

# Corporate Governance, Ownership Structure and ADR's: A descriptive study

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# XVI CONGRESO INTERNACIONAL DE CONTADURÍA ADMINISTRACIÓN E INFORMÁTICA



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## Corporate Governance, Ownership Structure and ADR's: A descriptive study

### Summary

The academic literature on corporate governance is extensive and it covers diverse economies and situations. However, little is known about the mechanisms that discipline corporate governance and control in Mexican corporations. This document makes an examination through a description of these mechanisms from an empirical analysis of corporate governance characteristics of Mexican corporations. The empirical analysis was made using information from non-financial Mexican corporations with shares listed in the Mexican Stock Exchange (BMV) during the years 1996, 2000 and 2006.

The companies currently traded in Mexican markets have 50 years old on average. The economic environment in Mexico suffered from drastic changes and the companies implemented diverse mechanisms to protect their property from external threats like nationalization processes and foreign investor takeovers. The legal system in Mexico is based on the Napoleonic code. However, the regulations applied to corporations are very similar to those that exist in the American economy.

The empirical results of this study report that the companies that held large amounts of assets and had American Depositary Receipts in the American markets presented an outstanding financial performance and the activity of the boards of these companies was intensive. During the years studied, most of the companies in Mexico were family business and they held their voting shares among two and a half members of the family on average. The size of the board and the percentage of independent directors did not represent a significant difference between companies.

These results support the theory that companies with cross-listing presents better financial performance due the law enforcements present in developed markets. The theory that the boards collect information from other boards is supported too

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## **Corporate Governance, Ownership Structure and ADR's of Mexican Companies: A descriptive study**

### **Ownership structure in Mexico**

The ownership structure of the equity is one of the main elements that determine the mechanisms of corporate control in companies. According to different studies, a close relationship exists between private property protection in a country and the level of concentration of ownership. In economies with legal systems based on French law, the protection of private property is not as strong as in those economies with a legal systems based on English common law.

Equity concentration and its relation to corporate governance have been empirically studied, and research has considered different economies on different continents. In spite of that, little is known about the structure of equity ownership and corporate governance in the Mexican financial market. The general feeling or perception regarding the financial markets is that Mexican firms tend to be owned by families and the concentration of control inside the families is still strong.

Through a description of the main characteristics of Mexican companies, this paper aims to analyze the structure of ownership and corporate governance in listed companies in the Mexican financial market. The analysis is based on samples of non-financial companies listed in the capital market of the Mexican Stock Exchange (BMV) for the years 1996, 2000, and 2005.

The analysis is done on a comparative basis, bearing in mind the size of the company (measured by total assets), the cross-listing (taking into account listed securities in American financial markets) and a combination of both.

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### **Literature review**

Literature on corporate governance mentions two internal control mechanisms: the board of directors and the equity ownership structure in each company (Denis and McConnell, 2003).

Research on boards of directors has focused on two important aspects, the boards' composition and how compensation is determined. Hermalin and Weisbach (2002) analyzed on literature that reviewed the composition and characteristics of boards of directors. Based on their results, the most widely studied characteristic has been the relationship of the prevailing ratio of the number of outside directors to the total number of board members and the financial performance of the company. The study arrived at three specific conclusions. First, having more outside directors on the boards is not related to better development in the company, but is related to better decision making regarding purchase acquisitions, determination of compensation levels for executives, or the election of a CEO. Second, the size of the boards is associated with bad financial performance of the company and unfortunate decision making. The bigger the board, the worse the performance and decision making will be. Third, the more the board members are changed, the worse the financial performance of the company will be, along with its decision making.

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Research on the characteristics of the boards has been done in other countries. Kaplan and Minton (1994) reviewed the effectiveness of boards in Japan. Blasi and Shleifer (1996) examined the structure of boards in Russia, whereas Wymeersch (1998) reviewed the way boards are comprised in Europe, and called attention to the fact that the role of the boards was not determined by many European laws. Rodríguez and Anson (2001) studied the effectiveness of boards in Spain.

Another important point is whether the CEO and chairman positions should be held by the same person. According to Denis and McConnell (2003), little or limited evidence exists to indicate that a better performance for the firm will mean a better performance for the firm.

As for decisions on compensation, little has been studied outside the USA. Core, Guay, and Larcker (2001) did a survey using data from American companies. The results showed that payment sensitivity and the performance of the firms have both increased with time in the US. The researchers also point out that this sensitivity was the result of the alignment of compensation plans with the performance of the company, such as the options over share purchase, and these compensation plans were amongst the most popular and had the highest growth rate in the USA.

Ownership structure and its concentration are the most widely studied topics in the world, thus the most extensive. Research has focused on different topics applied to different economies. According to La Porta et al. (1999), equity concentration is common in those economies that offer relatively lower protection to private property than in those in which property is protected. Faccio and Lang (2002) studied company ownership in Western Europe and considered that companies with higher levels of equity concentration are countries other than England and Ireland. For Latin America, Valdares and Leal (2000) documented a high concentration of ownership in companies listed in the Brazilian stock market. This equity concentration occurs primarily in blockholders and individuals.

The way in which property is concentrated can vary. The main mechanisms of stock control are dual-class shares, pyramiding, and cross-holdings. Studies done on dual class stocks state that, voting shares list higher prices than non-voting shares. This effect is known as private benefits of control. Research support the effect of private benefits of control has been done by Lease et al. (1984), DeAngelo and DeAngelo, and DeAngelo (1985), and Zingales (1995). As for pyramiding, Alemida and Wolfenzon (2006) offered a theory that explained the incentives to take control of the company through pyramiding when property protection was low in the economy. Faccio and Lang (2002) reported the use of dual class shares and pyramiding as the most widely used methods of equity concentration and control in Europe.

One conclusion about ownership structure is it concentrates more in countries other than the USA and England. The structure of ownership and its concentration have a higher impact on non-American companies. This fact demonstrates that concentration of property has positive effects on the performance of companies. A final conclusion states that private benefits of control surpass the benefits for preferred shares in a global context.

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Little has been researched on corporate governance in Mexican companies. The studies available were done at an aggregated level and derived few details on the companies. La Porta and López-

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de-Silanes (1997) studied the benefits for companies going private in Mexico. The study uses a sample of 218 non-financial companies that were privatized between 1983 and 1991. The result was that the prices of companies were positively correlated to the presence of foreign investment and the change of CEO's. Pinegar and Ravichandran (2003) examined companies that had ADR's for each of the two kinds of common stocks with different rights. Out of the ten pairs of shares studied, the ADR's of the five pairs of Mexican companies were handled on a discount basis (reinvestment discount). The authors concluded this was because firms in Mexico changed their structure of capital to debt.

Dubkovsky and García (2002) analyzed the Mexican firms that joint ventured, merged, or were taken over by foreign companies, and the positive abnormal returns for those companies related to those kinds of investment. They found this situation was a result of deregulation derived from NAFTA, since investors had a better perception of returns in companies. Perhaps the most closely related study on corporate governance and ownership structure in Mexico was the one published by Husted and Serrano (2002). The research analyzed, in a very general way, the development of the model of corporate governance in Mexico. The authors reviewed the factors that shaped the model in the last 25 years and, lastly analyzed the consequences of changes in the models of corporate governance for macroeconomic development.

Despite all of these studies, an in-depth description of the two main internal mechanism of corporate control in Mexican companies had not been done before.

### **Data base and sample**

For this research, information has been gathered from non-financial companies listed in the capital market of the BMV. The samples are for years 1996, 2000, and 2005. The data base is formed by three types of information: information on financial performance, information on ownership, and information on boards of directors.

The information on financial operations or performance includes data from corporate financial statements. The data was found in the annual balance sheet, income statement, the statement of changes in capital, and cash flows of each company. Information is provided on an annual basis and is given in constant Mexican pesos for December 2005. For companies that represent conglomerates and whose subsidiaries are also listed in the capital market of the BMV, the financial information was considered without those subsidiaries, aiming to avoid duplication of figures presented in the analysis. The sources of information are diverse. For the integration of the corporate information, data was obtained from the annual financial reports provided by companies. Information on the electronic data base Economatca was also used. Other electronic data bases of the BMV were used, as well as some other available at the World Federation of Exchanges. The process sought to verify the data from the two primary sources.

The information on structure of ownership includes the name of the voting shareholder in the company, and the percentage of stocks he/she owns. It is important to note that this information includes only information on voting shares. Restricted (limited) or preferred stocks are not included in the data set. Information is annual and was recorded on the date of the annual ordinary meeting of stockholders of the company under study. The rationale in this case is as follows: on the day of the annual ordinary meeting, shareholders have to vote on approving the

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financial statement for the previous period, and elect the board that will make important operative decisions during the upcoming year. This means the information is available “a-priori”. Hence, the data on stocks is found on the date of the ordinary annual meeting that took place in April 1996, 2000 and 2005 for each company.

Four kinds of companies can be found in the data set, categorized according to stock participation: family businesses, subsidiaries of domestic companies, subsidiaries of foreign companies, and unidentified-owner companies<sup>1</sup>. When the main shareholders of a company are members of a family, we summed up all the fractions the members held and considered the company to be a family business. We applied the same rule when a majority holder held a high percentage of shares and his/her children or relatives were small stockholders. Mexican companies represent the subsidiaries of domestic companies that are listed in the BMV. The subsidiaries reported that their main stockholder was a Mexican company. However, that company is private and is not listed in the capital market, hence we do not know its ownership structure. When a company is owned by a foreign corporation, whether it is listed or not in its domestic stock market, the category of subsidiary of a foreign company is ascribed. Unidentified-owner company is one that had no majority holder identified, since most of the shares were owned by the market. In this last case, we reported the fraction of shares owned by the market.

The ownership of companies was considered to avoid the pyramiding effect in the case of subsidiaries. This means that if company A has 40% of equities of company B, and the shareholder X has 50% of equities of company A, then shareholder X has 20% of equities of company B<sup>2</sup>.

Different sources were used to gather the ownership information of the companies. The main source was the acts from ordinary annual meetings. This source was chosen because those meetings are restricted to voting shareholders in the company. The agenda is included with each act, as well as the decisions made and the names of those who attended the meeting, the amount of stocks owned by each and the percentage each represents in the total. It is worth mentioning that there is the possibility of a shareholder being absent from the annual meeting. In this event, a representative can be assigned. This situation represented a problem for the generation of the data base, since in those cases the name of the stockholder was not given, but instead, the name of the representative was substituted. To solve the problems associated with this situation, we used the electronic data base of the depository company (INDEVAL). This data base provides information on stockholders of record for the date of the ordinary annual meeting. The disadvantage of using the electronic records of INDEVAL is that, given the stock activity, a share can have several different owners on a given day. In this case, we looked for the name of the holder in alternate sources, such as the minutes of extraordinary annual meetings, the annual financial reports of the company, the electronic reports of the BMV, and the information included in Lexis – Nexis. When the name could not be identified with precision, the note “Gran público inversionista” was used, noting that the stocks are owned by the market. This was the case for the unidentified-owner companies. It is also important to mention the cases of stock buyback and stocks

<sup>1</sup> Some companies are owned by the Mexican government. However, the number of companies is small and some of them were privatized during the period studied. Companies owned by the government are those where the main stockholder is a government office in Mexico, either a ministry, body or commission.

<sup>2</sup> Studies on pyramiding like Faccio et al. (2002) consider these procedures.

previously bought by the company. In both situations, those stocks were deducted from the total, since they were already owned by the company<sup>3</sup>.

Information on the boards of directors includes the names of the members of the boards in companies, the positions they held, and information on whether they were independent directors or not<sup>4</sup>. Data is provided for the date of the companies' ordinary annual meeting. To build this data base, only the information in the minutes of the ordinary annual meeting of stockholders was used, since the official information could be found there, signed by those who attended the meeting.

### **Corporate governance, ownership, and the size of the companies**

The first analysis takes into account the size of the companies, measured by the amount of assets they had.

The group of the 30 largest companies owned assets totaling an average of 48.31 billion Mexican pesos in 1996, 64.89 billion in 2000 and up to 81.61 billion Mexican pesos in 2005. Their levels of leverage were 47.27% in 1996, 54.10% in 2000, and a high of 52.24% in 2005. The M/B indicator for the 30 largest companies registered was, on average, 156.32% in 1996, 131.34% in 2000, and 240.00% in 2005. As for the group of small companies, their total assets reached 4.10 billion Mexican pesos in 1996, and 4.80 billion in 2000. In 2005, they registered 5.70 billion pesos, on average. As for leverage, the range was 44.81% in 1996; it increased to 59.66% in 2000, and reached 70.69% in 2005. The M/B indicator of financial performance for companies in the group of small firms registered levels of 93.20% in 1996, 73.77% in 2000, and reached a high of 104.15% in 2005.

It can be observed that the group of the 30 largest companies had boards that were a little bigger than those of the small companies, with an average difference of two members per board. There was also stability in the composition; this means that the numbers were almost constant in the three years used for this study. During the years studied the chairman of a small company most commonly held the position of CEO.

As for the average number of directors on each board, the groups of the 30 largest companies had 14.88 board members in 1996, 14.82 in 2000, and up to 15 in 2005. The fraction of independent directors for the 30 largest companies was 34.21% in 1996, 37.24% in 2000, and increased to 36.75% in 2005. The small companies group had an average of 11.34 members of the board in 1996, 11.94 in 2000, and by 2005, the number increased to 13.54 directors on the board. The fraction of independent directors for the small companies group reached 27.01% in 1996, 32.22% in 2000, and increased to 32.86% in 2005. In 1996, 29.77% of the 30 largest companies reported the positions of chairmen of the board and CEO were occupied by the same individuals. This percentage reached 26.67% in 2000 and 25.33% in 2005. In 1996, 45.77% of the small companies

<sup>3</sup> The LMV declared on December 30, 2005 that companies can buy their own stocks and that doing so does not mean a reduction in the total of stocks. However, since stocks used to be deducted before that date, this last criterion was applied.

<sup>4</sup> The companies used the definition for independent director provided by the LMV.

reported this same situation; In 2000, the percentage dropped to 44.45, and finally, fell to 43.33% in 2005.

We can see that the group of the 30 largest companies was more active and handled more information than the group of smaller companies, since the three indicators presented larger figures for the group of the largest companies.

As for the indicator of directors with outside appointments, we found that the group of the 30 largest companies had 2.88 outside appointments per director on average in 1996, and the number increased to 3.52 in 2000, by 2005 it decreased to 2.67 directors who held at least one position on the board of another company. The group of the 30 largest companies had an average of 16.63 outside appointments on their boards in 1996; this number increased to 26.26 in 2000, and decreased to 18.12 in 2005. As for the number of interlocks by board, the positions increased to 1.76 in 1996, 2.23 in 2000, and in 2005, fell to 2.22. The group of small companies had an average of 1.74 directors with an outside appointment in 1996, 2.01 in 2000, and increased in 2005 to 1.28 directors per board with at least one position on the board of another company. The total of outside appointments by board for small companies was 5.85 in 1996, 9.02 in 2000, and 5.15 in 2005. The group of small companies registered an average interlock indicator of 0.41 in 1996, 0.43 in 2000, and increased to 0.47 in 2005.

### **Corporate governance, ownership, and cross-listing**

#### *Corporations with ADR's listed in American markets*

The following analysis of the internal mechanisms that determine corporate control in Mexican companies was done bearing cross-listing in mind. To do so, the sample of companies was divided into those companies with American Depositary Receipts (ADR's) listed in American financial markets, and those companies listed only in the domestic market. This analysis did not take into account the type of ADR or the type of the underlying security.

The description identifies two groups: The ADR's group is the set of companies listed in American markets for the years studied; the Non-ADR's group includes the companies that did not list securities in those markets during the same time period.

In general, it can be observed that the amount of assets for both groups grew during the three years studied. The ADR's companies owned more assets than the Non-ADR's companies. Additionally, the performance of the market measured by the M/B indicator was much better for the ADR's. This observation is supported by international research on companies that own stocks in foreign markets. An important point is the fact that in both groups of companies, leverage is high; in some years it surpasses 50% of their capital structure. Companies in the Non-ADR's group had higher leverage than companies in the ADR's group. Furthermore, leverage increased in the three years used for this study

The ADR's companies had a total average of assets of 29.30 billion Mexican pesos in 1996, 35.39 billion pesos in 2000, and 52.50 billion pesos in 2005. The ADR's group of companies showed leveraged of 38.70% in 1996, 51.64% in 2000, and 56% in 2005. The financial performance of the ADR's group had high numbers, with a 166.50% average in 1996, 147.60%

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in 2000, and 207.20% in 2005. In the case of Non-ADR's companies, the average of stocks was 11.08 billion Mexican pesos in 1996; this indicator went up to 13.36 billion pesos in 2000, and reached 16.37 billion in 2005. Leverage was 46.82% in 1996, 60.27% in 2000, and 69.22% in 2005. The average financial performance in the group of Non-ADR's placed the M/B indicator at 95.14% in 1996, 69.91% in 2000 and 116.74% in 2005.

Boards of directors are more active in ADR's companies, so it can be assumed they handled much more information than their counterparts in the non-ADRs companies. For the ADR's group, the number of directors with outside appointments was 3.78 in 1996, 5.03 in 2000, and 4.16 in 2005. These numbers are higher in the Non-ADR's group, which reported 2.30 directors with outside appointments in 1996, 3.50 in 2000, and 2.87 in 2005. The total number of outside appointments by board in the ADR's group in 1996 was 12.17, in 2000 it was 17, and in 2005 it fell to 11.80. These numbers were also higher for the non-ADR's group, which accounted for 7.51 outside appointments by board in 1996, 11.70 in 2000, and 7.43 in 2005. Perhaps the most dramatic case is the interlock by board, because ADR's companies had an indicator of 1.26 interlocks in 1996, 1.58 in 2000, and 1.53 in 2005, whereas non-ADR companies reached 0.60 interlocks in 1996, 0.62 in 2000, and 0.73 in 2005.

This description suggests that Mexican corporations included in the ADR's group tended to hold more assets than their Non-ADR's peers. The performance of the ADR's group was better during the three years studied and the leverage was small. The ADR's group had more active boards and their CEO's and the chairmen of the boards were different individuals. This evidence may suggest that the corporations that held ADRs in the American markets had better performance because their boards had more information, more activity and more independence.

## Conclusions

The motivation for this research is to explain and describe the mechanisms that discipline corporate governance in Mexican companies. The financial market in Mexico is 150 years old. The market is one of the oldest in Latin America and the second largest in terms of market capitalization.

In general, Mexican corporations currently traded on the financial markets have developed their mechanisms of corporate control to protect the ownership from two major threats: nationalization processes and takeovers. The mechanisms these companies have used are dual-class shares, pyramiding, cross-holdings and the use of financial resources from internal capital markets. However, for almost a quarter of a century, Mexican corporations enjoyed the benefits of a protected domestic market. In the recent years, Mexico implemented one of the most extensive programs of privatization in the world. This fact, along with increasing international free trade agreements and increasing foreign investments brought the necessity of changes in regulatory policies related to corporate governance in Mexican corporations.

The legal / regulatory system is another external mechanism that disciplines the corporate control in companies. The Mexican legal system is based on the French law or Napoleonic Code. According to previous studies on corporate governance and law, this system offers limited protection to private property. However, corporate governance regulations are similar to the

American policies in many ways. In Mexico, the regulation of corporate governance is overseen by two laws: the general mercantile societies law (LGSM) and the stock market law (LMV).

The incorporation of a company can take place in any Mexican state. The shareholders' meeting is the ultimate body of corporate control in a Mexican corporation. In corporations, the board of directors is the collegiate body in charge of the corporate governance of the company. The major decisions affecting the life of the company are made in these meetings. In Mexico, the board has the following functions: to hire, evaluate, and fire top management. The board must be composed of no more than 21 directors. Directors can be independent or non-independent. The board of directors must be formed by at least 25% of independent directors. The shareholders who own 10% of the voting-shares have the right to name one director. The term of a director is a company matter, however, the common practice is to have a one-year term for each director, with reelection allowed. Staggered terms are rare in Mexican companies.

Minority rights recommended by OECD are covered by the Mexican laws and regulations. The LMV forces public companies to have at least two committees: the audit committee and the best-practices committee.

The Chief Executive Officer is the person in charge of direct management in a company. According to Mexican law, the CEO's functions are to run the company's operations and perform day-to-day management, propose business strategies to the board of directors, prepare financial information, and be responsible for maintaining the company's diverse systems.

The analysis of the financial performance of non-financial public companies concludes that financial markets in Mexico are concentrated. In the years studied, only 30 corporations controlled more than 85% of the total assets in this market. Most of the companies are family owned, and, on average, three family members control the voting shares of the entire company.

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The study reveals that in general, Mexican companies tended to have bigger boards of directors than their American peers. The percentage of companies in which the positions of CEO and chairman was occupied by the same individual is less than the percentage in American corporations.

The 30 largest companies in the Mexican market presented a better financial performance and tended to have bigger boards of directors with more outside activity during the years studied. The separation of functions between the chairman and CEO was common in the 30 largest companies. Small companies tended to have boards formed by directors who had at least 50% of the voting shares and the CEO was a shareholder in more than a half of them.

The Mexican companies that had American Depositary Receipts (ADR's) displayed an outstanding financial performance, also. These companies had more active boards, and as the 30 largest companies, demonstrated separation of functions between the chairman and CEO. The companies without ADR's as well as the small companies tended to have boards formed by directors who had at least 50% of the voting shares and the CEO was a shareholder in more than a half of them.

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The most relevant financial performance is reported by the companies that had ADR's and belonged to the 30 largest companies group. Once again, the activity reported by the boards from these companies was significant. It is worthwhile to mention that the large corporations with ADR's tended to have boards integrated by directors who held at least 50% of the voting shares. Commonly the CEO was a shareholder too in these kinds of companies.

The explanation and description made in this dissertation will help to understand the way in which companies are managed in Mexico. However, new questions remain for future analyses.

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