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External articles: Corporate governance and business economics outside the Oslo Stock Exchange

Non-listed privat companies represent a much larger part of Norwegian value creation than the public companies on the Oslo Stock Exchange. Nonetheless, both corporate governance and business economics in Norwegian non-listed companies have been analysed far less than in listed companies. The same is true in the rest of the world. As a first step towards better professional insight, we document that the ownership structure of Norwegian non-listed companies is very different from that of listed companies. We also show that these distinctive features provide quite different corporate governance than in a listed company. However, this does not mean that they are simpler.

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The content of the article does not necessarily represent the views of the Ministry of Trade and Industry.

Motivation

For many years, there has been great and welcome public interest in the relationship between corporate governance on the one hand and business economics on the other. The fundamental question is how the ownership structure, board composition and employee incentives affect the ability of a company to grow and evolve in a profitable manner. For example, does it matter whether the company has one main owner or many small ones, whether the owners are the State or private parties, whether the private owners are institutions or families, whether ownership is short-term or long-term, whether the owners are on the board, whether both men and women are on the board, whether the employees are represented on the board, whether they have shares in the form, or whether salaries are fixed or performance-dependent? And what does such corporate governance mechanisms mean specifically for the company's finances, such as the cost of capital, investment volume, innovative activity, employment growth, capital structure, dividend policy and return on capital invested?

Well-thought out answers to such questions are needed to develop good corporate governance models in the individual company. Good answers are also necessary for designing successful public policies as an owneralll framework for ownership. Even though recent research has provided help in understanding the difference between good and poor corporate governance, this applies almost exclusively to listed companies.[1] Non-listed companies, in other words the companies outside Oslo Stock Exchange, have for all practical purposes not been analysed. This situation is unfortunate both in terms of macroeconomics and the individual companies. First, we will shortly document that value creation in Norway is far higher in non-listed companies than in listed companies. Secondly, we will show that because both ownership structure and the corporate environment are so different for non-listed companies, their owners face completely different governance challenges than listed companies. Consequently, basic knowledge about corporate governance is weakest in the largest sector of the national economy.

The size of the non-listed sector in Norway

Our data comes from a database on business economics and corporate governance in all Norwegian limited companies. It contains complete data for each company's balance sheet, income statement, ownership structure, board composition, management, employment, industry, auditor comments and credit rating.[2] These data show that the number of Norwegian limited companies increased from approximately 100,000 in 1994 to 180,000 in 2005, while the number of active limited liability firms (AS and ASA firms) with reliable data rose from approximately 60,000 to 80,000. The figures in this article concern only this latter subgroup, where we have also omitted subsidiaries and instead used the parent company's consolidated figures. Based on these data, figure 1 shows the overall size ratio between non-listed (light column) and listed (dark column) companies as a whole in 2005.

The figure shows that for each listed limited company there are approximately 500 outside the stock exchange. Moreover, it shows that there are more than four times as many employed in the non-listed sector as in the listed sector and that the non-listed sector is nearly twice as large as the listed sector measured

[1] A good overview of international corporate governance research is provided in Becht, M, P. Bolton and A. Roëll: "Corporate governance and control", in G. Constantinides, M. Harris and R. Stulz (ed), *Handbook of the Economics of Finance*, North-Holland, 2003. A brief summary of issues and selected results for Norway can be found in Ø. Bøhren: "Eierskap og lønnsomhet" (Ownership and profitability), *Økonomisk Forum* 59 (5), 2005, pp. 4-14.

[2] The data are obtained from Creditinform (which receives its data from the Brønnøysund Registers) and Statistics Norway. There is a special database for listed companies based on data from the Norwegian Central Securities Depository (VPS ownership data) and the Oslo Stock Exchange (share prices, share issues and trading volume data). The database is to be expanded with family and kin relationships for each company board, management and owners.

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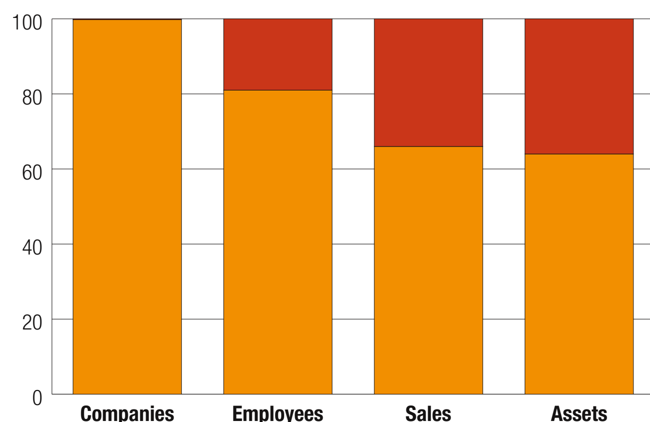
Figure 1: Size ratio between non-listed (light column) and limited liability companies (dark column) in Norway in 2005 measured by number of companies, employees, sales and assets.



by sales or assets. Consequently, the non-listed sector is 2-4 times larger than the listed sector regardless of size measure.[3]

In other words: If you picture overall employment in Norwegian limited companies as an iceberg, it is basically the listed companies that stick up above the surface of the water. To an even greater degree than relative size, this metaphor can be applied to the level of knowledge about business economics: Many people have examined much of what lies above the water, but almost no one has studied the conditions below the surface, where most of the activities take place.

It is also worth noticing that non-listed companies are not necessarily small. To be sure, the typical company on the Oslo Stock Exchange is 100 times bigger than the typical company outside the exchange. Nevertheless, there are far more large non-listed companies than listed. For example, if we define a large company as one with more than 100 employees, Norway had approximately 1 000 large companies in 2005, of which only 100 were listed.

The ownership structure of non-listed companies

Given this state of affairs, there is little systematic knowledge about the corporate governance of non-listed companies. This concerns both key characteristics such as ownership concentration, ownertype, long-term ownership, board composition, and the relationship between corporate governance and performance, for example whether employee ownership, long-term family ownership or majority owners matters for the firm's profitability. Studies from other countries, where access to data is in general more difficult than in Norway, nevertheless show that the corporate governance challenges in the non-listed sector are fundamentally different than for listed companies, and that the recipe for good ownership for listed companies is not transferrable to non-listed companies.[4] Preliminary analyses we have done ourselves point in the same direction.

A good starting point for addressing this issue is table 1, which shows some characteristics of the ownership structure of Norwegian limited liability companies in 2005. We give the results separately for all non-listed companies, for the large ones among them (i.e. with a similar size as listed) and for the listed companies. The figures are averages and weighted equally, i.e. all companies in the sample count the same in the calculation.[5]

Ownership concentration in table 1 reflects the degree to which the company has owners with sufficient power and

[3] Norway is no different from other countries in this area. Even though there is no data of the same type from other countries, the ratio of market value of listed sector to GDP, for example, suggests that Norway is close to the EU average.

[4] See for example Villalonga, B. og R. Amit: How do family ownership, control, and management affect firm value?, *Journal of Financial Economics 80*, 2006, pp. 385-417.

[5] For example, in table 2, use of equally weighted holdings means that owner types that are primarily owners in large companies, such as the State, receive a lower cumulative holding than they would have received if instead we had used value-weighted holdings, i.e. each ownership stake weighted by firm size. Since our purpose is to show who the typical ownership type is, rather than the type's contribution to overall value creation, we use equally weighted averages.

Table 1: Ownership concentration for non-listed and listed firms with limited liability in Norway in 2005.

Type of company	*Shareholding of largest owner, %*	*Shareholding of three largest owner, %*	*Companies with majority owner, %*	*No. of owners*
Non-listed	70	95	75	3
Large non-listed	71	92	70	13
Listed	25	43	5	3 863

incentives to engage in active corporate governance. The higher the ownership fraction, the greater the power and incentives. The first column shows that the largest owner in a Norwegian stock exchange listed company has on average a 25% shareholding. The largest owner is consequently far from a simple majority (50%) and cannot even stop charter amendments (34%). The situation is completely different in the average non-listed company, where the largest owner has 70% of the shares and hence far more than a simple majority and even a majority for charter amendments. The same story is evident from the fact that while the three largest owners all together own 95% of a non-listed company, they hold only 43% of a listed company. The table also shows that while 75 of 100 non-listed companies have a majority owner, only 5 of 100 listed companies have one.

Notice also that the figures for the large non-listed companies are nearly as high as for non-listed all together. Hence, the high ownership concentration in the non-listed sectors is not due to non-listed companies being typically much smaller than listed companies. For companies of comparable size, the owners have much greater power and incentives for active corporate governance when the company is non-listed.

Owner type in table 2 shows how much of the company's shares each type of owner has as a group. The most striking feature is that individuals (personal owners/families) are completely dominant in non-listed companies, where they hold 77% of the shares on average. This indicates that most non-listed companies are family companies and also that families rarely own through holding companies. By contrast, in listed companies, owners are not primarily individuals but other companies. For example, individuals on average own only 18% of the shares in a company on the Oslo Stock Exchange, while Norwegian institutional and industrial owners own in all 52%. This reflects the fact that while ownership rights in non-listed companies is exercised directly by the owner, this happens indirectly in listed companies, i.e. by employees of companies who manage the assets of other people.

The ownership concentration is consequently much higher and direct ownership is much more prevalent when the company is not on the exchange. Other analyses we have made also show that large owners are far more often represented on the board and in the management team when the company is non-listed. This ownership, board and management pattern is the key compnent in what is usually called the company's two fundamental corporate governance problems.

The first corporate governance problem occurs when ownership and control are seperated in that owners delegate power to a management with weak economic incentives. This problem therefore concerns the conflict of interest between owners and managers. The lower the ownership concentration, the more ownership is exercised indirectly, and the more owners are absent in the boardroom, the greater the problem. Tables 1 and 2 therefore indicate that the first corporate governance problem is potentially large in listed companies (low ownership concentration and low direct ownership) and small in non-listed companies (high ownership concentration and high direct ownership).

The second corporate governance problem concerns the conflict of interest between owners, and particularly between strong and weak owners. This arises when strong owners siphon off what they can from jointly owned companies at the expense of weak owners. Examples of such minority robbery is unfair tranfer pricing of deliveries to or from another company that the majority owns alone, excessive use of jointly owned company funds for private advantage, employment of incompetent family members, and minority owner freezeout at depressed prices. This conflict of interest between strong and weak owners is more serious the higher the ownership concentration and the more dominating the large owner on the board and in the management team. Tables 1 and 2 indicate that the second corporate governance problem is small in listed companies (low concentration and absent, indirect owners). In contrast, it is potentially large in non-listed companies, where one owner typically has full control, is a person, and has invested together with a few minority owners outside the family.

In summary, non-listed companies typically avoid the first corporate governance problem (the conflict between owners and managers), while they are correspondingly more susceptible to the second (conflicts among the owners). Consequently, corporate governance problems to not occur in listed companies only. For the same reason such problems can not be eliminated in a listed company by buying out most of the shareholders and taking the company private.

Nor is it obvious that the first corporate governance problem, which primarily afflicts listed companies, is more costly than the second, which the non-listed companies struggle with. However, there are several remedies that can reduce both problems. For example, the owners can influence the first corporate governance problem by working actively on the board, tailoring management incentives, and by ensuring that

Table 2: Owner types

Type of company	Foreign	State	Cumulative stake per owner type, % Institutional	Industrial	Personal	Unspecified
Non-listed	3	1	1	5	77	13
Large non-listed	25	3	1	13	29	26
Listed	25	4	14	38	18	0

that company has highly qualified executives. The regulator can affect the second by rules on insider trading and minority freezeouts, while owners can do their part by writing clear shareholders' agreements among themselves.

Otherwise there are several positive features of corporate governance of listed companies that are absent in non-listed companies. Non-listed companies are not threatened by hostile takeovers when they are poorly run, and there is no daily spotlight on the company by financial analysts and potential new owners. Internal recruitment within the family and closed boards can also lead to a type of inbreeding and incompetence to which listed companies are less exposed.

Economic challenges of being non-listed

We have documented that the ownership structure of Norwegian non-listed companies differs widely from that of listed companies. Consequently, they have diametrically opposite corporate governance problems. We will now briefly discuss how non-listed companies face special challenges in their business economics, partly due to their ownership structure partly due to not being listed. The key words are financing, investing and dividend policy.

Financing. Non-listed companies cannot finance themselves through a broad market for new equity. Nor can their shares be traded in liquid second-hand markets. Both handicaps make equity capital more expensive in non-listed companies than in listed companies. The cost of debt can also be higher when the bank has less information about a debtor who is not valued daily on the stock market, not analysed by the financial press and investment banks, and is not obliged to immediately inform the public about all price-related events. Non-listed companies may also have to choose a higher leverage and also accept more short-term instead of long-term debt because equity is difficult to raise. In all, this makes the costs of capital higher for non-listed companies than of listed.

Investment. Higher costs of capital may mean that non-listed companies invest less than listed companies by discarding projects that would be profitable if the company had been listed. The risk profile of the firm can also be different, particularly in family-owned companies where the family often invests nearly all its wealth in one company and thereby has a highly undiversified share portfolio. It is then tempting to let the company diversify itself by spreading its investments over several products and industries. In that case family companies take on conglomerate characteristics, while listed companies with diversified owners can more easily specialise with the blessing of their well-diversified owners.

A low level of investment and poor business focus are therefore potential problems for non-listed companies. On the other hand, it can be easier for them to make profitable long-term investments compared with listed companies. The idea behind this is "quarterly capitalism" by which an impatient stock market can force listed companies to invest in projects with a short payback period and high quarterly earnings, but with weak long-term profitability. Non-listed companies are probably less exposed to this pressure since they do not have to report quarterly, do not have thousands of owners who use financial statements as their main information source, and do not have owners who quickly sell out if earnings take time to materialize.

Dividend policy. Most owners of non-listed companies cannot easily sell their shares to obtain liquidity for personal use. However, the company can mitigate this problem by paying a high share of profits as a dividend. By contrast, the market for new equity is much thinner for non-listed companies. This indicates that more profits should be withheld to ensure sufficient self-financing of growth in the future. The net effect of these two opposing forces is not evident.

In this discussion of business economics challenges we have only indicated some possible patterns. It remains to provide credible answers to how this looks in the real world, for example regarding how large the capital cost difference is between listed and non-listed companies in Norway, how much the investment level and risk profile differs between family companies and other companies, and how much of the profits are ploughed back into a non-listed company compared to a similar one on the Oslo Stock Exchange.

Summary

We have made three main point in this article. The first is that the non-listed companies in Norway with limited liability represent a far larger share of value creation than the listed companies. Secondly, both the governance structure and governance challenges of non-listed companies are very different than those of listed companies, and this may have economic consequences. The third point is that the current insight into the corporate governance and business economics of non-listed companies is weak, particularly relative to the importance of these firms in the Norwegian economy.