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Ownership and Corporate Governance—Evidence from the Czech Republic

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The Czech voucher privatization scheme, which started in 1991, was one of the earliest, most comprehensive, and most rapidly implemented of all the mass privatization schemes in Eastern Europe and the former Soviet Union. The scheme has resulted in relatively concentrated ownership: of the shares offered, two-thirds ended up with investment funds, most of them with a small number of bank-sponsored funds. How have these changes in ownership affected enterprise governance and restructuring? There is some evidence to suggest that Czech firms are performing better than firms in other Central and Eastern European countries. But so far there has been only limited anecdotal evidence about the impact of the Czech ownership changes on governance. This Note reports on a new study that assesses whether concentrated ownership leads to better oversight of firm managers in the Czech Republic.

The best approach to enterprise restructuring?

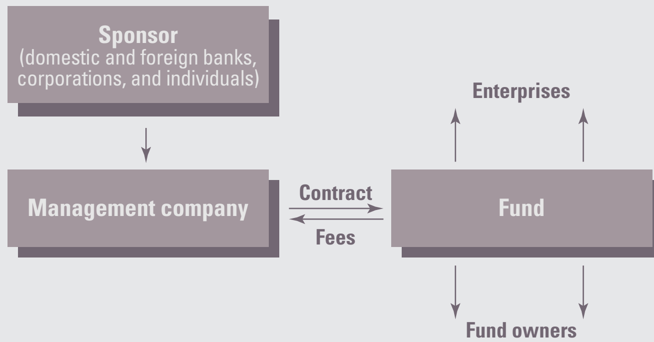
Large-scale enterprise restructuring in transition economies is a wide-ranging process of moving from a highly distorted economy with many loss-making firms to a normal market economy in which most firms are profitable. For government policy, it implies making losses transparent by liberalizing prices and adopting new accounting standards and practices. For firms, it usually means shedding labor and concentrating on activities in which they have a competitive advantage.

How to bring about enterprise restructuring most efficiently is a matter of lively debate. Different countries have used different strategies over the past seven years: depoliticizing management by giving managers more autonomy, increasing competition, improving financial discipline (including through bankruptcy and liquidation of loss-making firms), revamping state asset management systems, and privatizing firms. How much each of these reforms has contributed to improved performance has not been empirically established. But it is clear that better management is vital for restructuring—and better management will come about only through changes in firms' ownership structure.

There is much debate, too, over which method of privatization is best. Some countries have stressed the importance of attracting good owners in the form of strategic—usually foreign—investors. But the number of enterprises privatized and restructured through direct sales to foreign investors has been small. In Hungary, for example, the sale of firms to foreign investors has received much publicity, but only a few large firms with significant market power have in fact been privatized this way. Foreign investors have been uninterested in the average-size industrial firm.

Countries such as the Czech Republic and Russia have developed mass privatization programs where the emphasis has been on speed. The

FIGURE 1 INVESTMENT FUND STRUCTURE

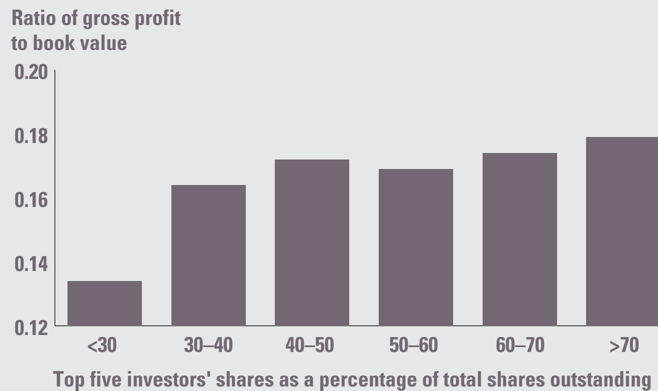


Czech mass privatization program, implemented first and covering the largest share of the enterprise sector, moved about 70 percent of the Czech economy from the state to private hands within a short period. The Czech program is thus a good test case of the effect of this predominant approach to changing the ownership of firms—an approach that has probably contributed to the Czech Republic's better record in enterprise restructuring compared with other transition economies.

The Czech mass privatization

In preparation for privatization, firms were corporatized but only very limited restructuring was carried out. Privatization occurred in two phases. The first phase, offering nearly 1,000 firms, started in late 1991 and ended in mid-1993. The second, offering more than 850 firms, started in January 1994 and ended in October of that year. The share auctions, organized in five sequential rounds of bidding, were designed to reveal as much information and analysis of firm valuation as possible, to improve price discovery. And after the bidding rounds, vouchers were exchanged for shares and secondary trading started on the Prague stock exchange.

FIGURE 2 OWNERSHIP CONCENTRATION AND PROFITABILITY



Source: Calculations based on data from the Aspekt Stock Market Database.

All citizens aged eighteen and over could buy vouchers for a nominal fee to use in bidding at these auctions—directly or through financial intermediaries called investment funds. In essence, these investment funds involved a sponsor first setting up a management company, which then set up a fund to own the shares. The management company manages the fund for a fee under contract and the shareholders of the fund are the former voucher holders and any new investors who buy fund shares in secondary markets. (See figure 1 for the structure of these funds.)

When initiated, the program elicited much skepticism. Mass privatization would lead to ownership by outside investors, but many expected that it would also lead to diffuse ownership and poor oversight of management. As things turned out, many investment funds emerged and, through aggressive marketing, collected 75 percent of the vouchers held by citizens. Bank-sponsored funds acquired the most, with the ten largest holding nearly 70 percent of the vouchers acquired by the investment funds. This outcome held out the promise of better oversight by owners: concentrated ownership gives the owners better incentives to monitor firms and make necessary changes in management. By contrast, in firms with diffuse ownership, no single owner has an incentive to "mind the store," so management is not disciplined for bad performance or rewarded for good performance.

In 1992–95 the Czech Republic had a good record in enterprise restructuring. A separate

study comparing enterprise performance in all Central and East European countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia) shows that Czech firms had the highest growth rates in labor and total factor productivity, followed by Polish and Slovak firms.[1] To shed more light on this result and to see how changes in ownership affect the way Czech firms are managed, the study that is the subject of this Note looks at whether firms with more concentrated ownership are indeed better managed. If that were the case, these firms would have higher profitability and their shares would trade for higher prices in the stock market. After all, if more concentrated ownership leads to better oversight of managers, profitability should correlate positively with the degree of ownership concentration. And market prices, which incorporate the effect of better oversight on future firm performance, should be higher for firms with more concentrated ownership. In market economies, where this is a much-studied topic, these relationships are quite strong.

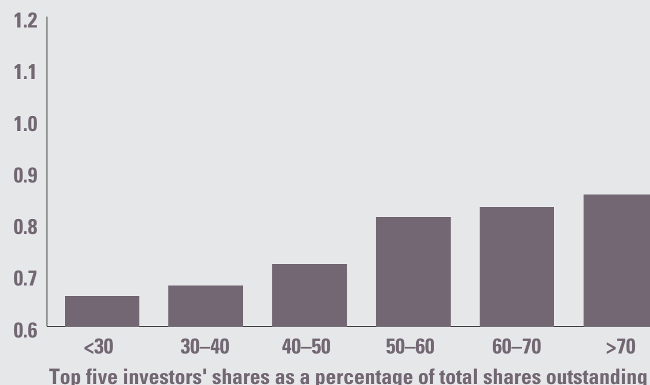
Analysis

Using data for all the more than 700 Czech firms that were consistently listed on the Prague Stock Exchange over the period 1992–95, the study finds that there are indeed strong positive relationships between ownership concentration and profitability (figure 2).[2] It also finds that the more concentrated the ownership of a firm, the higher its market value (figure 3, top panel).[3] (This correlation sometimes breaks down when a single investor holds more than 50 percent of all shares, since the shares of minority shareholders are then valued less.) Together, the two results suggest that the Czech privatization program was effective in improving firms' management because of the concentrated ownership structure that resulted.

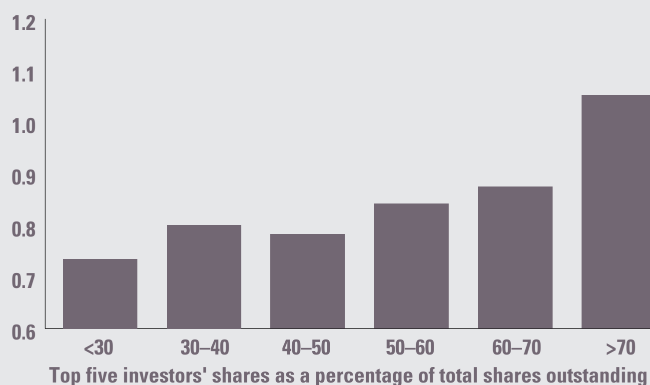
Much of the ownership is concentrated in turn among funds sponsored by commercial banks, which themselves are large creditors of the firms in which the funds hold equity stakes. What does this mean for the quality of corporate

FIGURE 3 OWNERSHIP CONCENTRATION AND MARKET VALUATION

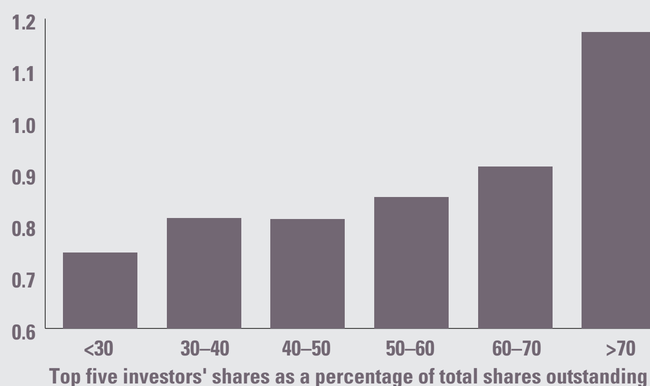
All firms



Firms in which bank-sponsored funds are the majority owners



Firms in which bank-sponsored funds are the majority owners and main lenders



Source: Calculations based on data from the Aspekt Stock Market Database.

governance? Many analysts have argued that the investment funds face conflicts of interest because they have to serve multiple objectives: when deciding in which company to invest and how to value firms, a bank-sponsored fund has to balance the interests of the bank with the interests of the fund shareholders. Under pressure from the sponsor, for example, the fund managers could encourage firms to borrow from the sponsor bank at higher interest rates, thus treating fund shareholders unfairly in favor of the bank. But it can also be argued that a bank that has an (indirect) equity stake in a firm can better monitor the firm and its management. Through its representation on the board of directors, the bank has access to more information and is more willing to monitor the firm. The better corporate governance that can result makes it more likely that the firm will restructure, leading to higher market value and profitability. The firm may also have easier access to bank financing, which again makes restructuring more likely.

Since ownership by bank-sponsored funds potentially has two opposite effects on the value and profitability of firms, the net effect is an empirical matter. But it is clear that banks have dual incentives to help firms restructure. First, improvements in firms' performance will increase their market value and thus the return on the assets of bank-sponsored funds. Second, firms with improved profitability are likely to borrow to finance new investments.

The empirical analysis shows that concentrated ownership by bank-sponsored investment funds is beneficial in improving firm management (figure 3, middle panel). And it finds no evidence that market value and profitability are lower for firms in which investment funds sponsored by the firm's main bank have a large ownership stake, which would be the case if conflicts of interest dominated. On the contrary, it finds that (indirect) ownership control by the main bank has a positive effect (figure 3, bottom panel). This suggests that, on balance, banks play a positive role in supervising firms when they also hold an (indirect) equity stake. Any negative effects of conflicts of interest—due to banks' controlling equity—thus appear to be outweighed by the positive effects of banks' close monitoring of firms in which they have an (indirect) equity stake.

Conclusion

The Czech Republic's mass privatization program has spurred enterprise restructuring and led to better monitoring of firms. The investment funds, which supervise and manage firms on behalf of their investors, have played a key part in this. The Czech model offers useful lessons for other transition economies: the speed of privatization matters, and both more concentrated ownership and indirect ownership by banks lead to faster restructuring.

This Note is based on a paper of the same title (Policy Research Working Paper 1737, World Bank, Washington, DC, April 1997).

[1] Stijn Claessens, Simeon Djankov, and Gerhard Pohl, "Determinants of Performance of Manufacturing Firms in Seven European Transition Economies" (World Bank, Europe and Central Asia, and Middle East and North Africa Technical Department, Washington, DC, March 1997).

[2] The definition of profitability is

$$\text{Profitability} = \frac{\text{Gross operating profit}}{\text{Net fixed assets + inventory}}$$

[3] The definition of market value is

$$\text{Market value} = \frac{\text{Stock market valuation + total debt}}{\text{Net fixed assets + inventory}}$$

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