

DUAL-CLASS CAPITALIZATIONS - FOR WHOM, FOR WHAT, AND FOR HOW MUCH?

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ABSTRACT

Approximately one-hundred-and-fifty actively traded corporations have dual-classes or multiple classes of common stock in their capital structure. Despite prolonged and active academic inquiry, no clear rationale has emerged to justify this practice.

This paper follows on our previous work in attempting to quantify the differences in the rates of return between the superior class and the restricted class(es) of common stock, and to identify and quantify the sources of those differences.

Three sub-samples of dual-class corporations are identified in which the characteristics of the classes share common attributes. For each, a model is presented which quantifies the contribution of each characteristic to the differences in the rates of return.

The application of this work is to suggest to corporations capital structure strategies which would reduce their cost of capital, and to suggest to investors equity-screening strategies which would increase their rate of return, decrease their portfolio risk, or both.

INTRODUCTION

The observation that approximately three percent of all publicly traded corporations have multiple classes of common stock suggests the need to provide a motivation for this practice. This paper follows on our previous work, Randall and Check (2005), in which we identified the subject firms, and examined differences in stock prices, rates of return, systematic risk, and abnormal returns between the two classes of common stock of dual-class corporations. That paper included a rudimentary model which attempted to quantify the contributions of the various distinct attributes of the classes to differences in the rates of return of the classes.

We have refined that modeling attempt. With the aid of a somewhat larger data set, we have formed three sub-samples of corporations in which the share attributes are more similar than in the general sample. We have formulated a model from each sub-sample which attempts to quantify the contribution of each attribute to the difference in rates of return.

Econometrically the models are disappointing as the coefficients are rarely statistically significant. However, the models do generate coefficient signs that are consistent with pricing theory and coefficient magnitudes that are reasonable. Slightly larger sample sizes would

provide sufficiently numerous degrees of freedom to create an omnibus model using quantitative (dummy) variables for the various share attributes.

For Whom, For What, For How Much?

The question of “For Whom” has, of course, three candidate answers; the corporation’s managers, the corporation’s shareholders, or both. We hope to model the differences in return as a way of determining which group benefits most.

Prior work has focused almost exclusively on the “For What” issue. All of the explanations (raising additional capital without diluting control, protecting incumbent management during the incubation period of profitable but slow-developing projects, providing editorial freedom, etc.) fail to address why dual-classes of common are preferable to using preferred stock in its traditional role. A glance at the variety of firms in our sample, Table 1 on page 144, is convincing evidence that a single motivation is unlikely. The difficulty that we have had in modeling the differences in returns is likely a symptom of the lack of a single motivation and evidence for a unique motivation in nearly every instance. If there are numerous reasons to adopt dual-class capitalizations perhaps more firms should do it.

We have been able to answer the “For How Much” question and the answer turns out to be a surprisingly large one.

Some Terminology

A review of some of the terminology used in this paper and comparable literature may be useful.

Dual-Class (Multiple-Class) Capital Structure - a firm may have more than one type of common stock in their capital structure; classes may differ in voting rights, dividend rates, rights in liquidation, conversion privileges, or other characteristics.

Superior Class - the class of stock which has the greater influence on the control of the firm; the superior class need not have the higher price or the higher rate of return.

Restricted Class(es) - the class or classes of stock which have less influence on the control of the firm; the restricted class need not have the lower price or the lower rate of return.

PRIOR RESEARCH

Since we believed this area of research to be interesting, relevant, and fertile, we continue to be surprised to find relatively little prior research. We have twice conducted lengthy, extensive, and thorough literature reviews.

Prior research in this field has concentrated on examining whether differences exist between dual-class shares in price, return and control. Academic interest in dual-class shares began in the 1980s. Using Israeli data, Levy (1983) found a significant price premium for superior voting rights (SVRs), which increased as the percentage of ownership was concentrated in the SVR shares. A study that same year by Lease, McConnell and Mikkelsen had similar findings using U.S. data. The authors suspected that the premium was tied to takeover avoidance.

This suspicion, combined with a flurry of takeover activity in the early 1980s, prompted a number of studies that attempted to tie price premium to control issues. DeAngelo and DeAngelo (1985) showed that not only were there price differences between classes of stock, there were significant liquidity differences as well. The authors argued that classes of stock might be exhibiting a clientele-like effect. In their study of 45 firms, they found that the

majority of voting rights (56.9%) were held by officers and family members. Rather than seeing any drawback to this, they felt that allowing the concentration of voting power provided benefits to both classes of stock. The SVR shareholders would not have to worry about fending off potential buyers, but instead could concentrate on investing in capital projects that would benefit the long-term financial health of the company, thereby providing maximum benefits to the shareholders with the regular or lesser voting rights (RVRs). The lower price demanded for the RVR shares would be offset by increased liquidity and future appreciation.

Partch (1987), Jarrell and Poulsen (1988), and Cornett and Vetsuypens (1989) extended the idea of both sets of shareholders benefiting from the dual-class organization by conducting event studies around the announcement of a second class of common stock. Partch, using the same data set as DeAngelo and DeAngelo, found mixed results. While the overall price response was positive and significant, the median response was negative, and the proportion of positive responses was only about fifty percent. Overall, she felt that shareholder wealth was unaffected by the creation of reduced-voting shares. The Jarrell and Poulsen study of 89 firms found significant *negative* returns at announcement, but again the results varied widely. Cornett and Vetsuypens had similar inconclusive results when looking at price movements around announcement date. That study also examined companies where the different classes of stock enjoyed different cash flows, i.e. preferences in dividends, and calculated the returns to each class. When the returns proved to be statistically the same for both classes, the authors posited a clientele effect; the shareholder gets what they want, superior votes or cash flows, but the returns will be the same.

The mid-to-late 1980s saw increased recapitalization activity, as prior poison pill defenses were ruled illegal, and the NYSE allowed for the listing of dual-class firms. Research in the 1990s tried to prove once and for all that the clientele effect was real, or that the price premium on SVR shares was simply tied to the avoidance of a takeover. Megginson (1990) examined 152 firms from the U.K., and while finding a price premium, could not explain that premium in terms of any likelihood of takeover. Amoako-Adu, Smith and Schnabel (1990) tried to explain the premium as possibly a difference in the risk of the different classes, however their research showed stable betas between stock classes, and returns that were statistically the same between classes of stock. Fisher and Porter (1993) and Shum

(1995) also examined returns to the classes of stock, and could find no statistical significance.

Event studies in the late 1990s, such as Maynes (1996) and Bacon, Cornett and Davidson (1997) looked at changes in legislation and characteristics of the board of directors to try and nail down the causes of the price premium. The Bacon, Cornett and Davidson article concluded that there is not one reason for a second class of stock, but three, all of which could explain a price premium. The clientele/optimal recontracting argument recognizes that sometimes different shareholders want different characteristics in their holdings, i.e. control or liquidity. Sometimes the concentration of voting power in SVR shares is critical in avoiding a takeover. And finally, sometimes companies create another class of common to raise equity without dilution of votes. A firm chooses the dual-class option based on their particular situation.

Since our data comes from the Internet sources *Yahoo! Finance* and *Mergent Online*, we were heartened by recent research, Clayton, Jahera, and Schmidt (2006), showing that such on-line sources are as reliable as data from the traditional source the Center for Research on Security Prices (CRSP).

Twenty years of research into the prices, the returns and the risk of dual-class common stock have yielded interesting stories, but few conclusions. As this form of capitalization continues to be utilized, we are curious as to why. Is there really a significant benefit to the firm? Is there really any importance to the investor?

THE EMPIRICAL PROCESS

We again began gathering data by searching through the daily closing-price stock listings in the *Wall Street Journal*. We identified forty-two (42) NYSE-traded corporations, four (4) AMEX-traded corporations, and eighteen (18) NASDAQ-traded corporations with dual-classes of common equity. Thirty-one (31) corporations were later eliminated because one class traded infrequently or did not trade at all. We obtained monthly price and volume data on-line from *Yahoo! Finance* for thirty-three (33) of the above corporations beginning with June 1996 and ending with May 2006; one hundred and twenty (120) months of data.

We obtained company-specific information from *Mergent Online* for the thirty-three corporations. These manuals provide extensive

information for 30,000 public companies worldwide including history, chronology, acquisitions, mergers, spin offs, properties, joint ventures, subsidiaries, officers and directors, consolidated income statements and balance sheets for three and two years, respectively, long term debt, options, and etc. The availability of this information on-line and in a searchable format greatly reduced the effort required as compared to the searching of the hardcopy manuals we had done last year.

The thirty-three (33) corporations and their industry / business appear in Table 1 as an appendix.

MODELING RETURN DIFFERENCES

To further understand the motivations for adopting dual-class capitalizations, we are attempting to model the differences in the rates of return and assign sources to those differences.

We have selected four attributes which distinguish the classes and appear frequently enough in corporations to be empirically viable. The attributes and their definitions are; *Votes*, the ratio of restricted votes per share to superior votes per share; *Dividend*, the ratio of the superior class dividend to the restricted class dividend, *Liquidity*, the ratio of restricted shares outstanding to superior shares outstanding; and *Board of Directors*, the ratio of the proportion of the board of directors elected by the superior class to the proportion elected by the restricted class.

The definitions of these variables may at first glance seem spurious and inconsistent. However, they are defined as they are to maximize the number of corporations available for inclusion in the process. For instance, a particular restricted class may have no voting privilege. If restricted shares were in the denominator of *Votes* that corporation would need to be excluded from our sub-sample to avoid division by zero. Similarly with *Dividend* where, in our sample, the superior class is more likely to not pay a dividend. Using the ratio of shares outstanding as a proxy for liquidity is consistent with practice in the literature

The definitions we have used do provide one extremely helpful benefit in the regressions; each coefficient is the contribution of that attribute to a one-unit change in the attribute. In the scale of our data, those coefficients are easily interpreted as basis point changes.

A hypothetical example may be helpful;

Table 2
A Hypothetical Example

Attribute	Superior Class	Restricted Class	Enters the Data Set as
Votes	ten votes per share	one vote per share	0.10
Dividend	120 % of restricted class dividend		1.20
Liquidity	10,000,000 shares outstanding	100,000,000 shares outstanding	10.00
Board of Directors	elects 75% of directors	elects 25% of directors	3.00

“Super Voting” Model

Twenty-eight (28) of our corporations exhibited differences in voting privileges between the superior class and the restricted class. Our “Super Voting” valuation model used *Votes*, *Dividend*, and *Liquidity* as explanatory variables and produced the following results.

Table 3
“Super Voting” Model

$R_S - R_R$	Intercept	Votes	Dividend	Liquidity
Coefficient	- 0.37%	- 0.06%	+ 0.30%	- 0.19%
Standard Error	0.227%	0.023%	0.193%	0.119%
t Statistic	- 1.63	- 2.58	1.55	- 1.60
p value	0.12	0.02	0.13	0.12

where;

Votes = the ratio of restricted votes per share to superior votes per share

Dividend = the ratio of the superior class dividend to the restricted class dividend.

Liquidity = the ratio of restricted shares outstanding to superior shares outstanding

The signs of the coefficients are as would be expected; increasing the voting power of the restricted shares or increasing the number of restricted shares outstanding would decrease the difference between the rates of return, increasing the superior dividend without changing the restricted dividend would increase the difference in the rates of return.

The magnitudes of the coefficients are sensible as well and indicate the magnitude of the changes in relative rates of return that might occur. For example, changing the relative voting power from say 10 to 1 (superior to restrictive) to say 5 to 1 would be expected to reduce the difference in rates of return by 6 basis points (0.06%).

The *p*-values are disappointing indicating that we should not put much faith in the predictive power of the variables aside from *Votes*.

“Dividend Preference” Model

Eleven (11) of our corporations exhibited differences in dividend privileges between the superior class and the restricted class. Our “Dividend Preference” valuation model used *Dividend*, *Board of Directors*, and *Liquidity* as explanatory variables and produced the following results.

Table 4
“Dividend Preference” Model

$R_S - R_R$	Intercept	Dividend	Board of Directors	Liquidity
Coefficient	- 0.22%	+ 0.11%	+ 0.01%	- 0.03%
Standard Error	0.192%	0.055%	0.009%	0.173%
t Statistic	- 1.15	2.00	1.11	- 0.17
p value	0.29	0.09	0.30	0.87

where;

Dividend = the ratio of the superior class dividend to the restricted class dividend.

Board of Directors = the ratio of the proportion of the board of directors elected by the superior class to the proportion elected by the restricted class

Liquidity = the ratio of restricted shares outstanding to superior shares outstanding

The signs of the coefficients are as would be expected; increasing the relative dividend of the superior shares or increasing the proportion of the board of directors elected by the superior shares would increase the difference between the rates of return, increasing the number of restricted shares outstanding without changing the superior shares outstanding would decrease the difference between the rates of return.

The magnitudes of the coefficients are sensible as well and indicate the magnitude of the changes in relative rates of return that might occur. For example, changing the relative dividend from say 1.5 to 1 (superior to restrictive) to say 2.5 to 1 would be expected to increase the difference in rates of return by 11 basis points (0.11%).

The *p*-values are disappointing indicating that we should not put much faith in the predictive power of the variables aside from *Dividend*.

“Liquidity Preference” Model

Twenty-four (24) of our corporations exhibited differences in the liquidity proxy, ratio of shares outstanding. Our “Liquidity Preference” valuation model used *Votes*, *Dividend*, and *Liquidity* as explanatory variables and produced the following results.

Table 5
“Liquidity Preference” Model

$R_S - R_R$	Intercept	Votes	Dividend	Liquidity
Coefficient	+ 0.13%	- 0.11%	+ 0.35%	- 0.14%
Standard Error	0.113%	0.047%	0.187%	0.096%
t Statistic	1.15	- 2.34	1.87	- 1.45
p value	0.26	0.03	0.08	0.16

where;

Votes = the ratio of restricted votes per share to superior votes per share

Dividend = the ratio of the superior class dividend to the restricted class dividend.

Liquidity = the ratio of restricted shares outstanding to superior shares outstanding

The signs of the coefficients are as would be expected; increasing the relative voting power of the restricted shares or increasing the number of restricted shares outstanding without changing the superior shares outstanding would decrease the difference between the rates of return, increasing the superior dividend without changing the restricted dividend would increase the difference in the rates of return.

The magnitudes of the coefficients are sensible as well and indicate the magnitude of the changes in relative rates of return that might occur. For example, changing the relative number of shares outstanding from say 2 to 1 (restrictive to superior) to say 3 to 1 would be expected to decrease the difference in rates of return by 14 basis points (0.14%).

The *p*-values are disappointing indicating that we should not put much faith in the predictive power of the variables aside from *Votes*.

For Whom, For What, For How Much?

Our work thus far provides an answer to only one-third of the question; the difference in monthly returns between the superior shares and the restricted shares in our sample was a very healthy 0.68 percent per month. That’s about 8.5 percent per year over a ten-year period! So there is money on the table, but the question remains as to whether this “superior class premium” is justified by differences in risk between the two class.

CONCLUSIONS

This paper takes us a step closer to the goal of quantifying the contributions of the various attributes of different stock classes to their differences in rates of return. Perhaps the most important result is the discovery of fifteen (15) additional firms beyond the eighteen (18) in our prior paper. This sample size offers the prospect of a possible single model using qualitative (dummy)

variables to capture the differences in the attributes' contributions. That modeling technique has been unavailable to us previously due to the small number of degrees of freedom available.

The format of the variables was chosen to maximize the number of corporations available for each of our three sub-samples. A qualitative variables model would remove the need for these arbitrary definitions but we are very tight on degrees of freedom.

For now, we have three models which are applicable to corporations with the particular class attributes captured by the model. Ultimately, with a single model, we hope to be able to make recommendations to corporations to adopt dual-class capitalizations and the attributes they should include, and to make recommendations to stockholders about which class of stock they should include in their portfolios.

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Table 1
Our Data Set

Company	Industry / Business
Aaron Rents, Inc.	Rental and Leasing Services
Advanta Corp.	Financial Services
Bandag, Incorporated	Rubber and Plastics
Brown-Forman Corporation	Alcoholic Beverages and Consumer Durables
Berkshire Hathaway	Property and Casualty Insurance
Comcast Corp.	Cable Television
Constellation Brands, Inc.	Beverages - Wineries and Distillers
Crawford & Company	Insurance Services
Curtiss-Wright Corporation	Aerospace / Defense Products and Services
Embotelladora Andina	Beverages - Soft Drinks
Forest City Enterprises, Inc.	Real Estate
Freescale Semiconductor Inc.	Wireless Communications
GameStop Corp.	Video Game Retailing
Gray Television, Inc.	Broadcasting - TV
Greif Inc.	Packaging and Containers
Haverty Furniture Companies, Inc.	Home Furnishing Stores
HEICO Corporation	Aerospace / Defense Products and Services
Hubbell Incorporated	Electrical and Power Systems
Kelly Services, Inc.	Staffing and Outsourcing Services
KV Pharmaceutical Co.	Drug Delivery
Lennar Corporation	Residential Construction
Liberty Global Inc.	Entertainment and Informational Programming
Liberty Media Corp.	Diversified Communication Services
McData Corp.	Communication Equipment
Moog Inc.	Aerospace / Defense Products and Services
Neiman Marcus Group	Retailing - Women's and Men's Clothing
Playboy Enterprises, Inc.	Entertainment
Rush Enterprises Inc.	Auto Dealerships
Sequa Corporation	Aerospace / Defense - Major Diversified
Tecumseh Products Co.	Power Equipment Manufacturing
Urstadt Biddle Properties Inc.	REIT - Residential
Triarc Companies, Inc.	Arby's Restaurant System
Wiley and Sons, Inc.	Book Publishing