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Shareholder Value and the German Business System

Online Seminar Series

The German System of Codetermination

Outline

- Introduction
- Terminology: The Concept of Financialization
- The Conventional Story and its Limits: The Decline of Germany Inc.
- The financialized subsystem and the rest
- The Rise of the Institutional Investor and Ownership Structures
- The Advance of New Ideas and its Carriers: Contested and Declining
- Shareholder Friendly Institutional Rules and Institutional Obstacles to Shareholder Primacy: Co-Determination and Company Law.
- The Relevance and Development of SV Related Policies: Dividends and Share-Buy Backs, management remuneration
- Conclusion

Introduction

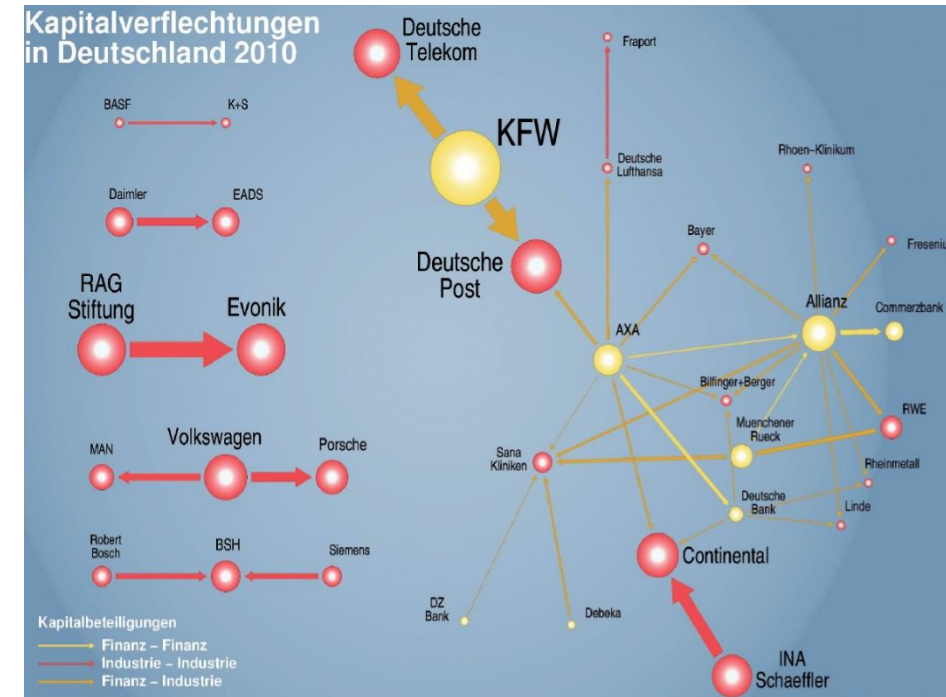
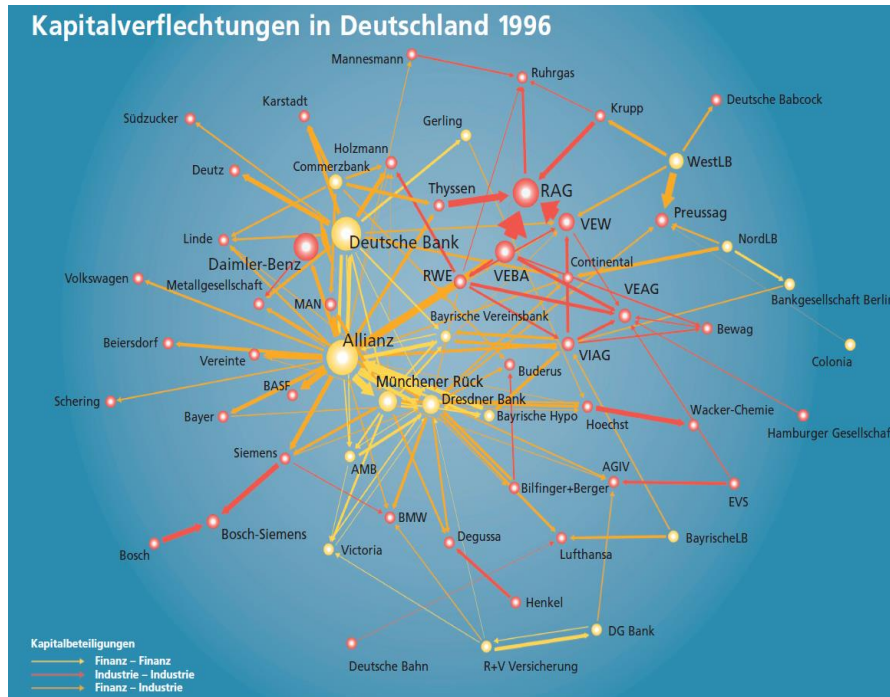
- The German Debate was and is primarily interested in *change* of the business system by the demise of Germany Inc. (Deutschland AG), the rise of the institutional investor and the concept/ideology of Shareholder Value. It was and is interested in effects on corporate strategy, employment, innovation, codetermination/worker's rights. The debate, particularly among critical observers, has a tendency to dramatize newness and to underestimate continuities. In the beginning quite some scholars expected the German business system (as a prototype of CME) to converge to a Shareholder Economy (or a LMC) (according to Hall and Soskice 2001). The German debate, hence, has the tendency to miss or to downplay what can be learned from the German experience where former institutional rules, ownership patterns and elements of the business culture have survived despite undisputable change. There is still a significant difference between the current German business system and an ideal type Shareholder Value Economy or the US Business System.
- Comparative analysis, on the other hand, is often in danger to produce functionalist-static pictures of business systems, somehow frozen pictures, that miss change over time on both sides of the comparison. Thereby, learning possibilities are also restricted but for other reasons.
- Therefore, if we want to learn something from the German experience (that's what our joint endeavor is all about) we have to keep the balance between continuity and change. This is what I want to take to heart in the following. Early contributions highlighted this in their headlines: Sigurt Vitols talked about "Negotiated Shareholder Value"; Uli Jürgens and colleagues about "Shareholder Value in an adverse environment". Others acknowledged that important institutional rules (esp. Co-determination) remained in place but that nevertheless the existing/remaining institutions changed their meaning and orientation. In German one could say: the institutional rules now are more guided by a different "Leitidee" (Lepsius) than before. Martin Höpner and Gregory Jackson grasped this as "gradual but nevertheless transformative change" (Streeck/Thelen 2005) as "conversion" (ibid.). In my view these diagnoses map important aspects of the changing situation but fail to account for other aspects: the range of its occurrence and the reverse influence: Co-determination and the business culture have an impact on what Shareholder Value means and effects (Faust 2012 in Lane/Wood).

Terminology

- Overall concept: **Financialization**; here: Control Financialization (Deeg)
- Advantage of a **process concept**: more or less, financialization and de-financialization
- **Dimensions of Financialization**:
 - Networks: ownership structure, constellations of actors.
 - Institutional rules
 - Ideas/ideologies (knowledge and values): concept of the firm, management concept (VBM).
- **Interactions between structures**: new ideas may spur institutional change; new actors as carriers („Trägergruppen“) of new ideas; persistent institutional rules support established stakeholders and hence contest new ideas, etc.
- The **multireferential enterprise** is not only financialized, but multiply embedded

The Impressing Decline of „Deutschland AG“

Cross-Ownership among 100 Largest Companies in Germany 1996 - 2010



Source: http://www.mpifg.de/aktuelles/themen/doks/Deutschland_AG_1996bis2010.pdf

Data: Hauptgutachten der Monopolkommission, several years

The Decline of „Deutschland AG“

The Conventional Story

The Retreat of the large private banks (Deutsche Bank, Dresdner Bank) and Allianz

- Large German Banks on their way to „Market-Based Banking“.
- German industrial holdings an obstacle to become an investment bank
- Presumably low returns from German holdings compared to global investment
- Retreat from public mandate (industrial policy) and as a barrier to unfriendly takeovers

The rise of the Institutional Investor in Germany and from abroad.

- They fill the gap that emerged by the retreat of patient capital.
- Industrial firms are therefore vulnerable to capital market pressures

Shareholder friendly reforms allow and stimulate foreign investors to invest in German stock

Capital Market Reforms allow tax-free sale of industrial holdings by banks and Allianz

Overall political and business climate favourable in the 1990s

- Germany as the „Sick Man of Europe“ has to catch-up
- The transient success of the „New Economy“
- The US economy as a role model – Shareholder Value as an inevitable new management concept

The Decline of „Deutschland AG“

Yes – but an uncomplete and partly misleading picture

Structural limits

- Relevance of the institutional subsystem disregarded
- Relevance of „new owners“ overstated
- Persistent Relevance of „patient capital“ overseen or underestimated

Institutional Reforms inconsistent and disputed – more continuity

- Co-Determination remained as an obstacle to shareholder primacy – re-discovered
- Stock Corporation Law and Corporate Governance Codex still support stakeholder concept of the corporation

New Ideas contested and not hegemonic, losing support over time

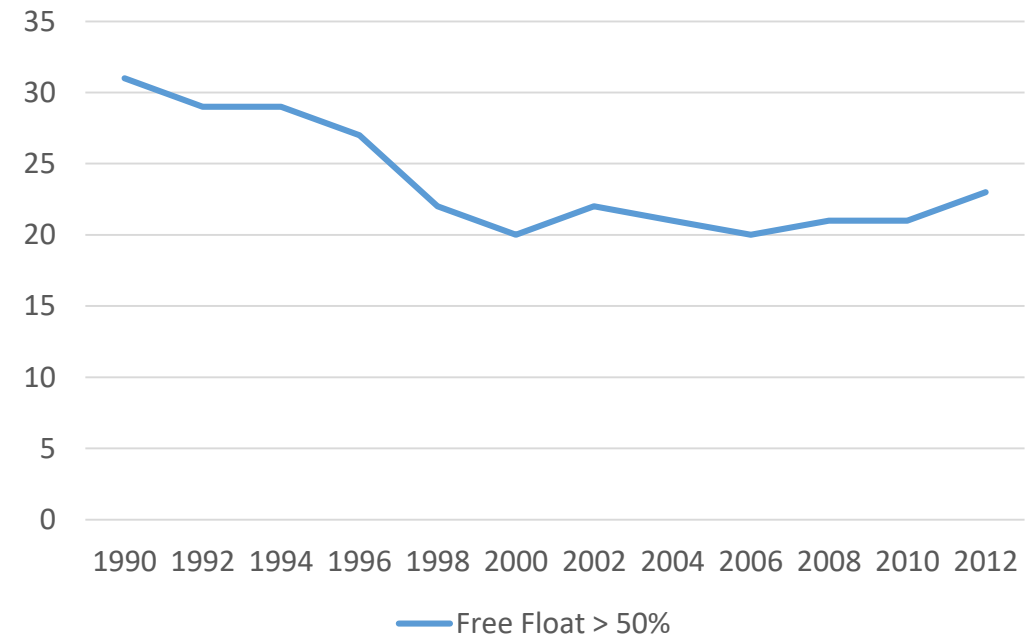
Varieties of Institutional Investors with less conformity vis-a-vis corporations and management

Number of Listed Corporations among top 100 fairly constant Free Float > 50% declining

Number of Listed Corporations among 100 largest firms



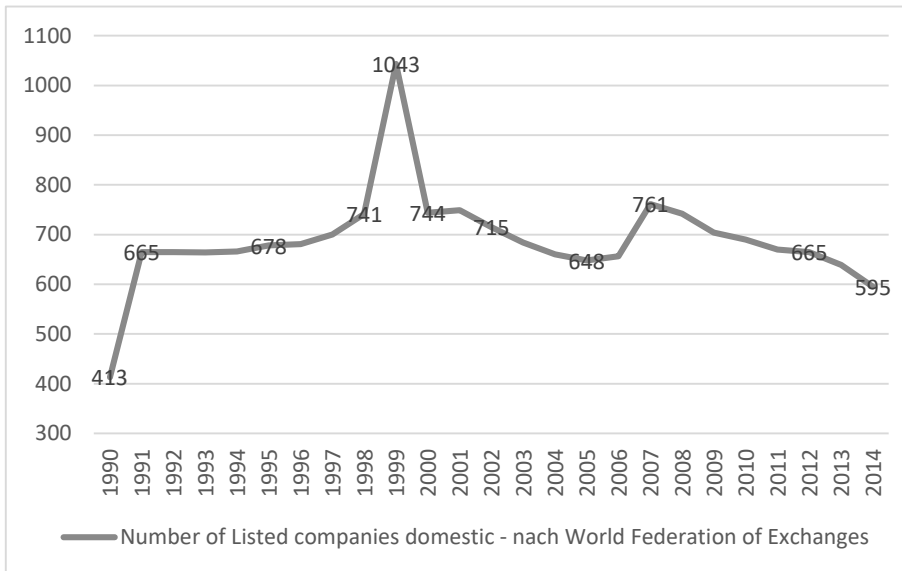
Number of Listed Corporations with Free Float > 50%
Among 100 largest firms



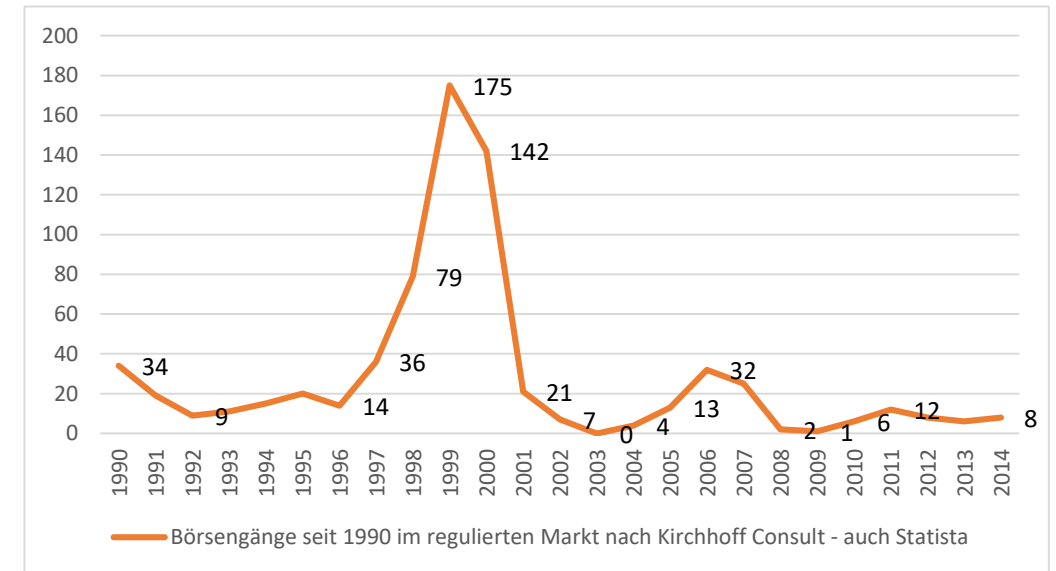
Source: Faust/Thamm 2016, 2015; Data: Hauptgutachten der Monopolkommission, diverse Jahrgänge, own calculations

Number of Listed Corporations and IPOs in Germany

From 1990 to 2014



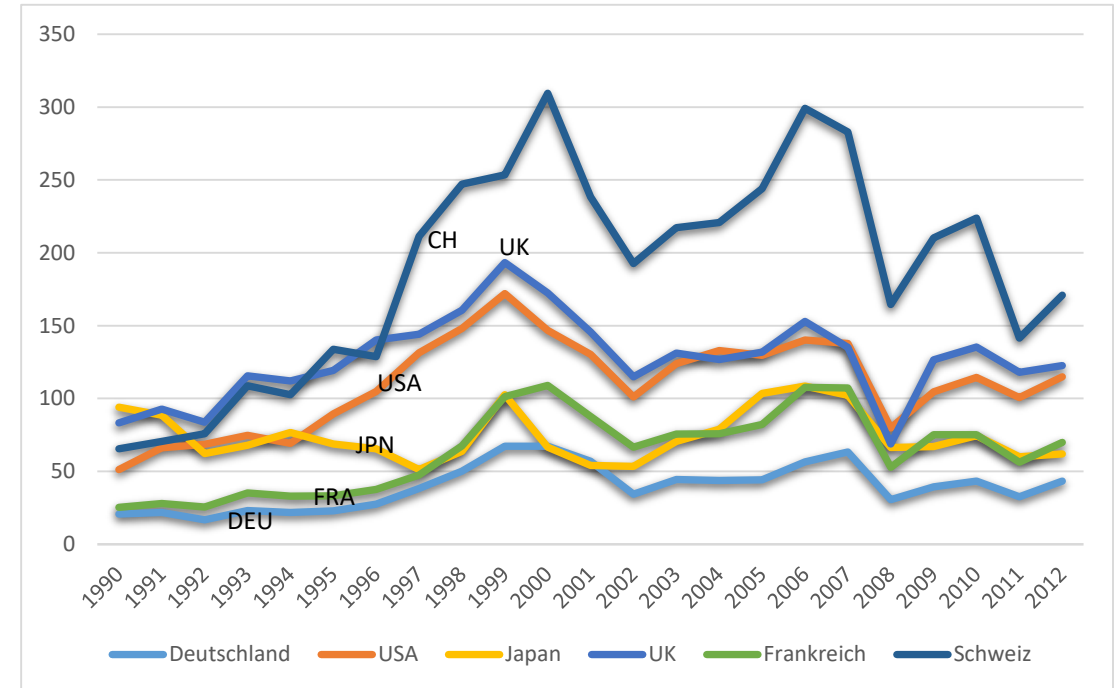
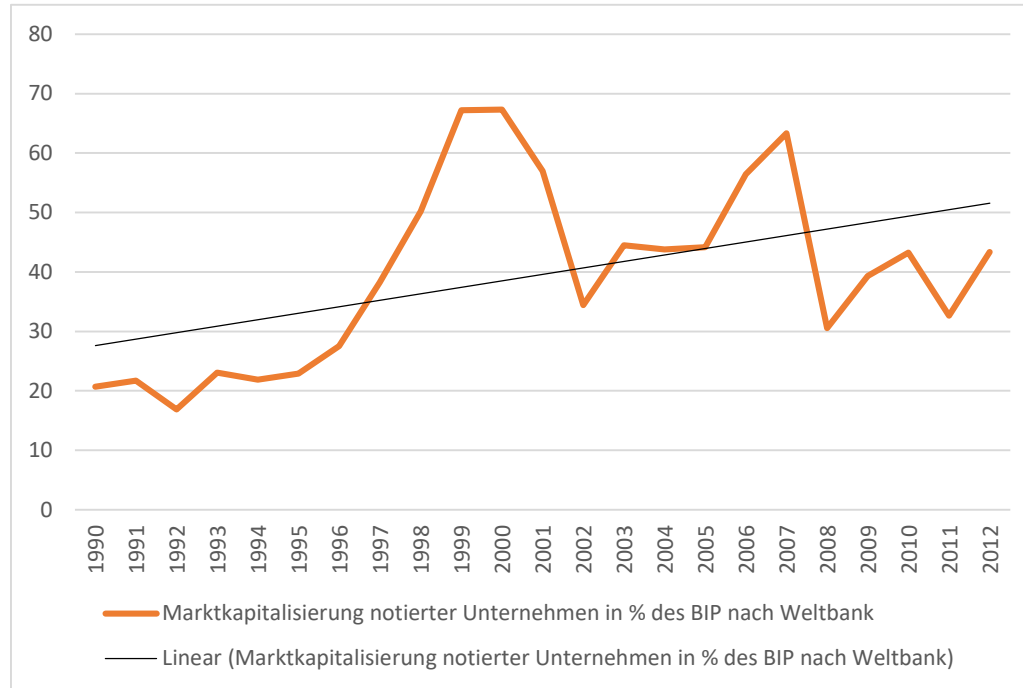
Source: Faust/Thamm 2016, Data: World Federation of Exchanges



Quelle: Kirchhoff 2014: 15.

Relevance of LC and IPOs: Peak during „New Economy“ followed by declining relevance

Market Capitalization (% of GDP): Relevance of Listed Corporations over Time and in International Comparison



Source: Faust/Thamm 2016, Data: World Bank

Listed Corporations often have Anchor Investors/“Patient Capital”

Voting Rights for Blocking Minority and Categories of Blockholders 2014

Kategorien →	No Blockholder	With Blockholder	Asset MGMT	Bank	Insurance	Sov. Wealth Fund/ State	German State Authorities	Families, Foundations, Founder	Other German Firm	Foreign Firm	Co-op Assoc.
Index ↓											
DAX30	70%	30%	0%	0%	0%	0%	3,3%	16,7%	10%	0%	0%
MDAX	38%	62%	4%	0%	6%	6%	4%	16%	12%	12%	2%
SDAX	28%	72%	6%	2%	2%	0%	2%	46%	8%	4%	2%
TecDAX	43,3%	56,7%	0%	0%	0%	0%	0%	46,6%	3,3%	6,7%	0%
Total	41,9%	58,1%	3,8%	0,6%	1,9%	1,9%	2,5%	31,3%	8,8%	5,6%	1,3%

Source: Faust/Thamm 2016, own calculations

Anchor Investors: Decline over time but remain highly relevant

Studie	Year of inquiry	With De-Jure Blocking Minority*(% of all Firms)	With De-Facto** Blocking Minority* (% of all Firms)
Franks/Mayer 2001	1990	85,4	
Jenkinson/Ljungqvist 2001	1991	87,4	
Edwards/Nibler 2000	1992	71,4	
Becht/Boehmer 1997	1996	82,3	
Ampenberger 2010	1995	88	
	2000	77	
	2006	67	
Kammerath 1999	1999	81,1	
Van der Elst 2000	1999	75,1	
Rapp/Wolff 2010	2005 – 2007	ca. 54	
Fichtner 2009	2008	56,3	69,4
Fichtner 2015	2011	57,5	
Faust/Thamm 2015	2014	58,1	71,2

* Blocking Minority means at least 25 percent of voting rights

* „De-Facto“ considers attendance at General Assembly

The ten largest Financial Investors: Patient?

Number of holdings among 160 DAX/MDAX/SDAX/TecDAX Firms (2014)

Financial Investor	Number of Holdings
BlackRock	47
Allianz Global Investors	22
Norway State Fund	21
Capital Group	20
Deutsche Asset & Wealth Management	17
Fidelity	16
Franklin Templeton Investments	15
Sun Life Financial	12
BNP Paribas	7
Threadneedle	6

Source: Faust/Thamm 2016

Who cares about firm-in-industry? Who is patient/activist?

A Typology of Shareholders

No reference to „firm-in-industry“

- Passive index funds, no selection of firms, no interest in strategy, potentially engagement (ESG) on AGM
- Behavioral finance, reference to other investors (e.g. momentum), no engagement
- Quantitative chart analysis, reference to share price movements, no engagement
- HFT, reference to other regions/asset classes (arbitrage), no engagement possible

With reference to „firm-in-industry“

- Active investment strategies, stock picking and „fundamental“ analysis, „essentialists“ (Beunza/Stark 2004), potentially engagement influencing management, but also „rational apathy“
- Event-driven short term strategies, only observer, no voice, no engagement („transient“, Bushee 1998)
- Activist hedge funds, select targets, restricted criteria (M&A, Focus, Pay-Out), (joint) activism in order to produce desired event.

Strategic control or decisive influence

- (Founding) families, founders, foundations, trusts
- Other NF-companies
- State, state authorities/ development banks
- Traditional German bank holdings
- Representation on supervisory board, influence on strategic decision making, voice and loyalty

Source: Faust 2017; see also Deeg/Hardie 2016

The Constellations of Actors Matters

Example: Hedge Fund Activism

- Activist Hedge Funds attack target companies, start public campaigns and demand particular strategic changes: special dividends, focussing/desinvestment, board membership that may find wider support.
- They mostly have minority stakes and try to convince (opportunistic) passive and transient institutions.
- They have a short term interest because they sell after the strategic change is in place or announced and share price has gone up.
- Short term gains often come at the expense of long term stakeholder: employees, the public, creditors, long term investors, especially anchor investors.
- Anchor investors are the main remedy against (successful) activist campaigns and the disciplinary pressure of a „market for corporate control“. „Patient capital“ among institutional investors (Deeg/Hardie 2016) also relevant?
- Accordingly hedge fund activism is comparatively low in Germany (2002 -2010, Becht et al. 2014):
 - All over 1, 796
 - USA 1, 166
 - Japan 186
 - UK 168
 - **Germany 55 (3,1%)**

The Constellations of Actors Matters

Example: Competitive Environment

- Corporations do not only compete in capital markets but predominantly in product and labor markets
- Whether or not firms can afford short termism, to reduce investment and innovative activities depends on the structure of the market and the degree and culture of co-determination
- Co-determination gives emphasis on investment in capacities in order to maintain employment and sustainable growth. Common interest of workers' representatives and patient capital: long-term survival
- German Automotive Industry (OEMs): Two of the three large automotive corporations/groups have large anchor investors (families, state). Daimler unclear. Many foreign competitors also have anchor investors (families, state, others): Toyota, PSA, FiatChrysler, ...
 - BMW (BMW, Mini, ...): Quandt family 46,7%
 - VW group (VW, Audi, Porsche, Skoda, SEAT ...) Land Niedersachsen 20%, Porsche family 53,1%, Qatar 17,3 %
 - Daimler Geely 9,7%, BAIC 5%, Kuwait 6,8%, Renault-Nissan 3,1%
- Automotive supplier industry: Three German automotive suppliers are among the five largest worldwide. All of them are characterized by patient capital.
 - Bosch not listed, Foundation Continental listed, Schaeffler (IHO) 46% ZF not listed, foundation

The Advance of New Ideas and its Carriers

- The **economic and cultural context of the 1990s and early 2000s** was favorable for dissemination and adoption of the new ideas: the „Sick Man of Europe“, parochial and backward while the US economy represented the new era („new economy“).
- **Institutional Investors and analysts** (often from abroad) confronted managers with the new demand to serve predominantly their shareholders at analyst/investor conferences and one-on-ones. They served as an ambassador of the „alien“ model.
- All global **US consultancies**, having expanded in Germany since the 1980s, propagated the Shareholder Value concept and offered concepts and techniques for their clients to implement it. They spread fear and hope.

McKinsey Consultants Tom Copeland, Tim Koller und Jack Murrin (forword to German edition, 1998) praise the US as a role model „that is based on the maximization of corporate value and brings with it a widespread participation in credit and equity capital as well as an open market for corporate control“. They warn German managers and politicians that „countries that do not follow the maximization of corporate value, deliver lower returns on capital to their investors than other countries will suffer from lack of capital and will fall behind in international competition because of the proceeding globalization of capital markets“.

- **The business press** often served as an amplifier.
- **German managers** with international experience disseminated the new salvation doctrine, promised obedience or at least were eager to earn higher salaries from adoption. Highly visible followers among top managers of corporations exposed to capital markets, particularly CFOs.
- Parts of **German business economics** (Finance, Management, Accounting) became adherents of agency theory and translated VBM („Wertorientierung“).

The Advance of New Ideas and its Carriers

Limits and Decline

- The burst of the Internet bubble and the disappointment about the “New Economy” changed the perception of the shareholder value concept from a bright promise to a dark apprehension in the public opinion and a unpleasant but urging need in parts of management. The recovery of the German economy after the mid 2000s and the financial crisis lead to a further erosion of the belief.
- Nevertheless, nowadays wider recognition of VBM (techniques, ratios) and the need for capital market orientation among managers.
- Already in the 1990s there was widespread, but less visible scepticism against the SV doctrine that gradually gained ground
 - Widespread disinterest and refusal among German Mittelstand owners and managers
 - Pragmatic and adoption and translation in listed corporations with anchor investors and its managers
 - Managers from other functions and professions than finance, accounting and general management, particularly among technicians/engineers are more reluctant
 - Management consultants moved on to other fields of profitable advice giving.
 - Other fields of business economics than finance, controlling, accounting and of course in the wider social sciences stick to their dedication and increasingly contradict.
 - Increasing rejection and hostility against SV among unions and work councils, particularly since downsizing, outsourcing and offshoring was associated with the doctrine.
 - Social Democrats and the Green Party, once the precursors of shareholder friendly reforms, discover/emphasize its dark sides (“Heuschrecken” – “Locusts”). Moreover, even conservative politicians rediscover the advantages and blessings of co-determination as a counterforce to a disembedded, predatory capitalism.

Institutional Rules: Shareholder friendly reforms

- Prohibition of multiple voting rights, preferential voting rights (golden shares) and maximum voting rights.
- Restriction of execution of voting rights by banks
- Prohibition and control of Insider Trading
- Extended obligation of transparency and disclosure according to international standards
- Restrictions for management to protect the firm/themselves against unfriendly takeovers which agency theory holds necessary to discipline managers
- Permission of share buy backs previously forbidden to help align interests of managers and shareholders
- Permission of share options in remuneration schemes previously forbidden
- Strengthening of the supervisory board vis-a-vis executive directors („Vorstand“) potentially giving also (but not only) the capital side more control/influence

Institutional Rules: No Shareholder Primacy

Persistent Institutionalization of Workers' Voice

- Always opposition to Co-determination from employer/industry associations and private owners (“Herr im Haus”). During 1990s new ideological support for attacks by the rise of neoliberalism and agency theory
- Supporters come from (neo)liberal parts of the party system, the financial sector, management consultants and parts of the academia (financial economics)
- Opposition/objections not only from the unions and Social Democrats but also partly from Christian Democrats and some (prominent) top managers
- A government commission (“Biedenkopf Kommission”) failed to come to a shared conclusion. The advisory opinion of the academic members (chair: Streeck) only recommended minor corrections.
- In 2006 the grand coalition ended the attempt to dismantle co-determination.
- After financial crisis renaissance and broader acknowledgment of co-determination – decreasing influence of neoliberal ideas

Institutional Rules: No Shareholder Primacy

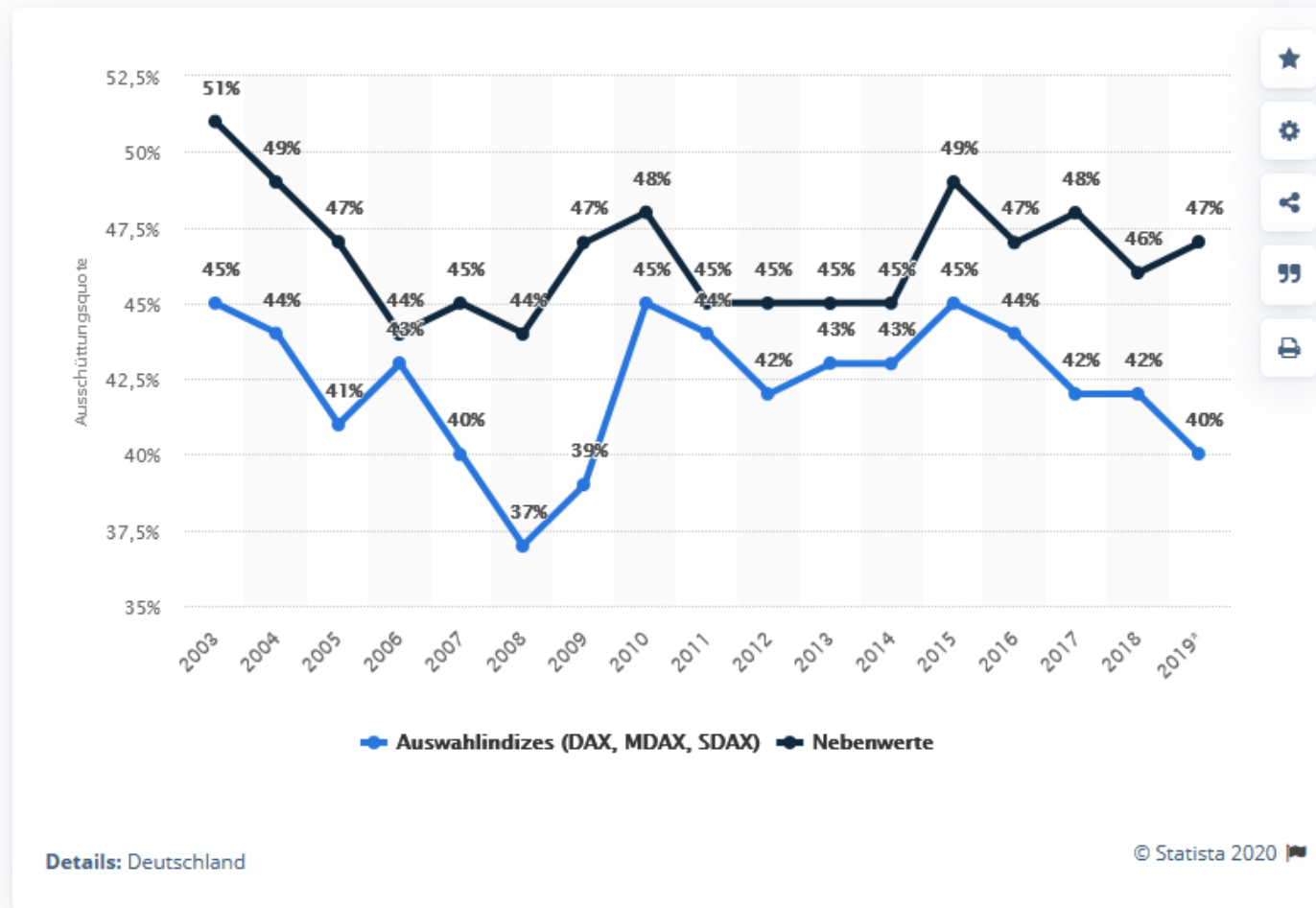
Confirmation of Pluralistic Concept of the Corporation

- Despite shareholder-friendly reforms the stock corporation act („Aktiengesetz“) still defines an *interest of the corporation* („Unternehmensinteresse“) with *own legal personality* („eigene Rechtspersönlichkeit“). Accordingly, the Board of executive directors (Vorstand) and the supervisory board (Aufsichtsrat) are committed to the corporation as such.
- The Corporate-Governance-Kodex (CGK) is even more specific in this respect. The board of directors (Vorstand) has to act in the „interest of the corporation“ thereby considering the interests of the shareholders, employees and other related groups (stakeholders) without giving priority to one of them. The overall objective is „sustainable value creation“.
- »Der Vorstand leitet das Unternehmen in eigener Verantwortung im Unternehmensinteresse, also unter Berücksichtigung der Belange der Aktionäre, seiner Arbeitnehmer und der sonstigen dem Unternehmen verbundenen Gruppen (Stakeholder) mit dem Ziel nachhaltiger Wertschöpfung« (Regierungskommission Deutscher Corporate Governance Kodex 2015: 5).

Dividend Payout Ratio fairly constant over time

Always below 50%, fluctuations, no obvious trend

Dividends as a Percentage of Earnings – DAX/MDAX/SDAX and Second Tier Stocks



Share Buy Backs fluctuating relevance

Institutional Rules and Development

Institutionalized since 1998:

- Approval of General Assembly necessary, Reservation Resolution valid 5 years
- Execution: restricted to 10 % of market capitalization

Widespread Option, little Usage (2018)

- 66 out of 80 corporations (DAX, MDAX) have a reservation resolution („Vorratsbeschluss“)
- 7 out of 80 execute share buy backs, mostly corporations with free float

Number of executing firms: cyclical fluctuation

- Maximum in 2008: 16
- Minimum in 2009: 2
- New high in 2017: 11

Average Volume as Percentage of Market Capitalization:

- High: 5.1 in 2005
- Low: 0.9 in 2011; 0.7 in 2017

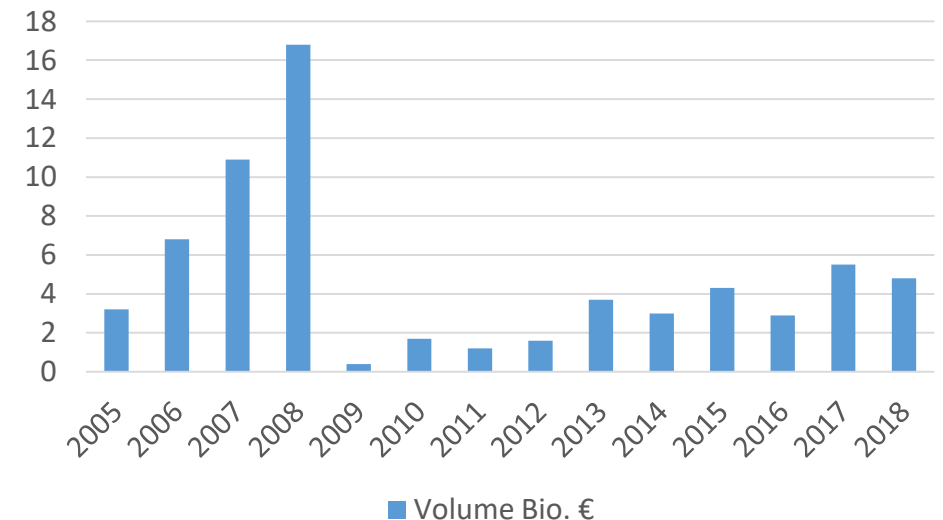
„Bad Timing“* before/within financial crisis:

- 2006: 100%; 2007: 96%; 2008: 83 %; 2009: 99%

* no increase of share price within 2 years

Volume from 2005 – 2018

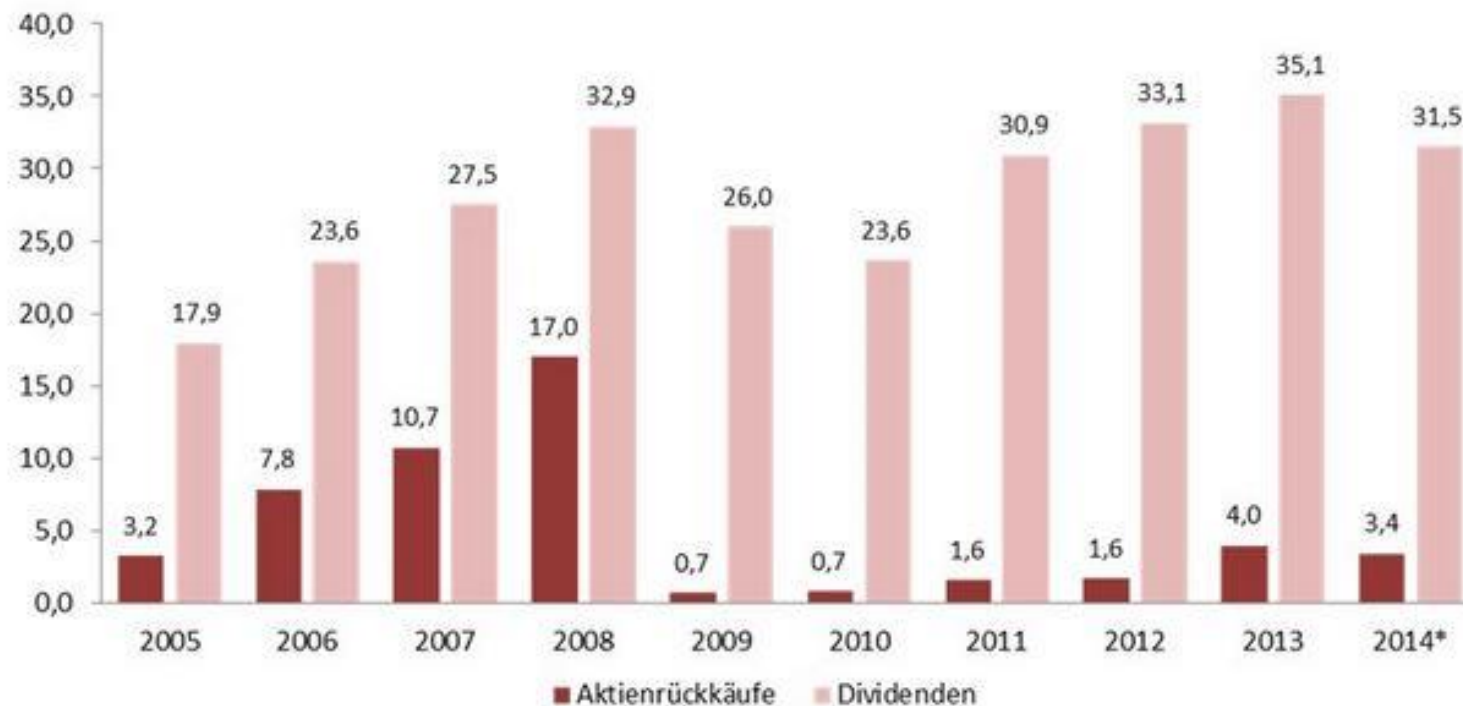
2018 only till July



Share Buy Backs compared to Dividends

Volume Bio. € - DAX/MDAX

Abbildung 2: Volumen von Aktienrückkäufen und Dividendenzahlungen in Mrd. Euro



*) Für das Geschäftsjahr 2014 sind nur 62 Unternehmen erfasst.

Quelle: Geschäftsberichte

Source: DasInvestment

Management Remuneration

Institutional Rules, Components, Development

Institutional Change

- Share Options institutionalized since 1998 (KonTraG)
- Modification 2009 after Financial Crisis (VorstAG): Sustainability: long term incentives for variable remuneration – regarding both pay out horizon and reference figures
- Corporate Governance Kodex (2019): committed to sustainable development and long-term perspective; disposal right: 4 years; comply or explain.

Components:

- Cash: fix, variable,
- Share price based: real: restricted stock plan or stock option plans; virtual: phantom stocks or stock appreciation rights

Remuneration Executive Directors (Vorstand incl. CEO) 2019

- Cash Fix: 1.155; cash variable: 1.228; cash total: 2.383; share price based: 1.063; total: 3.446 (Mio. €)
- Max CEO: VW 9.851; Min: CEO Infineon 2.610

Comparison 2019 Share Price Based/Total

- DAX 30%; EuroStoxx: 39%; Dow Jones: 70%
- DAX/Dow Jones total: 27%; DAX/Dow Jones share-price based: 11%

Management Remuneration

Institutional Rules, Components, Development

Manager to Worker Pay Ratio

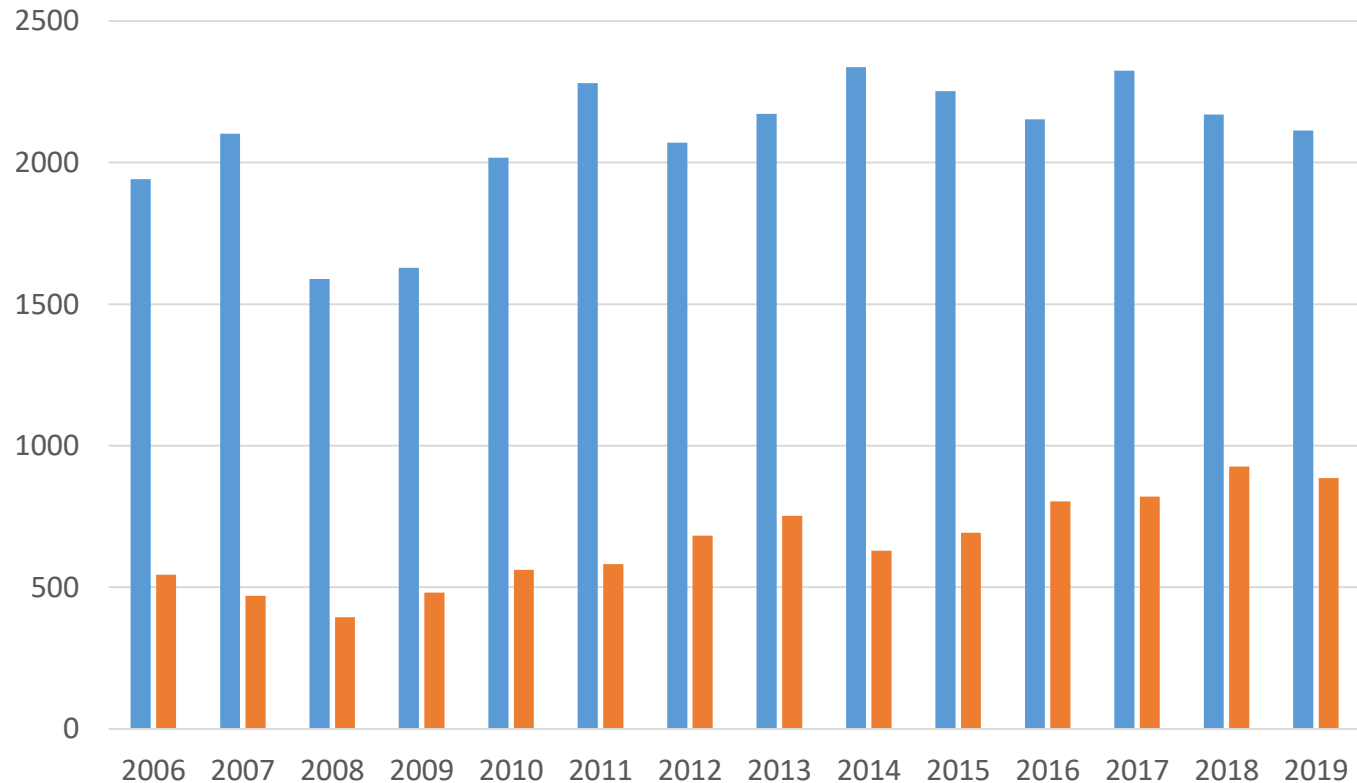
1987: 14:1
 1990: 40:1
 2005: 42:1
 2008: 58:1
 2011: 62:1
 2014: 57:1
 2017: 71:1

Source: Weckes 2018

Dominated Corporations (with anchor investor): lower total remuneration and less share price based

Source: Rapp/Wolff 2010

Cash and Share Price Based Remuneration



Source: DSW 2020

■ Cash ■ Share Price based (CEO excluded)

Variation SP/Total from 18,3% (2007) to 29,9% (2018)

Conclusion

- Since the 1990s the German Business System was increasingly financialized.
- But this process was structurally (subsystem, ownership structure), institutionally (reforms, constraints) and culturally confined, contested and restricted.
- Co-determination is both institutionally and culturally a main counterpart to Shareholder Primacy despite the fact that successful co-determination may foster structural inertia.
- The persistence of a viable subsystem of non-listed firms and of anchor investors in the other subsystem are an important obstacle against shareholder primacy and a source of a sustainable economic development (despite severe problems with increasing inequality).
- Lessons for the US? As copy, transfer and even imitation of foreign institutions, structures and cultures are impossible or at least limited, one could/should look for functional equivalents?

Thanks for Attention

**Questions , Critique
welcome**

Selected Literature

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