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MULTI-CLASS STOCK AND FIRM VALUE EXECUTIVE SUMMARY

Does Multi-Class Stock Enhance Firm Performance? A Regression Analysis

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The full-text version of this study is available here:

http://www.cii.org/files/publications/misc/05_10_17_dual-class_value_study.pdf

Abstract

This paper addresses a gap in literature on the possible relationship between multi-class stock with differential voting rights and firm performance. The Council of Institutional Investors (CII) conducted regression analysis on the potential impacts of different voting structures on return on invested capital (ROIC) over a meaningful period of time. CII built two regression models, using data on 1,762 Russell 3000 companies over nine years, sourcing the data from FactSet and the Securities and Exchange Commission (SEC). Each model evaluates several potential drivers of performance and determines the strength and direction of their influence. Overall, our models found that multi-class structures did not result in a meaningful statistical increase in long-term value creation as measured by ROIC.

Consider this scenario: A growing company in a cutting-edge industry files for an initial public offering (IPO) that is expected to raise a significant amount of capital. The founders and early investors of the company now face a dilemma: The more common stock they issue, the more they will dilute their voting power. To retain control while accessing public capital, they decide to issue non-voting common stock to public investors and retain voting common stock for themselves.

This anecdote should be familiar to investors, many of whom have decried the recent spate of multi-class IPOs and recapitalizations. Multi-class companies often justify their capital structures by claiming that public markets are impatient, and that visionary founders need the protection of superior-class common shares to innovate and create long-term value. However, evidence has been mixed as to whether multi-class equity structures create higher, lower or equivalent returns for shareholders compared to single-class companies. Previous studies have returned a variety of conclusions, most of which depend on the measure of firm performance used and the time period studied.¹

To further explore the relationship between multi-class equity and performance, CII built two regression models from nine years of FactSet and SEC data on 1,762 Russell 3000 companies. Each model evaluates several potential drivers of performance and determines the strength and direction of their influence. This study expands on existing research in two ways: 1) the extensive length of the time covered, and 2) the use of return on invested capital (ROIC) as the measure of performance in a regression analysis.

Key finding: Overall, our models found that multi-class structures did not result in a meaningful statistical increase in long-term value creation as measured by ROIC.

¹ See, for example: Edward Kamonjoh, “Controlled Companies in the Standard and Poor’s 1500”, *IRRC Institute and ISS*, March 2016; Renée Adams and Daniel Ferreira, “One Share, One, Vote: The Empirical Evidence”, *European Corporate Governance Institute*, 2007; Paul Gompers, Joy Ishii, Andrew Metrick, “Extreme Governance: An Analysis of Dual-Class Firms in the United States”, *The Review of Financial Studies*, May 2008, accessed through the *Social Sciences Research Network*, <http://ssrn.com/abstract=562511>.

Defining multi-class companies

Companies with multi-class structures have at least two classes of common stock outstanding with unequal voting rights.² In a typical arrangement, owners of the class of common stock with superior voting rights (the superior class) receive 10 votes per share, while the owners of the class of common stock with reduced voting rights (the inferior class) receive one vote per share. Superior-class owners remain in control of the company without shouldering a proportionate share of financial risk, while inferior-class owners get little to no say in how their capital is used. Some companies allow inferior-class stockholders to vote on an equal basis with superior shares on certain matters, while limiting voting rights on others, such as the election of directors. Preferred stock carrying preferential rights on dividends or in the event of liquidation is not part of the discussion in this paper on multi-class stock, as it differs in substantive ways from common stock.

History of multi-class stock

Although a hot topic of discussion in 2017, multi-class stock is not new. For decades, founders (and in some cases their descendants) have used these structures to retain control. In 1925, auto manufacturer Dodge Brothers went public with owners who controlled 100% of the vote despite owning only 1.7% of the equity. The Dodge IPO caused such an uproar that the New York Stock Exchange (NYSE) launched an investigation into nonvoting stock and warned that it would “give careful thought to the matter of voting control” in the future.³ That “careful thought” eventually led to a 1940 NYSE rule barring listed companies from issuing nonvoting classes of common stock and preventing superior-voting stock from constituting more than 18.5% percent of all outstanding votes.⁴ While this rule was not a complete ban on multi-class common equity, it did successfully limit multi-class listings. As of 1985 there were just 10 multi-class firms on the NYSE.⁵

Other major exchanges such as NASDAQ and AMEX never adopted such restrictions. The lack of restrictions by these exchanges did not pose a competitive threat to the NYSE until the 1980s, by

² As a policy matter, the term “dual class” is often used interchangeably with “multi-class”, as the former generally intends to cover all companies having *at least* two classes of stock with unequal voting rights.

³ Stephen M. Bainbridge, “The Scope of the SEC’s Authority over Shareholder Voting Rights”, UCLA School of Law Research Paper No. 07-16, May 2007, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=985707##, p. 6.

⁴ Robert A.G. Monks and Nell Minnow, *Corporate Governance* (Chichester, UK: John Wiley and Sons, 2015), p. 241, note 74.

⁵ Joel Seligman, “Equal Protection in Shareholder Voting Rights: The One Common Share, One Common Vote Controversy”, *George Washington Law Review*, Vol. 54, p. 6, available through LexisNexis at <https://www.lexisnexis.com/en-us/gateway.page>.

which time NASDAQ in general did pose real competition, and when a wave of hostile takeover bids led companies to try various protective tactics, including recapitalizing with multi-class stock. Companies threatened the NYSE with listing on another exchange if they could not adopt multi-class structures. In 1986, the NYSE relented, permitting listed companies to recapitalize with multi-class shares.⁶

Seeking to level the playing field among the exchanges it regulates, the SEC responded in 1988 by passing Rule 19C-4, which required that listing standards prevent companies from issuing new common shares with per-share voting rights greater than those of current outstanding shares. The Business Roundtable challenged the rule on the basis that voting rights are a matter of state law, and in 1990 the D.C. Circuit Court of Appeals agreed unanimously and struck down the rule. By 1994, the three major U.S. exchanges had adopted a uniform policy assuring multi-class companies' ability to list and placing no restriction on voting rights assigned to new public offerings.⁷

Today, the tech sector has led a new wave of multi-class stock, with companies like Alphabet, Facebook, Zynga, Box, GoPro and Snap adopting multi-class equity structures. While nearly 90% of the companies in the Russell 3000 only have one class of voting shares, the recent spate of multi-class IPOs is causing consternation among investors and other market participants. Certain listed companies' payment of dividends in non-voting shares has also brought the issue to the forefront.⁸

Measuring multi-class equity and company performance

Measuring multi-class equity poses a challenge, as the degree to which multi-class structures distort the connection between ownership and control varies by company depending on the number of shares outstanding and the voting rights assigned to each class. To navigate this, we created a measurement we called **Percent Superior Vote**, which ranges from 0 to 100 and represents the percentage of total voting power controlled by superior-class shareholders. All "one share, one vote" companies were automatically assigned a zero, including those where insiders control a significant

⁶ Michael A. Hiltzik, "NYSE Decides to End Its One-Share, One-Vote Standard", *Los Angeles Times*, July 4, 1986, http://articles.latimes.com/1986-07-04/business/fi-648_1_voting-rights.

⁷ Jason Howell, "Essays on the US Dual Class Share Structure", (Ph.D Dissertation, University of Georgia, 2009) p. 7, http://media.terry.uga.edu/documents/finance/howell_dual_class_share.pdf.

⁸ CII analysis of FactSet data.

percentage of voting power. Mathematically the variable is measured as:

$$\frac{(Superior\ Shares\ Outstanding * Votes\ Per\ Superior\ Share)}{[(Superior\ Shares\ Outstanding * Votes\ Per\ Share) + (Inferior\ Shares\ Outstanding * Votes\ Per\ Share)]}$$

This measurement enables us to test not just the effect of *having* a multi-class structure on performance, but also the assertion that performance improves as control derived from superior share classes increases.

Defining firm performance presented another dilemma. Many earlier studies use Tobin's Q, the ratio of the market value of assets (tangible and intangible) to their replacement costs, approximated by the book value of assets. Tobin's Q has drawbacks, namely that it depends on the valuation of intangible assets that are difficult to measure, such as human capital, goodwill and institutional knowledge. Because of these drawbacks, we decided to measure performance by average ROIC. At its most basic level, ROIC is net income divided by total average invested capital. Since these measurements are themselves calculations, the precise definition of ROIC is:

$$\frac{[(Sales - (COGS + Depreciation + SG\&A + Interest + Taxes) - Discontinued\ Operations)]}{[(Total\ Shareholder\ Equity + Preferred\ Stock\ Equity) + (Long\ Term\ Debt + Capitalized\ Leases)]} \quad ^9$$

Building our model

We used a combination of FactSet and SEC filings to find the data for our Percent Superior Vote and ROIC figures. For each, we collected and annualized nine years of information from 2007 to 2015, the last complete year for which data was available when we began the research process.

In order to control for other potential drivers of ROIC, we also collected data on the following:

- **Age:** Age of the firm in years as of Dec. 31, 2016
- **Index:** Whether the firm was in the S&P 500, S&P 400, S&P 600 or none of the three
- **Dividend:** The average dividend yield
- **Buybacks:** The average ratio of total share buybacks to shareholders' equity
- **Sales:** The average percentage change in sales
- **Debt:** The average ratio of debt to assets

⁹ COGS is cost of goods sold. SG&A is selling, general and administrative expenses.

- **Capital Expenditures:** The average ratio of capital expenditures to assets
- **R&D:** The average ratio of R&D spending to assets
- **Industry Group:** Global Industry Classification Standard (GICS) industry group

Results and implications

Our first model found no meaningful relationship between the average control of a company's vote by superior class shareholders and ROIC. Essentially, the margin of error of the predicted relationship was so large that it undermined any statistical correlation.¹⁰

This model assumes that multi-class stock affects ROIC, but that ROIC doesn't in turn determine whether or not a firm decides to issue multi-class stock. However, it is likely that only companies that can command a high valuation will go public with a multi-class arrangement, since investors are more liable to overlook such a concentration of power if returns are sufficiently large. To account for this problem, we developed a second model using a technique called instrumental-variable (IV) regression, which uses a different data point as a proxy for the average control exerted by superior class shares.

This second model also found no relationship between multi-class equity structures and firm performance, as the predicted correlation between the average vote control of superior class shareholders and ROIC again had a large margin of error. Essentially, because we failed to find a meaningful relationship between multi-class stock and ROIC, we have to maintain *that there is no relationship*.¹¹

Both of our analyses provide no support for the assertion that the degree of control wielded by holders of superior class shares influences long-term company performance. They underscore that investors should be skeptical of claims that companies will outperform if their founders and other insiders are freed from the disciplinary effects of one share, one vote structures.

¹⁰Statisticians usually require a less than 10% chance of a false positive in order to conclude that a relationship exists. Our results had a 35 percent chance of being false positive.

¹¹ To use proper statistical terminology, we *failed* to disprove that no relationship exists.