

OWNERSHIP STRUCTURE AND STOCK REPURCHASE POLICY: EVIDENCE FROM FRANCE

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ABSTRACT

This article studies the relationship between ownership structure of French companies and their stock repurchase policy. According to financial theory, the presence of institutional investors negatively influences repurchasing policy because the preference of these investors is to reinvest in projects. The theoretical hypotheses of interest alignment and entrenchment have been used to justify the relationship between management stockholding and repurchasing policy. We tested the validity of our hypotheses on a sample of 40 French companies using data from 2004-2008. The results show that institutional investors positively affect the repurchase because institutional investors can control managers by forcing them to repurchase stocks to pay their excess cash flows. Moreover, we found a positive relationship between management stockholding and the repurchase. This finding is explained by the power of entrenchment from the repurchase that can raise the stockholding percentage of managers who repurchase the stocks.

JEL: G35, G32

KEY WORDS: Stock Repurchases, Ownership Structure, Institutional Investors, Managerial Ownership

INTRODUCTION

In this paper, we study the relationship between stock repurchases and ownership structure. Stock repurchases have greatly increased in France from €1,682 million in 1998 to €10,902 million in 2009. They have grown considerably since the law of July 2, 1998, which significantly relaxed the regulation of these operations. Thus, the initial French regulation controlling stock repurchasing, defined by the law of July 24, 1966, allows stock repurchases according to a very strict and rigid procedure. This law was significantly reformed on July 2, 1998. The new law relaxed the conditions under which companies can repurchase their own stocks. Because of the increasing use of repurchases, studies have examined the motives of these operations.

If distribution policies are intended to limit agency conflicts, they should be influenced by the stockholding structure (concentration and nature of stockholders), which is a decisive element of the agency conflicts. We observe little investigation into the relationship between ownership structure and company policies for repurchasing its own stocks. A point of particular interest in this research is to study the effect of property structure on repurchase policy in a context characterized by its concentration and where there are an excess of certain types of stockholders, including institutional investors or managers.

Our study considers a sample of 40 French companies listed at the CAC 40 index, during a five-year period from 2004 to 2008, including 200 observations. The final sample consists of 160 observations. This article is presented as follows. The first section underpins the literature. The second introduces the sample and methodology. The results are shown in the third section, and the last part concludes the work.

LITERATURE

Two data types allow us to characterize ownership structure: ownership concentration and nature of the largest stockholders. Whatever the data source, various studies agree on the highly concentrated character

of the stockholding in France and the importance of family capital. Institutional comparisons bring out the characteristic of continental Europe, in particular France regarding stockholding structure.

The Institutional Investors

Generally, institutional stockholders (banks, insurance companies, pension funds) hold only minority interests (less than 10%) in listed companies. Their role is still important as they define to a great degree the stock value of companies. They exert a big influence on the dynamics of financial markets and within the companies.

Agency costs may become considerable in the case of diffuse external stockholding due to the high costs of information and the heterogeneity of external stockholder interests. The presence of institutional investors can then have a direct effect on the agency costs resulting from separation between ownership and control. The manner with which institutional investors influence the manager's conduct is an empirical question since we can find cases of a passive policies (Porter, 1992) and cases of active control from a certain category of investors (Bushee, 1998).

The exact consequences of institutional stockholding on the companies remain unknown to date. Implicitly, the main question about the relationship between the presence of institutional investors, company performance and the policy of repurchasing emerges. These general questions require reviewing the knowledge we have about these stakeholders.

The holders of control blocks, like institutional investors, can plan an important role in taking on surveillance activities to the extent that they possess a considerable portion of the stocks. In this context, Shleifer and Vishny (1986) and Allen and al. (2000) suggested that these stockholders can control managers more than scattered owners. They have a privileged position to access company information and its competitors. Therefore, they can better assess the manager's performance by comparing them to those in the other companies of the same sector with whom they have information. Starting from the general description by Jensen (1986), with a strict surveillance of the managers, companies have to pay their excess liquidity flow as dividends.

Grinstein and Michalely (2003, 2005) showed that a large ownership stake by the investors would be linked to a high level of distribution because of the surveillance functions exercised. It is the role of the mechanism of controlling the managers and the majority stockholders which is brought out here. Repurchases have become a real means for distributing funds to stockholders. It represents an alternative to the classic cash dividend.

Fama and French (2001) noted a significant fall in the percentage of companies distributing dividends, and Grullon and Michalely (2000) observed for the first time in 1998 the amount stock repurchasing programs was higher than that of dividends. Grullon and Michalely (2000) explained this behavior by the existence of different fiscal conditions between the two distribution modes. Companies were attracted to repurchases in part because of important fiscal advantage pertaining to it. In a period characterized by different fiscal regimes, the results of Rau and Vermaelen (2000) on the English market prove this fiscal hypothesis. It is the tax system borne by the institutional investors and not by the individual investors that determines the distribution policies of the companies.

Yet, another research trend predicts a negative relationship between the presence of an institutional investor and the distribution policy. Indeed, given the importance bestowed by these investors upon projects and reinvestment, this stockholder type prefers holding the profits and reinvesting them instead of distributing them.

The Managerial Property

Given that the investors often incorporate the managerial decisions concerning the choice of the company policies (debt policy, distribution policy) in assessing future performance (De Angelo and al., 1996 et Benartzi and al.1997), a thought trend has recently focused on the study of managerial holdings and distribution policy link.

Prime facie, a research trend showed that Free Cash Flow distribution decreases with the stockholding importance of managers, considering it a means of aligning interests between agent and principal. (Charlier and Du Boys, 2010. Thus, the more shares owned by the manager, the more their objectives converge. So, resorting to other disciplinary mechanisms including the payment of dividends or the repurchase of stocks has proved useless by the theory of alignment of interests (Jensen et Meckling, 1976). Actually, the larger stock holdings by managers, the more managers will be motivated to search for more profitable projects and the more their interests converge with those of others stockholders. This implies a reduction in the costs born to control the manager. On the other hand when their right for residual profit is weak, managers may make profits from other sources in the company, which risks affecting its value (Ali, Chen and Radhakrishnan, 2007).

However, on introducing other variables, recent studies have contradicted this idea leaning on the entrenchment effect which can dominate the managerial property and profit distribution relationship. It is the theory of entrenching the managers (Collins and Wansley, 2003). The model of managerial entrenchment stipulates that at a certain ownership level, managers benefit from a control power that consolidates their position and they enter into a position not to maximize the company value once the costs relating to a certain behavior are lower than the control benefits.

In the absence of complete contracts, the principal-agent problem reveals itself owing to a divergence of interests of different stakeholders; the owners want to maximize the value of the company and the managers look for maximizing their own utility, which reduces the value of the company. This type of conflicts appears mainly in big companies with diffuse stockholding where managers do not hold any significant part of the capital (Charreaux, 1997; Alexandre and Paquerot, 2000). Separating power and ownership might offer the non-owner managers the scope of pursuing the specific objectives, most often not compatible with those of the stockholders. (Burkart and al., 2003; Anderson and Reeb, 2003; Sharma, 2004; Charlier and Lambert, 2009).

This divergence of interests between the principal and the agent is more pronounced given that capital is scattered among several stockholders. The agency relationship is due to the fact that the principal (owner) thinks the agent (manager) is better placed than him to control his property. Information asymmetry is then the origin of the conflicting relationship. The information differential generates an opportunist behavior of the manager who acts against the interests of the other party. It follows a moral-risk phenomenon which occurs due to the fact that an agent has not learned how to realize his promises when his behavior is non- observable by the other party.

The agency theory provides a new interpretive framework to go through the distribution policy which is a means for reducing the real or potential conflicts between the stockholders and managers. As put forward by Jensen and Meckling (1976), each group of individuals is supposed to maximize its utility function and consequently conflicts might appear. Easterbrook (1984) and Jensen (1986) proposed a partial solution to this problem. If the stockholders can minimize the free cash under the control of the managers, managers will not have the ability to spend on projects with a negative Current-Net-Value.

For Easterbrook (1984), collecting capital in the financial markets creates a behavioral discipline for managers because of the surveillance activity generated by the investors. It is therefore necessary to

intensify access to financial markets while limiting self-financing to control conflicts between the managers and external stockholders. The sole means to reach that is the regular distribution of profits.

For a given investment policy, the profit distribution leads the managers to search for the necessary funds to keep the same investment policy. The additional borrowings require implementing an audit and reviewing procedure in the company. Accordingly, the repurchase puts together an implicit mechanism to control the management of the leaders and to know if they act in the interest of the company.

In general, the scattering of the capital weakens the power of controlling the stockholders, leaving greater operation margins to the managers. More particularly, the managers are interested in giving up the payment of dividends that allow them to receive the payment in excessive kind, which is reflected by a drop in the company value. This drop entails a fall in prices of which only the stockholders (as principals) suffer the consequences.

Using the repurchase programs can be linked to the will of the companies to declare their undervaluation at the stock market. Contrary to the rise in capital sanctioned by the negative abnormal profitabilities (Myers and Majluf, 1984 and Asquith et Mullins, 1986), the announcement of a repurchase program must correspond to good news for the investors. The American studies of Comment and Jarrel (1991) and of Grullon and Michaely (2000) present the abnormal profitabilities on announcing a program of repurchasing actions from 2 to 3%. This positive result exists in Europe, as well.

Nevertheless, launching a repurchase program is a low-costly signal because it is quite easy to get the consent of stockholders. The company managers do not commit themselves; they assume the possibility of buying the stocks on the stock market. From this standpoint, the repurchase program looks strongly like a free option from which the managers benefit when the stock price strays off the “real” value of the company. This option hypothesis was checked by Ikenberry and Vermaelen (1996). They showed that the effect of announcing a repurchase program depends on the volatility of the stock profitabilities and the number of concerned stocks. However, all the companies do not permanently have an active program of purchasing stocks. The option of repurchasing stocks is valuable only if the company has the funds to be invested in it and the managers are qualified to mark out the errors of the economic development on the market. Under these circumstances, the option is stimulated by the managers who really buy the stocks.

On the one hand, the risk of the company disappearance often prompts the managers to diversify the activities of the company. On the other hand, such a strategy is confronted with the refusal of the stockholders who prefer a less costly diversification of their stock portfolio rather than an expansion of the activity field of the company. Consequently, the interest divergences form a source of potential conflicts between the managers and the stockholders.

SAMPLE AND METHODOLOGY

There is little investigation into the relationship between the ownership structure and the company's policy of repurchasing its own stocks. A point of particular interest in this research is to study the effect of the property structure on the repurchase policy in a context characterized by its concentration and where there is a wealth of certain types of stockholders, either being the institutional investors or the managers.

The study is based on a sample of 40 listed French companies during a five-year period from 2004 to 2008, hence having 200 observations. To maintain sample coherence, we eliminated banking and financial companies as well as the real estate businesses because their repurchase policies, their governance systems and also their borrowing notions are different in comparison to the non-financial companies. Through this procedure the sample is reduced to 32 companies including 160 observations.

For each company, we collected accounting data and data concerning the profit distribution, stockholdings and governance over the five years from 2004 to 2008. Data concerning dividends are extracted from the financial statements (statement of accounts and statements of results) and the activity reports published on the Internet sites of the concerned companies. Data regarding the stockholding and governance were gathered from the company annual reports. Data concerning the repurchase of stocks were derived from the “information note relating to the programs of repurchasing stocks” and “the company’s declarations of the purchases and the concerning sales of their of their own stocks”, as well. These documents are published on the Internet site of the Authority of the Financial Market (AMF).

The data indicated that there exist many forms of effective repurchasing (repurchase, transfers, cancellation), used according to the motivations presented by the company. In order to isolate the stock purchases resulting from a distribution decision, we eliminated all the accomplished repurchases with the aim of providing the stock-option plans, controlling the price, or investing. So, we retain the notion of NET REPURCHASE; i.e., it is the number of repurchased stocks during the year, which is reduced by the sold and transferred stocks.

This repurchase measure estimates stocks which are cancelled or kept within the company, which corresponds neither to a coverage to stock-option plans, nor to an investment, and nor to a price control. In the case of a negative net repurchase, we considered that repurchases of the company were not carried out with a view to distribute to the stockholders. The net repurchase has been considered as non-existent.

Institutional property is the percentage of the institutional investors measured by the number of stocks held by the institutional investors over the total number of stocks. Allen and al. (2000) suggest that these stockholders are more capable of controlling managers than other owners. They have a privileged position for acceding to company data. So, they will be more influential concerning the financial decisions of the company, especially the policy of distributions in the form of repurchasing.

The property of the managers is the percentage of the stocks held by the managers, the employees and the directors of the same company. According to the theory of interest convergence (Jensen et Meckling, 1976), the possession of a part of the capital by the managers makes up an excellent encouragement to run the company in accordance with the interests of the stockholders. The more capital held by the managers is important, the more interest divergences between the stockholders and the managers will be low. Therefore, resorting to repurchase policies as a controlling mechanism turns out to be useless.

METHOD OF DATA ANALYSIS

To test our research hypotheses, we used linear declines that are robust against heteroscedasticity problems or residue normality. In this case, the estimators obtained by ordinary least squares are unbiased. Furthermore, we have given attention to the problem of collinearity between explanatory variables. Thanks to the study of the indexes of conditioning and VIF (Variance Inflation Factor) of each variable, we conclude that there is not any problem of collinearity in the declines.

The followings regressions equations were estimated to identify the determinants of stock repurchases:

$$NET\ REPURCHASE = \beta_0 + \beta_1 INS + \beta_2 SIZE + \beta_3 DEBT + \beta_4 FCF + \beta_5 ROA + \beta_6 DIV + \mu_{IT} \quad (1)$$

$$NET\ REPURCHASE = \gamma_0 + \gamma_1 MNG + \gamma_2 SIZE + \gamma_3 DEBT + \gamma_4 FCF + \gamma_5 ROA + \gamma_6 DIV + \mu_{IT} \quad (2)$$

Ordinary-Least-Squares estimates were obtained. The results are presented in Table 2 and 3. In the following section, we discuss the presentation and interpretation of the results.

EMPIRICAL RESULT AND DISCUSSIONS

The descriptive provides information on the characteristics of our sample. Table 1 summarizes the statistics of the variables. With respect to the nature of stockholders, we notice the percentage of stocks held by the institutional investors is the highest (40.01%). This result shows that these latter are the preferred stockholders of French companies. These investors participate increasingly in the stockholding of the French firms. The fact that French pension funds have not been sufficiently developed up to now does not hinder an astounding growth of the other institutional investors.

Table 1: Descriptive Statistics

	Mean	Standard-deviation	Minimum	Maximum	Median
NET REPURCHASE	1,494,767	3,350,504	0	21,100,000	58,945
INS	0.4001	0.2781	0.0001	1	0.3570
MNG	0.3182	0.0446	0	0.1916	0.0005
SIZE	16.206	1.451	12.458	18.404	16.649
DEBT	0.2331	0.1296	0.0034	0.5828	0.2265
FCF	0.0227	0.0351	-0.0764	0.1418	0.0219
ROA	0.0625	0.2428	0	1	0.0399
DIV	-2.7502	3.2847	-9.2103	0	-1.2132

This table presents the descriptive statistics of the sample variables. NET REPURCHASE: is the repurchase of stocks measured by the number of stocks repurchased during the year reduced in the sold stock and transferred stocks. INS: is the percentage of the capital held by the institutional investors. MNG: the percentage of the capital held by all the employees, managers and directors of the same company. SIZE: is measured by the logarithm of the total assets. DEBT: is measured by the total debts/ total assets. FCF: is measured by the net profit decreased in dividends and increased in depreciations (paying off) divided by the sum of credits of the company. ROA: is measured by the net profit/total credits ratio. DIV: is the rate of dividend distribution measured by the Napierian logarithm (of dividend / net profit ratio).

Tables 2 present the results of the linear regressions. Most retained variables seem to highly affect the level of the net share repurchases. Panel A shows regression results based on equation (1) and Panel B presents those of equation (2)

Table 2 shows that net repurchases increase with the presence of institutional investors among the stockholders of the company. This relationship can be explained by the fact that these investors (investment funds, banks, insurance companies...) have considerable power within the organization, which allows them to ensure management follow-up to take advantage of opportunities, which present themselves to the company. A way of controlling the managers consists of distributing the available free cash flow in the form of repurchases to limit absurd uses of funds by the Manager.

Grinstein and Michalek (2001), found that institutional investors invest in companies which would repurchase their stocks and reduce their investment in companies which distributed the dividends, and so they would have a preference for repurchases compared with dividends. Also, in 2005 these authors showed that these investors benefit from the opportunities which would arise in the company. A way of controlling the managers consists of distributing the available free cash flow in the form of repurchases so to limit an aberrant use of the funds by the manager.

This result is opposite that of Maury and Pajuste (2002), who found a negative relationship between repurchases and the investment of institutional investors. These authors affirm that the distribution ratio

declines when the controlling owner is an enterprise or a financial institution affiliated with a company group. According to these authors, it is possible for these companies to prefer holding these funds in order to exploit them in group projects.

Table 2: Regression Results

Panel A: Equation 1 Estimates		Panel B: Equation 2 Estimates	
INS	0.2798* (0.083)	MNG	0.4542*** (0.002)
SIZE	0.0754*** (0.000)	SIZE	0.0939*** (0.000)
DEBT	-0.6118** (0.013)	DEBT	-0.7180*** (0.010)
FCF	-0.0383 (0.737)	FCF	-0.0647 (0.896)
ROA	0.5662*** (0.000)	ROA	0.5754*** (0.000)
DIV	0.0262 (0.359)	DIV	0.0150 (0.628)
Adj. R ²	0.2424	Adj. R ²	0.2898
Number of obs.	160	Number of obs.	160

*This table present the regressions of the distribution under the form of repurchase on the property variables as well as on the control variables. The coefficients are estimated from linear regressions. The second figure in each cell is the t-statistic. INS: is the percentage of the capital held by the institutional investors. MNG: is the percentage of the capital held by all the employees, managers and directors of the same company. SIZE: is measured by the logarithm of the total assets. DEBT: is measured by the total debts/ total assets. FCF: is measured by the net profit decreased in dividends and increased in depreciations (paying off) divided by the sum of credits of the company. ROA: is measured by the net profit/total credits ratio. DIV: is the rate of dividend distribution measured by the Napierian logarithm (of dividend / net profit ratio). ***, **, * mean that the coefficients are statistically significant for the respective thresholds of 1%, 5%, and 10%.*

The payment of FCF to the stockholders is an efficient mechanism to help resolve agency conflicts, whatever the form of this distribution including the repurchase of stock. Therefore, according to Jensen (1986) FCF represents the cash flow (or discretionary funds) held by managers after financing all the positive Current-Net-Value projects. Managerial ownership can form an important mechanism for aligning the interests of managers with those of stockholders bringing about a reduction in the costs that they support to control the manager. Besides, when their right to residual profit is weak, managers may take profits from other sources in the company, which risks affecting its value. When managers do not hold all the capital, they will raise their withdrawals from the company from the time that they do not bear all the costs of their opportunism. In fact, managers constitute the agent who can use the resources of the company to establish or increase their power as well as other advantages they receive (freedom of action, job security, remuneration, payments in kind...)

Stiglitz and Edlin (1992) showed how managers could use information asymmetry with different partners and competing managing groups to dissuade these latter from applying for the direction of the company. The investment policy represents, in this respect, a conspicuous entrenchment tool for the managers. The entrenchment strategy developed by managers aims to increase their discretionary space using all the means at their disposal, namely their human capital as well as the company assets, to neutralize the control systems and increase the dependence of all the company partners on the resources they control (specific human capital, information asymmetry...)

Therefore, the positive relationship observed for the managerial ownership can be explained by the fact that the repurchases constitute an additional means of entrenchment for the managers. This result is in agreement with that of Skjeltorp and Odegaard (2004). Definitely, managers who want to raise the proportions of their stockholdings in the companies they run must repurchase the stock. The financial choices (in terms of dividend and indebtedness policy or stock repurchase) can represent a vector of managerial deep-rootedness. Indeed, the financial policies can enlarge the discretionary power of the manager.

Our model includes company characteristics as control variables. The results show that net repurchase is positively linked to the performance of the company and its dividend policy. The coefficients of these variables are statistically significant. However, both the indebtedness and the FCF negatively influence the repurchase. Indebtedness represents a control mechanism which is replaceable for the repurchase. While these two variables have the control mechanism of the agency costs linked to the FCFs, the companies using less indebtedness should, equally, repurchase more stocks.

The negative relationship between the repurchase and FCF contradicts the hypothesis of Jensen (1976) which specifies that a company having high FCFs raises these distributions to reduce the problem of abnormal use of the funds by the manager in non-profitable investments. This let us suggest that the French stockholders do not use repurchases as a means of controlling the funds made available to the manager. They use other disciplinary instruments for their needs. A debt issue can be one of these instruments, which obliges the manager to allocate the FCFs as a priority to the repayment of the loan.

We observe the most successful companies repurchase more stocks. This positive relationship was first identified by Nohel and Tarhan (1998) who showed that the market disciplinary power would replace a mechanism of internal governance. Still, as suggested by Denis and McConnell (2003), the distribution policy could improve the company performance by reducing agency conflicts. The positive relationship between repurchasing stocks and distributing dividends can be explained by the fact that these two policies are rather complementary than substitutable; i.e., the repurchase and the dividend coexist and do not substitute each other.

CONCLUSION

In this paper, we tested the relationship between institutional stockholding and managers, and the policy of repurchasing stocks. We used Ordinary-Least-Square on a sample of 77 French companies during the 5 years, from 2004 to 2008. The results show that institutional investor's ownership positively influences the repurchase of stocks which can be explained by the fact that distributing the available free cash flow in the form of repurchases is a way to control the managers and limit an aberrant use of the funds. We found a positive relationship between the stockholding of the managers and repurchases. This has been accounted for by entrenchment power which can be a factor for the repurchase by increasing the percentage of manager stockholdings.

The paper has limitations. We used a sample of 40 French firms. In future studies a larger sample would provide more insights. Future research might also study the relation between the concentration of French companies and their repurchase policy.

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