How ownership concentration influences R&D investment

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Exploring the dynamics between ownership structure and R&D expenditure in Spain, reveals new insights into what drives investment preferences.

A company's ability to remain successful in the long term depends on how committed that company is to research and development (R&D), and that is often determined by the firm's ownership structure. Yet few can agree if large blockholders have a positive, negative or even a neutral effect on R&D investment.

In their journal article "Do the Type and Number of Blockholders Influence R&D Investments?" authors Josep A. Tribó, IESE Prof. Pascual Berrone and Jordi Surroca offer new evidence from Spain, which effectively represents a middle ground between the outsider ownership systems that typify Anglo-American firms and the documented insider systems of Asia. Comparing and explaining the different tendencies of these other regions with Europe, the authors make a deeper analysis of how different types and numbers of block owners influence investment decisions.

Spanish firms merit study for three reasons, they say. First, capital markets are underdeveloped in Spain. In terms of total market capitalization as a percentage of GDP, Anglo-American markets are three times the size of Spanish markets. Yet, Spain still ranks much higher than other European countries, notably Germany and France.

Second, large ownership concentration is encouraged in Spain by failings to offer adequate investor protection via corporate governance, compared to the United States, Britain, Japan

and Germany. This also serves as a motivation for greater involvement among blockholders. Together, these factors help to explain why Spanish holdings for firms, individuals and banks were an average of 15 percent, 11 percent and 7 percent respectively, compared to 5 percent, 1.6 percent and 1.8 percent in Britain.

Third, a large proportion of banks serve as major blockholders in Spain, as a result of the government-promoted privatization program to create a wide range of stable investors, or *núcleos duros*. Noting the strong presence of banks as owners, this study separated blockholders into three classes of ownership groups.

Banks: Firms with banks as major blockholders did not typically make large-scale investment in R&D. This can be explained by the fact that banks often provide debt financing to the firms in which they hold equity-ownership stakes, resulting in a heightened degree of risk exposure. This encourages a more conservative approach, both through a greater focus on short-term gains and by minimizing long-range investment where outcomes are uncertain, as with R&D, wherever possible.

Non-financial institutions: In the case of non-financial corporate blockholders, separation between external debt financing and the equity stake helps prevent a short-term bias. Corporate blockholders are more likely to have a similar strategic view of the firms they invest in, allowing them to appreciate the long-term benefits of R&D investment.

Furthermore, these block owners can also benefit from R&D investment directly through synergy and learning transfer between the two firms. In some cases, corporate owners may fund R&D as a strategic investment, to test it out before adopting learning on a larger scale within their own firms.

Individuals: Finally, with individual or non-institutional blockholders, predicting R&D investment intensity is more complicated because of two countervailing effects that alternate influence in different situations, sometimes even cancelling each other out.

Since individual blockholders usually outnumber corporate blockholders for a given company, there is a corresponding breadth in views toward risk and investment horizons. This makes achieving consensus more difficult, and limits investment.

However, because investment by individuals represents a greater share of their total wealth, there is a greater incentive to observe managers' actions, monitor firms vigilantly and favor R&D investment to encourage long-term growth. Overall, the amount of R&D investment tends to decline as the number of blockholders increases. This "disagreement effect" occurs

as difficulty in obtaining consensus leads to a lack of support to authorize R&D spending.

This disagreement effect led the authors to predict and test whether increases in the number of blockholders have a negative impact on R&D investment. This is so because the existence of a set of large shareholders with different individual objectives makes reaching consensus on firm decisions more difficult, especially when those decisions involve long-term agreements like those to undertake R&D-intensive projects.

A note of caution

These findings beg the question: Does the presence of large block shareholders lead to appropriate investment decisions and strong performance?

In situations where R&D investment is more than the mean average for their sector, presence of non-financial corporations as large shareholders was found to have a positive impact on financial performance. This illustrates a key advantage of corporate blockholders - a positive influence through bringing their own experience managing R&D investments - to help guide their partially owned firms toward projects that improve financial performance.

Consequently, prospective investors should exercise caution with firms with a high number of blockholders. This holds especially true if the company belongs to a high-tech sector, where innovation is vital for organizational survival, as ownership structure may impede the investment necessary to survive and thrive in a fast-moving environment.