

SHAREHOLDER VALUE ENHANCING STRATEGIES - EMPIRICAL EVIDENCE ON MULTINATIONAL CORPORATIONS BEHAVIOUR

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Abstract

The shareholder value maximization objective function of Anglo-Saxon publicly quoted corporations over the last three decades gave raise to contrasted reactions. The controversy raised by the implementation of this new form of capitalism goes beyond the simple interactions between corporate governance and its achievements. The means allowing corporations to maximize shareholders' wealth are nowadays fuelling the debate, especially when considering the eventual generalization of the Anglo-Saxon corporate governance model to other countries. Excessive corporate debt, massive job cuts, considerable assets reductions etc. are the most recurrent corporate strategies denounced as harmful by shareholder value maximization detractors. While these strategies are often retained in descriptive studies or in the Medias as a byproduct of the shareholder value maximization policy, empirical support in this direction is lacking. The econometric study conducted herein allows us to put into perspective the role of the above mentioned strategies in the shareholder value creation process.

Key words: shareholder value, Economic Value Added (EVA[®]), multinational corporations (MNCs), shareholder value maximization strategies, financing choices, probit econometric model.

JEL classification: F23, G32, G34

1. Introduction

Long time outpaced by managers, the shareholders are nowadays the key players of corporate business and financial risk management. The economic context in which shareholders emerged as central players in the corporations' management field was particularly suitable: slow economic growth, high inflation (two-digit levels), increasing interest rates (after a period of mostly negative real interest rates), and financial disintermediation, all specific to early eighties and inherent to the oil shocks of the 1970s. Due to the lack of an intermediary organism able to absorb any substantial variation of their wealth, the shareholders became increasingly involved in the corporations' management, imposing transparency and communication exigencies to executive board.

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A new concept has thus emerged: the shareholder value maximization, so identifying the new objective function tying irremediably the publicly quoted corporations to stock markets. The corporations become mainly concerned with the shareholder wealth maximization goal, i.e. the sum of dividend payments and capital gains. New corporate performance instruments are proposed. The Economic Value Added (EVA®) of Stern & Stewart embodies nowadays the main evaluation criteria of corporations' commitment with the shareholder value maximization objective.

Most likely an inheritance of the period of high U.S. Treasury bond interest rates, the supposed 15% minimum return on investment expected by shareholders fuels the critics against this new corporate objective function. The debate over the wealth distribution justice within corporations, within society overall, is open and fuelled by large media coverage. The subordination of publicly quoted corporations to the "quarterly income tyranny", source of "accounting errors" in the management of some large U.S. and European industrial corporations (WorldCom, Xerox, Enron, Vivendi, Parmalat), turns failed corporations into an emblem of the new form of capitalism. The consensus of a "project lacking economy" (*économie sans projet*) emerges [Artus, Virard, 2005]. Obsessed by short-term performance objectives, the publicly quoted corporations would thus overlook long-term beneficial investment projects. The critics of the new corporations' objective function leave then room to critics looking to the means allowing corporations to achieve the shareholder value maximization goal. Dividend payments, stock buybacks, delocalization, layoffs, etc. are regarded as grounds for transforming employees in victims of the shareholders' primacy. A part of the risk assumed by shareholders would hence be transferred toward employees, which, contrary to shareholders, don't benefit of any risk prime. In this perspective, two opposing worlds are formed: the one of the employees, with unstable jobs, and another of merciless shareholders, looking for high investment returns.

Seemingly, the rupture from the classic maximizing benefit corporation is not very well perceived, and often identified as the source of all troubles. Deficiencies in product innovation, low capital intensity, high corporate debt, and worsening employee status would thus represent the issue of short-term oriented corporate management. Engaged in the stock market performance race, corporate management is subject to institutional investors pressures (exerted either by an active portfolio management, either by imposing their opinions when considerable parts of corporate stocks are detained) and to hostile takeover threats. Hence, the management is obliged to reduce the investment time horizon, choosing only those activities with immediate results and which meet shareholders' expectations. The short-term rationale of financial investors is supposed to transfer toward the corporate management, with mainly negative effects for employees and corporations as whole.

The concerns about the shareholder value maximization objective function are further increased by the emerging consensus of its generalization to other non Anglo-Saxon corporations. Nevertheless, this hypothesis is based on descriptive studies about the institutional and cultural comparisons across countries [Coffee Jr., 1999; Nestor, Thompson, 2000; Mintz, 2005], much like the harmful shareholder value maximization driving strategies identified by its detractors and mentioned above.

The lack of empirical studies assessing the real weight of these strategies in the shareholder value maximization process justifies the econometric analysis presented in this paper. In order to identify the importance of corporate financing choices, of corporate assets and of jobs management, an empirical study is conducted on an Anglo-Saxon, European (French and German) and Japanese multinational corporations' panel.

2. Empirical analysis

The purpose of the following empirical analysis is twofold. First of all, it aims to identify the main shareholder value driving strategies of multinational corporations. This will permit the evaluation of the validity of the postulates made by the shareholder value maximization detractors. Secondly, the analysis will allow us to quantify the influence of multinationals' home country financial system (and their subsequent corporate governance principles) – *market-* versus *bank-oriented system* – on the shareholder value creation process.

The study is conducted on very large (revenue superior to three billions USD) publicly quoted and non-financial multinational corporations over 1996-2005 period. The annual balance sheet data is extracted from the Bureau Van Dijk's ORBIS database. According to our empirical analysis purpose, the U.S., British, French, German and Japanese MNCs were retained. Nevertheless, due to the lack of fulfillment of data series and to delayed time series across companies, the study is realized on a considerably smaller number of corporations than initially predicted. Hence, the final panel of 959 MNCs breaks down into 640 U.S. MNCs (out of 783), 114 British MNCs (out of 292), 68 French MNCs (out of 204), 59 German MNCs (out of 142) and 78 Japanese MNCs (out of 92). With the exception of the 10-years Treasury bond interest rates which were taken from the Eurostat database, all other variables were deducted from the data included in the corporate financial accounts from Bureau Van Dijk.

2.1. Method and model

In order to identify the real contribution of the corporate debt financing, corporate assets and jobs management on the created shareholder value, the Economic Value Added (EVA®) was used for measuring the corporations' performance. The EVA® computation is based on financial account data, and it measures *ex post* the created shareholder value as a difference between the corporate net operating profit after taxes and the employed capital cost – both equity and debts (short- and long-term debts altogether).

$$EVA = NOPAT_{it} - WACC_{it} \cdot CE_{it-1} \quad (1)$$

$$NOPAT_{it} = EBIT_{it} - Tax \quad (2)$$

$$WACC_{it} (\%) = k_{FP, it} (\%) \cdot \frac{Equity_{it}}{Equity_{it} + Debts_{it}} + \frac{Paid\ interest_{it}}{Debts_{it-1}} (\%) \cdot \left(1 - \frac{Paid\ tax_{it}}{Income\ before\ tax_{it}} \right) \cdot \frac{Debts_{it}}{Equity_{it} + Debts_{it}} \quad (3)$$

$$CE_{it-1} = Equity_{it-1} + Debts_{it-1} \quad (4)$$

where:

$NOPAT$ = Net Operating Profit after Tax

$EBIT$ = Earning Before Interest and Tax

$WACC$ = Weighted Average Cost of Capital

CE = Capital Employed

In the equation (3) used in the measure of EVA® (equation (1)), the $k_{FP}(\%)$ represents the opportunity cost of equity; this is, therefore, the shareholders' expected return rate, and it will thus be calculated using the Capital Asset Pricing Model (CAPM), given by the equation (5) below:

$$k_{it} = k_{ft} + \beta_{it}(k_m - k_{ft}) \quad (5)$$

where:

k_{it} = expected return rate on the capital asset i over the period t , in (%);

k_{ft} = risk-free interest rate (usually, a 10-years Treasury bond), in (%);

k_m = expected return of the market, in (%);

β_{it} = covariance(i,m)/ σ_m^2 – the sensitivity of the asset returns to market returns

The equation (5) shows the traditional financial vision according to which the similar risk assets can't affect different rates of return. The risk, i.e. the beta coefficient, is calculated from the monthly data, the corporate core stock market index being used as proxy for the market returns. The reference stock market indexes thus retained are CAC40, DAXX, DJ Industrial Average, NASDAQ Composite, NASDAQ 1000, Nikkei.

In the calculation of the equity capital cost (equation (5)), we imposed the condition of positive market returns. This condition appears to be essential in our opinion in order to obtain positive values for the equity capital opportunity cost, which couldn't be negative. By excluding the negative stock market performances, we have, once more, reduced the time coverage of our panel dataset.

Beside the equity cost, the measure of the weighted average cost of capital (equation (3)) makes use of the debt financing cost. The latter is computed as the ratio between the effective interest paid by companies and the interest bearing debts at the beginning of the fiscal year.

To resume, as it is calculated, the Economic Value Added ® measures in fact the excess shareholder value created (the net operating income) over the shareholders expectations (as quantified by CAPM).

In order to evaluate the shareholder value creation strategies amongst those identified by new capitalism detractors, several explanatory variables were considered, and are detailed next.

The corporate financial choices (debt *versus* equity financing) might influence the created shareholder value by influencing the corporate tax. Fiscal optimization function strategies by MNCs are possible in an international perspective, as long as corporate tax discrepancies persist across countries. Choosing a low-tax destination country for high profitable activities may considerably improve the corporate annual net income. On the contrary, choosing an adequate financial structure in countries with high corporate tax rates would provide a debt tax shield to MNCs, as long as the debt cost is tax-deductible. Hence, the appropriate financing choices allow corporations to increase their net income, thus satisfying shareholders. Nevertheless, higher corporate debt is synonym of higher corporate risk, and thus higher shareholder expected returns on investment. All other things being equal, this only leads to lower effective shareholder value. Consequently, higher debt tax shield must be negative correlated with the created shareholder value.

The corporate assets management is also very often cited by shareholder value principle detractors as one of the harmful strategies leading to higher shareholders' wealth. Shareholder value maximizing corporations would thus give up several production processes, mainly the capital-intensive ones. Externalizations, focusing on the core activities, and lowering the capital intensity, all represent key assets management strategies enhancing the shareholder value [Jeffers & Plihon, 2001]. The empirical estimation of the importance of this variable in the shareholder value creation process will set the true value of the hypothesis formulated by shareholder value critics.

Another explanatory variable is supposed to capture the pertinence of the traditional opposition between the *market-oriented* and *bank-oriented* financial systems of multinational corporations' home countries in the shareholder value creation process. Since the capitalistic financial systems are divided into *market-* and *bank-oriented* ones corresponding to the main corporate financing practices (stock market *versus* bank), this opposition is supposed to testify about the corporations' commitment with the shareholder value creation purpose. A *dummy* variable is thus constructed: the value 1 is associated to Anglo-Saxon multinationals, while the value 0 is associated to Continental European (German and French) and Japanese multinationals. The aim of including this variable is to measure the importance of the multinational home country financial system on the created shareholder value, and hence to test the shareholder value principle generalization hypothesis.

According to the purpose of this empirical analysis, the *probit* method was chosen.

The endogenous variable in the econometric model will thus be a *dummy* variable. Its values are 0 or 1, according to whether the created shareholder value is lower or greater than the industry average (the latter being calculated as the industry average, all countries included). In order to define this *dummy* variable, we had thus calculated both the EVA® series and then the industry average EVA® across countries. The gap between the calculated value of EVA® for each couple (corporate, year) and the industry average EVA® allowed us to define the endogenous *dummy* variable (ΔEVA). The *probit* method will thus allow us to highlight the variables increasing the probability that a multinational corporation creates a greater shareholder value than its corresponding industry¹ average.

The exogenous variables included in the estimated model are the corporate debt tax shield (testifying about the corporate financial choices aiming at maximising the net income), the net income ratio (thus summarizing the corporate operating and administrative cost minimization), the capital intensity ratio (total assets per employee), and the MNC home-country financial system dummy variable. The tested equation is given below:

$$P(\Delta EVA_{it} = 1|x) = G(\beta_0 + \beta_1 \cdot dummy_country + \beta_2 \cdot debt_tax_shield_{it} + \beta_3 \cdot net_income_ratio_{it} + \beta_4 \cdot capital_intensity_{it}) \quad (6)$$

where: $0 < G(z) < 1, \forall z \in \Re$

Beside the variables emerging from the corporate financial accounts, we have also taken into account the financial market variables, such as the corporate stock price evolution and stock market index evolution. In order to measure the influence of the stock market performance on the shareholder value drivers, we made the distinction between the periods of negative and positive stock market performance. Hence, corresponding to each period, two other models derived from the equation (6) were also estimated (equation (7) and (8)). This will allow us to verify if corporate shareholder value creation strategies are influenced by the stock market evolution.

$$P(\Delta EVA_{it} = 1|x) = G(\beta_0 + \beta_1 \cdot dummy_country + \beta_2 \cdot debt_tax_shield_{it} + \beta_3 \cdot net_income_ratio_{it} + \beta_4 \cdot capital_intensity_{it}) \quad \left\| \begin{array}{l} \text{if stock market} \\ \text{performance} < 0 \end{array} \right. \quad (7)$$

$$P(\Delta EVA_{it} = 1|x) = G(\beta_0 + \beta_1 \cdot dummy_country + \beta_2 \cdot debt_tax_shield_{it} + \beta_3 \cdot net_income_ratio_{it} + \beta_4 \cdot capital_intensity_{it}) \quad \left\| \begin{array}{l} \text{if stock market} \\ \text{performance} > 0 \end{array} \right. \quad (8)$$

where: $0 < G(z) < 1, \forall z \in \Re$

2.2. Results

The *probit* estimations were run with STATA 9.1. All continuous variables were normalized, such that each variable average is equal to one. This operation allow us to take into account the relative values of estimated parameters and thus establish a hierarchy of the exogenous variables influence on the endogenous variable. The estimated results are reported in the Table 1. Tables 2, 3 and 4 present the exogenous variables marginal effects.

Table no. 1 - Estimation results

Exogenous Variable: ΔEVA	Model 1 (eq.(6))	Model 2 (eq.(7)) (performance < 0)	Model 3 (eq.(8)) (performance > 0)
Dummy country	0.198**	0.109	0.267**
<i>z-statistic</i>	(2.30)	(-0.706)	(2.25)
Debt tax shield	-0.571**	-0.706**	-0.595**
<i>z-statistic</i>	(-2.67)	(-2.18)	(-1.97)
Net income ratio	0.425***	0.501***	0.387***
<i>z-statistic</i>	(6.19)	(4.90)	(3.89)
Capital intensity	-0.263**	-0.577***	-0.067
<i>z-statistic</i>	(-2.21)	(-2.90)	(-0.43)
Constant	0.532**	1.084***	0.268
<i>z-statistic</i>	(1.94)	(2.62)	(0.70)
<i>Wald chi2(4)</i>	77.25/0.0000	45.45/0.0000	33.58/0.0000
No. of observations	1895 (429 ^E)	934(387 ^E)	961 (405 ^E)

Note: Stata probit estimations results; the endogenous variable is the dummy variable ΔEVA ; ***, **, and * denote significance at 1%, 5%, and 10% level, respectively. The values within parenthesis represent the respective statistical test values. If the chi2 test is calculated, both the test values and the p-values are reported. The panel size (number of observations and of MNCs) is also given.

Table no. 2 - Marginal effects (Model 1, equation (6))

Variable	dy/dx	Std. Err.	z	P>z	[95% C.I.]	X
Dummy country	0.078	0.034	2.290	0.022	0.011 0.144	0.703
Debt tax shield	-0.223	0.084	-2.670	0.008	-0.387 -0.059	1.055

Net income ratio	0.166	0.027	6.200	0.000	0.114	0.219	0.965
Capital intensity	-0.103	0.046	-2.210	0.027	-0.193	-0.012	1.026

Note: dy/dx represents the discrete variation of the endogenous dummy variable between 0 and 1. The statistically significant coefficients in the table are in bold.

Table no. 3 - Marginal effects (Model 2, equation (7))

Variable	dy/dx	Std. Err.	z	$P>z$	[95% C.I.]	X
Dummy country	0.042	0.050	0.840	0.402	-0.056 0.139	0.759
Debt tax shield	-0.268	0.123	-2.180	0.029	-0.508 -0.027	1.064
Net income ratio	0.190	0.039	4.920	0.000	0.114 0.266	0.958
Capital intensity	-0.219	0.075	-2.900	0.004	-0.366 -0.071	0.995

Note: dy/dx represents the discrete variation of the endogenous dummy variable between 0 and 1. The statistically significant coefficients in the table are in bold.

Table no. 4 - Marginal effects (Model 3, equation (8))

Variable	dy/dx	Std. Err.	z	$P>z$	[95% C.I.]	X
Dummy country	0.106	0.047	2.250	0.024	0.014 0.198	0.648
Debt tax shield	-0.236	0.119	-1.970	0.049	-0.470 -0.001	1.046
Net income ratio	0.153	0.039	3.890	0.000	0.076 0.230	0.971
Capital intensity	-0.027	0.062	-0.430	0.667	-0.147 0.094	1.055

Note: dy/dx represents the discrete variation of the endogenous dummy variable between 0 and 1. The statistically significant coefficients in the table are in bold.

Most of the exogenous variables are statistically significant, regardless the estimated model. Nevertheless, we can observe that the statistical significance of the MNC home-country financial system and that of the capital intensity variables changes with the estimated model, hence with the stock market performance.

Thus, the multinational corporation home country financial system (as identified by the *dummy country* variable) seems to explain the gap between the created shareholder value and the industry average shareholder value according to the stock market index performance. In this way, one might observe the neutrality of this variable when the stock market index performance is negative, while it is statistically significant during good stock market performance. Therefore, the Anglo-Saxon multinational corporations seem to better do than their European and Japanese homologues in creating value for shareholders as long as the stock market performance is positive. On the other hand, differences are dissipating while stock market performance is negative, when multinational corporations' purpose seems to be a better use of financial resources. Then, the multinational home country financial system induced difference does not necessarily explain the created economic value deviation from the industry average.

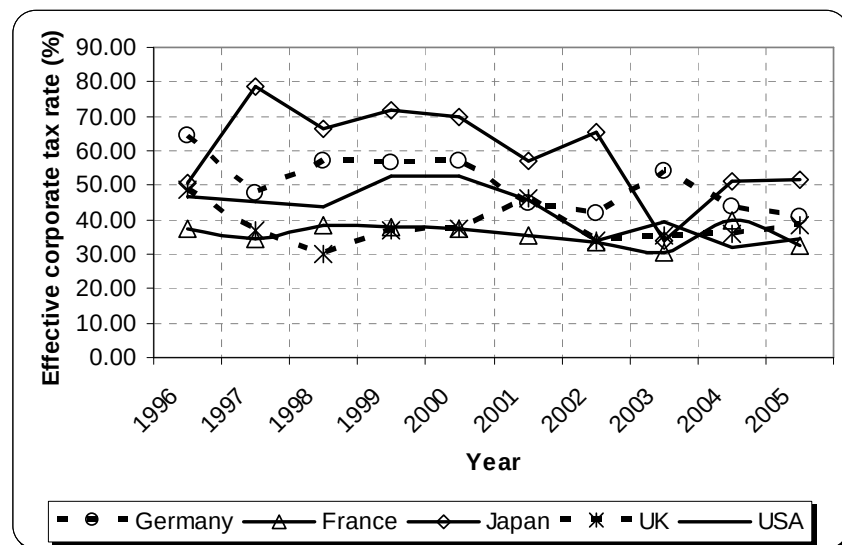
Similarly to this *dummy country* variable, the influence of the capital intensity ratio variable on the created shareholder value varies with the capital market index performance. The capital intensity ratio is statistically significant only when bad stock market performances are recorded. This result might suggest a bad timing for productive investments during

a relative decline in the stock market. The negative correlation between the capital intensity variable and the endogenous one underlines the relevance of time in the valorization of any productive investment. Since, over the analyzed period, both the number of employees and the capital intensity ratio values of the Anglo-Saxon multinationals are on an increasing trend (as illustrated on the Figure 1), we can retain the consolidation propensity of these corporations over 1996-2005. The observed negative correlation between this variable and the probability of an EVA® superior to the industry average come to strengthen the shareholders' "impatience" hypothesis, posing that shareholders are mainly encouraging the productive investments with immediate results, but not during periods showing poor stock market performance.

At the same time, the estimated results might testify about the MNCs' international location strategies, showing a preference for low workforce cost countries, which allows them to substitute employees to capital, and hence improve their capital intensity ratio. Another possible strategy is the accumulation of high-tech assets and the increasing importance of the goodwill [Plihon, 2004].

Nevertheless, the capital intensity variable is not statistically significant during good stock market performance periods. At that moment, other variables seem to prevail: the financing cost management, the net income ratio maximization, or other variables not included in this study.

Contrary to the home-country financial system and capital intensity ratio variables, the debt tax shield is statistically significant regardless the stock market index performance. The negative sign of this variable suggests that any increasing debt tax shield leads to lower effective shareholder value.



Source: Own calculations from data provided by ORBIS.

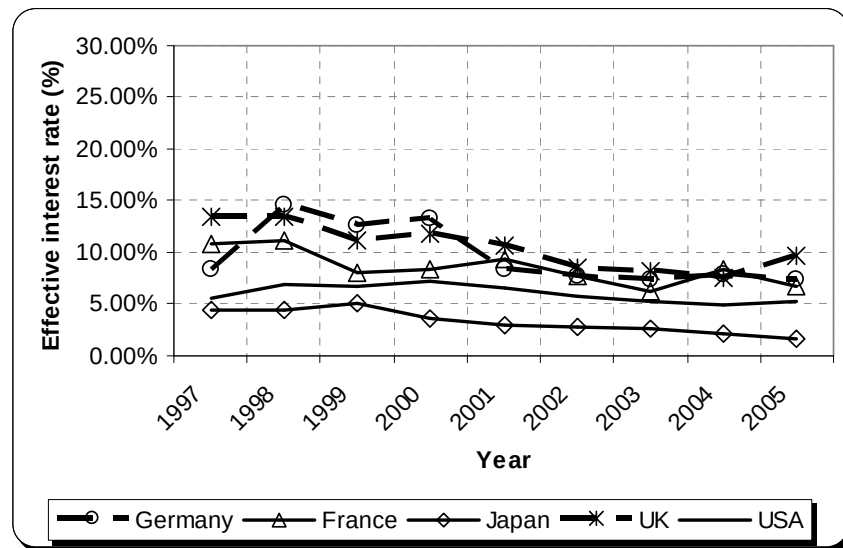
Figure 1: Effective average corporate tax rate of MNCs by countries (%)

A higher debt tax shield might be explained either by any increase in due interests (which might be the consequence of raising interest rates and/or raising corporate debts), or by an increase in corporate tax rate. Since multinational corporations are pursuing fiscal optimization strategies [Iosub-Dobrica, 2006], and multinational corporations effective tax

rates are decreasing over the analyzed period (Figure 1), any increase of the debt tax shield might only be explained by an increase in the interest paid by MNCs. Nevertheless, over the analyzed period, the interest due by the studied MNCs by unit of debt does not necessarily increase (Figure 2). Hence, the increase in MNCs' paid interests is backed by an increase in corporate debt.

Thus, the negative influence of the debt tax shield on the probability of superior performances with respect to the industry average is only explained by the superior risk associated to high corporate debt. Other things being equal, a higher risk leads to shareholder claims for higher return on their investments, as measured by CAPM. Hence, the created shareholder value (calculated as the difference between the effective return and the expected return) is diminished. This result actually proves that higher corporate debt empowers shareholders' claims for higher returns. In turn, higher claims do not necessarily lead to higher created shareholder value. The MNCs ability to create value, and hence to improve the capital return, appears to be capped.

At last, the net income ratio is always statistically significant. The positive correlation signifies a better cost management (all, operative, logistic and fiscal) in the shareholder value creation process (quantified by the EVA®). Thus, any corporate expansion (measured by higher economic return) must lead to better cost control. As long as the EVA® might, at least partially, influence the stock market prices, it is easy to understand that the pressure toward improving the net income ratio is high in corporations looking for stock market satisfaction. Since the corporate stock market price represents a criterion for being prey for competitors, a good stock market price evolution is necessary.



Source: Own calculations from data provided by ORBIS.

Figure 2: MNCs' effective average interest rate (%)

3. Conclusions

The main critics of the actual model of capitalism target the means by which corporations achieve the shareholder value maximization goal. Accordingly, the workforce becomes

the adjustment variable, the externalization of different productive activities becomes the trend, while debt financing becomes the leading financial strategy. Thus, the stock market is perceived to take to corporations more that it would give them.

In this paper, an empirical study was conducted in order to identify the shareholder value creation strategies of Anglo-Saxon, European (French and German) and Japanese MNCs. The estimated results allow us to retain the pertinence of the opposition between the Anglo-Saxon and European countries with regard to their respective multinationals' involvement in the shareholder value creation process. Seemingly, the international openness of the multinational corporations' capital does not remove the border between the two country sets. By taking into account the multinational corporations' home country stock market index (which, in most cases, represents its core stock market), the hypothesis of the dependence upon the home financial market is made. Nevertheless, the international portfolio constitution rationale comes to mitigate it. The results of the econometric estimations highlight differences among countries in the financial investors' behavior while good stock market performances are recorded. During these periods, the investors optimism might lead to risk under-estimation (and thus to the under-estimation of the expected return) which, in turn, might explain higher levels of created shareholder value, all other things being equal. Hence, the positive influence of the Anglo-Saxon financial system upon the probability of a superior EVA® to the industry average might be explained by the investors' propensity to risk under-estimation in good stock market periods.

Nevertheless, the distinction between the two country sets dissipates during bad stock market index performance. This might be synonym of identical risk evaluation amongst countries while the financial investors are facing the risk they long-time ignored. During poor stock market performance periods, the shareholder value maximization corporations seem to make use of another variable, i.e. the capital intensity ratio. The observed negative correlation of this variable with the probability of a superior EVA® with respect to the industry average testifies about the negative impact of a higher capital intensity ratio. In these conditions, a better assets management would allow corporations to improve their market performance. Even if the assets management appears to be more important than the net income ratio management for the realization of an EVA® superior to the industry average, there are others strategies open to MNCs.

The estimated influence of the corporate financial choices on the created shareholder value provides us with a very interesting result. Even if a higher corporate debt allows shareholder to claim higher returns (induced by higher risk associated to higher corporate debt), this does not necessarily lead to higher created shareholder value, as claimed by shareholder value detractors. It seems that the corporations' ability to obtain benefits from the invested capital has an upper limit.

Consequently, the cost minimization strategies, as well as the controlled asset expansion relative to employee number of the analyzed multinational corporations, seem to play a significant role in the shareholder value creation process, contrary to the corporate debt financing.

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Notes

¹The industry classification is the one proposed by General Industrial Classification Standards (GICS®) developed by Morgan Stanley Capital International (MSCI). More information can be found at: <http://www.msicibarra.com/products/gics>.