Why Companies Are So Different?

Alternative View on The Firms' Financial Design

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Abstract

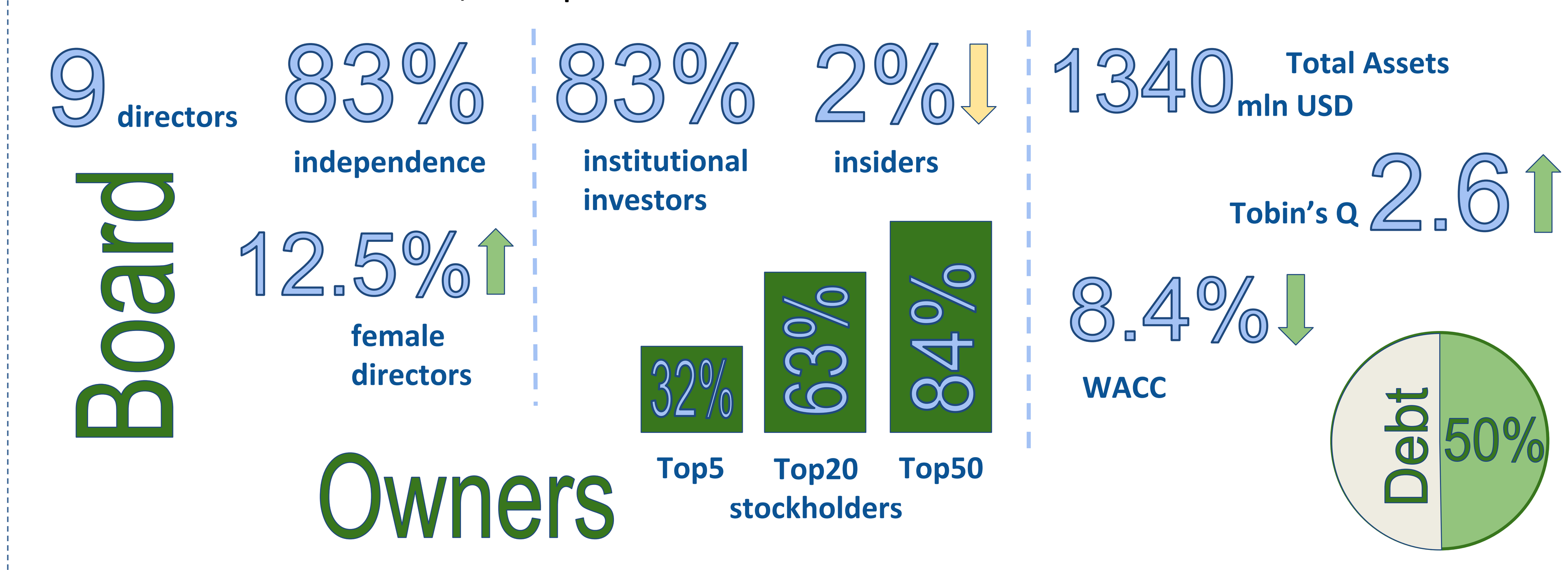
For years we believed in the sectoral structure of the economy. We believed in similar business models, decision-making processes, risk preferences and performance for firms in one sector. However, now we observe the structural changes in the global economy. New leaders have different business models, stakeholders, and risk preferences. Today it is more about people, we believe. Decision-makers (investors, CEOs, directors) develop the firm financial design based on their risk preferences, goals, and behavioral biases. We reexamine the links between the financial decisions in the corporates and governance mechanisms. We apply cluster analysis to determine the typical patterns of firm design. We show that there are 9 sustainable patterns of firm design in US market nowadays, and describe the portraits of typical firms in each cluster. We show that performance and risk differ significantly through clusters. Finally, we state that industry factors do not play a crucial role in the firm's risk preferences and performance anymore.

JEL: G32, G34.
Keywords: ownership structure, corporate governance, firm performance, cluster analysis

Data

Russell 3000 index as of EoY 2015:
- ➔ 98% of US market covered
- ➔ All sectors covered, except financials

Median Firm



Background and objectives

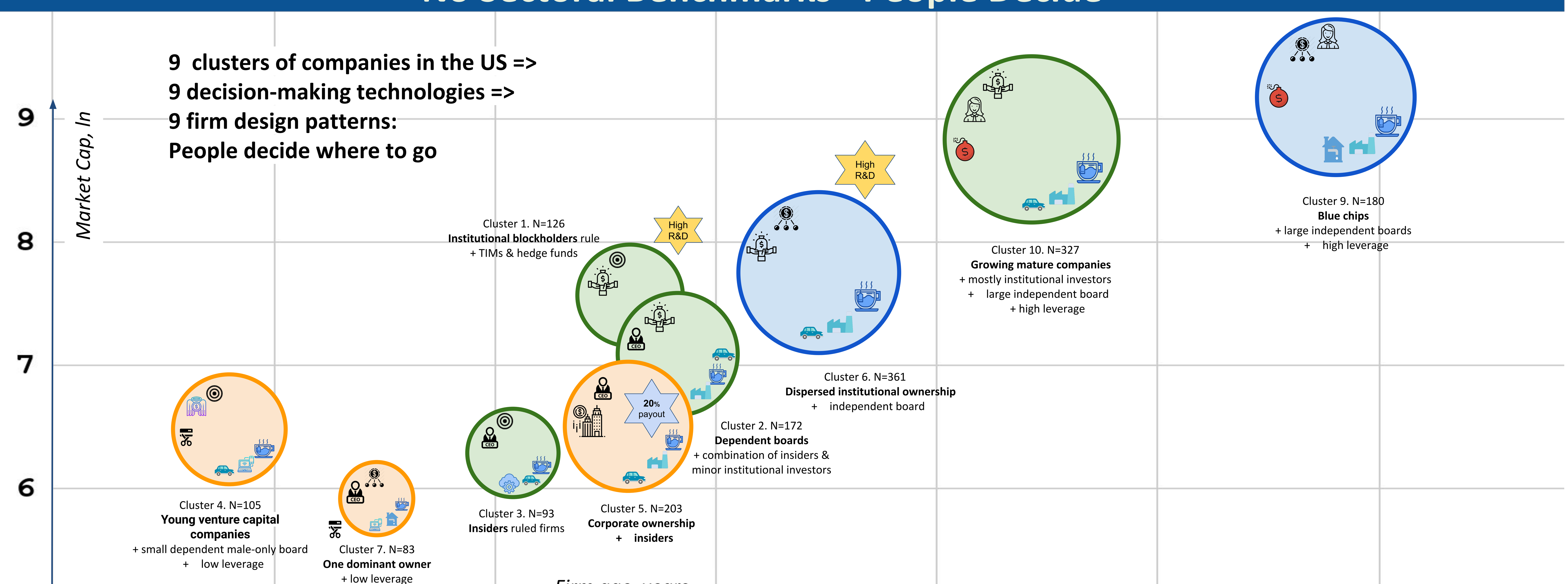
We used to believe in the sectoral structure of the economy:
- we believe that the comparable companies are those from the same sector,
- we used to apply the similar multiples to the sector,
- in asset management, we used to make benchmarking to the sector of the economy.

But now we have evidence of structural changes in the global economy:
- New sectors emerged within the last 20 years
- Ownership structure changes (concentration growth, institutional blockholdings)
- Conservative debt policy
- New instruments in the financial market based on trust and other human features
- Much faster decision-making preferred (e.g. small affiliated boards)

Methodology

We apply **cluster analysis** as an agnostic, black-box approach in contrast to the clustering by the exact criteria (age [La Rocca et al., 2011], sector [Jain, Kini, 2006]).
Step 1. We choose 9 firm internal characteristics that **influence the decision-making process** and, in turn, firm design. **Inputs** are governance variables (board size, independence, gender diversity); ownership variables (ownership concentration and the ownership of insiders, PE/ VC, corporations, institutions); capital structure.
Step 2. k-means clustering of the companies EoY 2015 and EoY 2011;
Step 3. 8-9 clusters are the optimal number for firm design.
Step 4. Cross-cluster analysis of inputs' and outputs' medians.
Outputs are risk and performance (Tobin's Q, ROE, ROA, payout ratio, growth rates).

No Sectoral Benchmarks - People Decide



Legend: *icons are provided by flaticon.com*
high insiders' ownership
concentrated ownership
highly dispersed ownership
high institutional ownership
venture capital & private equity are among top investors
low leverage
high leverage
women on board
corporation is a major investor

Discussion and open questions

Should we rely on the common benchmarks, or it's worth trying to capture differences in decision-making processes (governance, ownership, risk preferences)?

What comes first? What makes companies different? Industry, life cycle, decision-making, ownership or financing? How to find a benchmark?

Findings

- ★ Firm design patterns are not highly correlated with the sectors but correlated with the life-cycle stage
- ★ Firm performance differs significantly from cluster to cluster
- ★ A significant difference between patterns of financial design with firms driven by institutional investors (Clusters 1, 2, 6, 10) and the corporates with insider and family ownership (Clusters 3 & 7)
  - ○ The institutional investors behave differently depending on the presence of other large stakeholders
- ★ Blue chips and other mature companies (9 & 10) have the specific financial design patterns with the traditional mechanisms of corporate governance
- ★ There is a specific pattern of financial design for companies with VC/ PE

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