's Q which is consistent with our basic hypothesis (H4), and those of Adams and Mehran (2003) and Louizi (2006) stating that board size has a positive impact on performance. However, we also note its weak influence on value creation process. Note that dual management (DUAL) has a negative and statistically significant impact on value creation confirming the findings of Panasian (2004) and Boyd (1994), who found that this form of ownership creates negative effects on the value creation process. The percentage of outside directors (AEXT) have negative relationships that are significant with performance as measured by Tobin's Q, as well as value creation as measured by REVA ratio (model 3), which does not support our hypothesis (H6).

For the control variables and their influence on value creation, we note that firm size (SIZE) has a negative and significant sign, which is not confirmed by the results found Boyd and Runkle (1993); Pinteris (2002), Adams and Mehran (2003), which support the idea that performance is positively associated with firm size. Regarding the debt ratio (DEBT), it has a negative and statistically significant impact on REVA ratio, and a positive and significant impact on Tobin's Q, which is consistent with research by Jensen (1993) and Harry et al. (2002), who suggest the existence of a positive relationship between financial structure and performance of listed firms. For the variable solvability (SOL), it is significant for performance and value creation with a negative effect. The variable (AGE) is significant and has a positive effect on value creation variables namely RMVA and REVA, and has a positive and significant effect on performance variables with stock return and Tobin's Q. Moreover, the variable (FCF) has the largest contribution with a high and significant coefficient (18.373) which shows its explanatory power of performance. It is also significant for the variable value creation (RMVA and REVA) with a positive effect.

Table 2. The impact of board characteristics on value creation (model 2)

Model 2: $SVC_{it} = \mu_0 + \mu_1 BOARD_{it} + \mu_2 CV_{it} + \nu_{it}$			
	Regression 1: **Tobin's Q**	Regression 2: **RMVA**	Regression 3: **REVA**
C	**14.93553*** **	**5.581269*** **	**0.123367*** **
TCON	**0.183420** **	0.058050	-0.000171
AEXT	**-1.843856*** **	-0.064264	**-0.022262** **
DUAL	-0.264644	**-0.363178*** **	**-0.020921*** **
Size	**-1.781912*** **	**-0.722701*** **	**-0.011641** **
DEBT	**1.671721** **	-0.178310	**-0.032432** **
FCF	**18.37391*** **	**6.732639*** **	**0.461433*** **
SOL	**-4.554866*** **	**-1.583879*** **	**-0.033435** **
AGE	**0.024222*** **	**0.015663*** **	**0.000177* **
LIQ	0.004254	0.000566	3.49E-05
Adjusted R^2	0.322648	0.270966	0.472856
Where SVC is shareholder value creation or performance as measured by Tobin's Q, RMVA, REVA. BOARD is board characteristics as measured by TCON, AEXT, DUAL. CV is control variables as measured by SIZE, DEBT, FCF, SOL, AGE, LIQ.			

Note. *, **, *** respectively significant 10%, 5%, 1% thresholds.

5. Simultaneous Effects of Ownership Structure and Board of Directors on Value Creation

The aim of this section is to understand the simultaneous effect of all variables on value creation. In particular, we propose to estimate the following regression:

$$SVC_{it} = \alpha_0 + \alpha_1 OWS_{it} + \alpha_2 BOARD_{it} + \alpha_3 CV_{it} + \theta_{it} \quad (3)$$

The Test Results (Table 3) are sometimes different from those obtained with the previous analysis (Table 1 and Table 2). Denis et al. (1997), Agrawal and Knoeber (1996) suggest that capital concentration guarantees effective shareholders control over management. In our research, capital concentration is significantly associated negatively with firm performance and value creation. This result confirms the importance of the informal relationships between executives and major shareholders. We can therefore assume that managers can invest in riskier activities because of the comforting and support of their major shareholders. This strategy may also allow managers to strengthen shareholders dependence on them (Stiglitz & Edlin, 1992). We also note a positive influence of the percentage of capital held by institutional shareholders. Institutional shareholders cannot force managers to perform given their informal relationship with and dependence on their human capital.

Table 3. Simultaneous effects of ownership structure and board of directors

Model 3: $SVC_{it} = \alpha_0 + \alpha_1 OWS_{it} + \alpha_2 BOARD_{it} + \alpha_3 CV_{it} + \theta_{it}$

	Regression 1: **Tobin's Q**	Regression 2: **RMVA**	Regression 3: **REVA**
C	**21.38837***	**7.745775***	**0.139410***
TCON	**0.240454***	**0.097990***	0.000142
AEXT	**-2.332392***	-0.423114	**-0.024202**
MAJ	**-2.558506***	**-0.680803***	-0.005891
INST	**2.741465***	**1.441921***	0.010805
DIR	-0.289382	0.186821	-0.000460
DUA	-0.457471	**-0.351578**	**-0.021100***
SIZE	**-2.449313***	**-1.003380***	**-0.013614**
DEBT	1.409319	-0.212065	**-0.033660**
FCF	**17.99396***	**6.829080***	**0.461778***
SOL	**-6.057518***	**-2.280805***	**-0.038754**
AGE	**0.024315***	**0.016149***	**0.000178***
LIQ	-0.002492	-0.002093	1.37E-05
TCA	**0.590126***	**0.266562**	-0.000992
Adjusted R^2	0.398929	0.338318	0.467584

Where SVC is shareholder value creation or performance as measured by Tobin's Q, RMVA, REVA. BOARD is board characteristics as measured by TCON, AEXT, DUAL. OWS is ownership structure as measured by MAJ, INST, DIR. CV is control variables as measured by SIZE, DEBT, FCF, SOL, AGE, LIQ.

6. Conclusion

The theme of corporate governance remains a real hot topic; and this is because firm performance inevitably depends on governance system. Our goal in this research was to study the impact of the problem of separating decision from ownership on performance and shareholder value creation. In other words we tried to examine how governance mechanisms and rooting can contribute to increasing firm wealth. We noticed that academic work and previous research often resulted in contradictory results about the effectiveness of some governance mechanisms and their impact on performance and value creation. This discrepancy led us to empirically study the interrelationships between governance mechanisms and their impacts on value creation and performance. By using a panel of listed Tunisian companies the empirical study was conducted in two phases:

In the first phase, the impact of ownership structure on performance and value creation for shareholders shows a significant relationship between managerial ownership and corporate performance: (i) The presence of institutional investors in ownership structure seems to exercise effective control over the external manager. Indeed, we find that this group of investors is involved in value creation and performance. This finding may be explained by the development of a collusion effect between minority shareholders and investors to favor social interests over personal interests. (ii) Capital concentration appears to have a negative effect respectively on performance and value creation. These results are consistent with the work of Kirchmaier and Grant (2005), Thomsen, Pedersen and Kvist (2006) who claimed that the impact of ownership concentration on performance is negative. We therefore concluded that the absence of a relationship between ownership concentration and performance, corroborates the neutrality thesis developed by Demsetz (1983), Demsetz and Lehn (1985) and Demsetz and Villalonga (2001).

Moreover the empirical tests in the second phase on the impact of the Board lead us to the following results (i) The presence of outside directors has a significant negative impact on value creation and performance of Tunisian listed companies. (ii) Board size has a positive impact on Tobin's Q. This relationship can be explained by the benefit of the company while other measures show insignificant effect on relationships. This can be explained by the fact that in the presence of a large number of people, there will be conflicts within the board and thus a problem of coordination and loss of time which will lead to a loss of value. (iii) Dual management has a negative and statistically significant impact on value creation, confirming the findings of Panasian Christine (2004) and Boyd (1994), who showed that this form of ownership has rather negative effects on the value creation process. The role of the Board of Directors through its function of revocation and appointment of the manager, and its contribution in the formulation of strategies, is crucial in resolving problems between the two parties especially if the number of outside directors is important and its size is reduced.

The results can be used to reconcile the findings in prior studies and a starting point for further research in which we will introduce other governance variables that explain the opportunistic behavior of the manager. Finally, we note that this study could have been richer if we had more data to that could have better explained the empirical results.

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