

Information Asymmetry and Internal Monitoring: Which Blockholders Monitor Managers More Effectively?

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Abstract

This paper studies the impact of information asymmetry between blockholders and managers on firm performance. The ability of blockholders to effectively monitor managers depends on how informed they are about the firm's business. Same-industry (SI) blockholders – blockholders that operate firms in the same line of business - are likely to be more informed than blockholders outside the industry, and thus better monitors. Consistent with this argument, this paper finds that firms with SI blocks tend to have higher Tobin's Qs and lower corporate payouts and managerial equity ownership than other firms, *ceteris paribus*. In addition, using acquisition data, this paper finds that acquirers with SI blocks, having higher Tobin's Qs, tend not to over-pay targets, resulting in lower target returns and higher buyer returns. Finally, using block trade data, this paper finds it is that SI blockholders increase firm values, not that high-value firms attract SI blockholders.

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1. Introduction

Blockholders are prevalent. Many firms have blockholders (Mehran, 1995).² However, blockholders are also different. For example, in 1999, 14.1% shares of CompUSA, the national leading computer retailer, are held by Grupo Sanborns, S.A. de C.V. who is the only blockholder of CompUSA and is also a retailer selling computers and electronics. As one of CompUSA's top competitors in 1999, Office Depot has three blockholders with 24.07% total blocks, who are all institutions, including FMR Corporation, Harris Associates L.P., and Massachusetts Financial Services Company. The existing literature on blockholders and firm performance has not definitely established whether the impact of blockholders on firm value is positive or negative (Holderness, 2003). This paper explores the role of one type of blockholders – same-industry (SI) blockholders – versus different-industry (DI) blockholders in monitoring managers. An SI blockholder has an informational advantage in monitoring managers and reducing agency costs because it usually holds stocks in the same industry as it operates³ and so information asymmetry between managers and shareholders is less severe and monitoring costs are lower.

This paper argues that information asymmetry between managers and blockholders for firms with SI blocks is less severe and therefore the SI blockholders monitor managers more effectively and at a lower cost than DI blockholders. Accordingly, such firms tend to have lower agency costs and higher values. The main empirical findings of this paper can be summarized in the following three parts. First, this paper shows that firms with SI blocks have higher Tobin's Qs and lower corporate payouts and managerial equity ownerships. Second, acquirers with SI blocks, having higher Tobin's Qs, tend not to over-pay targets, resulting in lower target returns and higher buyer returns. Third, using block trade data, this paper finds it is that SI blockholders improve firm values, not that high-value firms attract SI blockholders.

² He finds that 56% of a sample of randomly selected manufacturing firms have outside blockholders.

³ 4-digit SIC codes are used to check whether blockholders are in the same industry as the held firms. If 4-digit SIC codes are not available, then profiles of these blockholders are examined by searching Yahoo Finance to check whether blockholders are in the same industry as the held firms. The definition is described in details in Section 3.

The main contributions of this paper are as follows. First, it studies the role of SI blockholders, and empirically documents information asymmetry between managers and blockholders by distinguishing SI blockholders from DI blockholders. Second, this paper finds a robust positive impact by SI blockholders on firm performance. Empirical results from firms M&A activities re-enforce the finding that the more effective monitoring by SI blockholders leads to better firm performance of acquirers. Third, this paper studies the issue of endogeneity, finding that it is that SI blockholders improve firm values.

The remainder of the paper is organized as follows. Section 2 reviews literature and proposes hypotheses. Section 3 describes data. Section 4 presents results. Section 5 concludes.

2. Literature and Hypotheses

Starting at least by Shleifer and Vishny (1986), it is suggested that large blockholders can effectively monitor top managers and therefore reduce the agency costs between shareholders and managers. Consistent with effective internal monitoring of blockholders, McConnell and Servaes (1990) find a positive relation between institutional shareholdings and Tobin's Q and they attribute this finding to improved corporate monitoring at higher levels of institutional ownership. Denis et al. (1997) document that the turnover probability of top executive with previous poor performance is positively related to the presence of an outside blockholder. Qiu (2004) finds that the presence of public pension fund blockholders reduces firms' acquisition activities, and particularly reduces the acquisition frequency by cash-rich and low-Q firms. However, recent evidence shows that blockholders may not be able to effectively monitor managers. Dlugosz et al. (2004) document that the relation between outside blocks and Tobin' Q is U-shaped, instead of a positive linear relation. Himmelberg et al. (1999) find that changes in managerial ownership seem to affect neither firm value nor firm performance. Qiu (2004) also finds that the presence of mutual fund blockholders encourages acquisitions by firms with potentially higher agency costs.

Most previous empirical papers only focus on the relation between the entire group of either inside or outside blockholders and firm performance. Results are ambiguous and mixed. There is little empirical work that addresses whether and/or which blockholders are able to monitor managers or can monitor managers effectively. Research on different blockholders' impacts on firm performance is likewise rare.

The following table briefly describes some empirical findings on blockholders.

Table A: Impacts of blockholders on firm performance

Authors	Which blockholders	Impacts
Morck, et al. (1988)	Insider	Saw-toothed
Himmelberg, et al. (1999)	Insider	0
Holderness and Sheehan, (1988)	Total blocks	0
McConnell and Servaes, (1990)	Institution	+
	Other blocks	0
Chen, et al. (2004)	Large institution	+
	Other institution	0/-
Dlugosz et al. (2004)	Small outsider	-
	Large outsider	+
Qiu, (2004)	Public pension fund	+
	Mutual fund	-

This paper explores the role of one type of blockholders – same-industry (SI) blockholders – versus different-industry (DI) blockholders in monitoring the managers. This paper argues that, as a large shareholder, an SI blockholder has an informational advantage in monitoring managers and reducing agency costs, because they usually hold stocks in the same industry as they operate. Therefore, information asymmetry between managers and blockholders is less severe and monitoring costs is lower. DI blockholders may also monitor managers, but SI blockholders can monitor managers more effectively and at a lower monitoring cost. The main argument of this paper is that the SI blockholders monitor managers more effectively than DI blockholders and accordingly such firms have lower agency costs and higher firm values.

Consider the following simplified Shleifer and Vishny (1986) model. Assume that a large shareholder (L) holds a fraction $\alpha < 0.5$ of the firm. With probability of I , L can adopt a technology to increase firm value from q to $q + Z$, where $Z \sim F(Z)$ and $Z \in (0, Z_{\max}]$. Finding an improvement of value Z , L can make a tender offer of $0.5 - \alpha$ to gain control. Suppose that L also incurs a cost of C to improve the firm value by Z . C represents the cost L has to bear in order to improve the firm value. For example, if information asymmetry between L and firm management and operations is higher, then C is higher.⁴ L will move to make a tender offer if he can buy $0.5 - \alpha$ of the shares from the small shareholders for any bid $q + \pi$, with π satisfying $0.5Z - (0.5 - \alpha)\pi - C \geq 0$. The small shareholders' best forecast of Z is then given by $E[Z | 0.5Z - (0.5 - \alpha)\pi - C \geq 0]$. Under these conditions, as shown in Shleifer and Vishny (1986), an increase in C results in a fall in the market value of the firm.⁵ The intuition is the following. As L knows little about the firm, the cost C is greater and therefore the firm value is lower. Using Tobin's Q as the proxies to firm values brings the following first hypothesis:

(H1): Firms with SI blocks tend to have higher Tobin's Qs.

Empirical literature has used other different measures to proxy the agency costs. The idea that dividend payout also serves as an internal mechanism in controlling agency or free cash flow problem has also received a lot of attention (Easterbrook, 1984; Jensen, 1986; Lang and Litzenberger, 1989; Myers, 2000; and Allen et al., 2000).⁶ Although there is disagreement on how to get managers to disgorge cash, the common key point among these papers is that unless profits are paid out, if there are no other control devices, then

⁴ Shleifer and Vishny (1986) interpret C as the administrative cost that L has to bear when making the tender offer and improving the firm value.

⁵ Refer to Proposition 2 (Shleifer and Vishny, 1986) for proof of the proposition.

⁶ Although earnings and tax clientele preferences are two major driving forces for corporate payout (DeAngelo et al., 2003; Allen et al., 2000), agency explanation of corporate payouts still attracts a lot of attentions.

they may be diverted by the insiders for personal use or committed to unprofitable projects that provide private benefits for the insiders.⁷

La Porta et al. (2000) provides evidence that dividends are paid because minority shareholders pressure corporate insiders to disgorge cash due to the concern of agency costs, so stronger minority shareholder rights should be associated with higher dividend payouts.⁸ Lambert et al. (1989), Jensen et al. (1992), Schooley (1994), and Fenn and Liang (2001) also document the similar finding that higher corporate payout is associated with firms with the greatest potential for agency problems. This paper argues that higher information asymmetry in firms without SI blocks tend to have higher corporate payouts.

Managerial equity ownership is another measure of agency costs (Jensen and Meckling, 1976). Higher managerial equity ownership is likely to be associated with higher voting control and correlated with more power of managers, which can protect managers from dismissal or takeover. DeAngelo and DeAngelo (1985) argue that this is beneficial to shareholders if it encourages managers to invest in firm-specific human capital whose returns might otherwise be appropriable if controls were transferred to another management team. Mikkelson and Partch (1996) document the evidence of the decline of takeovers associated with higher managerial ownership. If managers are more informed, it is likely that they are able to obtain more equity ownership ex ante in order to protect them from dismissal and appropriation after their investments in firm-specific human capital. This paper argues that higher information asymmetry in firms without SI blocks leads to higher managerial equity ownership. Summarizing the above arguments brings the following hypothesis:

⁷ Allen and Michaely (2002) have a survey paper with both theoretical and empirical summaries about agency explanation on corporate payouts.

⁸ Two agency models of dividend in their paper, outcome model and substitute model, are tested. According to the outcome model, dividends are paid because minority shareholders pressure corporate insiders to disgorge cash. According to the substitute model, insiders interested in issuing equity in the future pay dividends to establish a reputation for decent treatment of minority shareholders. The outcome model predicts that stronger minority shareholder rights should be associated with higher dividend payouts. The substitute model predicts the opposite. They test these two models using a cross section of 4,000 companies from 33 countries with different levels of minority shareholder rights and tests support the outcome model of dividends with robustness check.

(H2): Firms with SI blocks tend to have lower corporate payouts and managerial equity ownership.

Many studies on M&A document the evidence of positive target returns and mixed acquirer returns (Akbulut and Matsusaka, 2003; Berger and Ofek, 1995; Morck et al., 1990; Jensen and Ruback, 1983). Many explanations, among which the agency theory is quite popular, have been proposed to explain the findings of positive target returns and mixed acquirer returns. Roll (1986) argues that buyers tend to overpay targets because of their hubris. Another similar argument is “the winner’s curse.” Morck et al. (1990) argue that negative returns to buyers imply that acquisitions may be driven by managerial motives, like building empire, consuming perquisites, and obtaining private benefits, rather than value maximization. Moller et al (2004) find that large acquirers tend to over pay the targets, as opposed to small acquirers. Qiu (2004) finds that the presence of mutual fund blockholders encourages acquisitions by firms with potentially higher agency costs. She attributes it to the poor monitoring by this type of shareholders. On the contrary, she also finds that public pension fund blockholders reduce acquisitions by firms with potentially high agency costs.

The presence of effective internal monitoring can reduce inefficient M&A activity, discipline managers, and hence reduce agency costs. It can serve as a signal of the credible promise of penalizing value-destroying actions. Managers of such firms tend neither to carry out bad acquisition actions, which might result in possible layoff, nor to propose the deal at all since it is unlikely to get approval from more informed shareholders. However, once managers of such firms decide to take the action, it is likely that these firms are good and the deals tend to be good for shareholders, as opposed to firms without SI blocks. In addition, managers of such acquirers tend not to be able to overpay the targets since such a proposal is hard to go through due to more effective monitoring. Following Moller et al (2004), we have the following hypotheses:

(H3): In corporate acquisition activities, firms with SI blocks, having higher firm values, tend not to over-pay targets, resulting in lower target returns and higher acquirer returns.

3. Data description

The Securities and Exchange Commission (SEC) compulsorily requires the filings of ownership reports from all 5% and above stock beneficial owners of a publicly traded firm and institutional investment entities managing equity assets of \$100 millions or above. Compact Disclosure provides the firm's annual proxy statement with large owners' information with 5% or above shareholdings. Accordingly, empirical literature uses 5% as the threshold to define blockholders.

WRDS provides blockholders data from 1996 till 2001. This data set is originally from the study of Dlugosz et al. (2004). They start with about 1300 single-class firms covered by Investor Responsibility Research Center (IRRC) from 1996 to 2001. These firms are the largest US companies from Standard & Poor's 500 as well as the largest corporate in annual publications of Fortune, Forbes and Industry Week. They obtain the ownership data from the Compact Disclosure. Finding that the ownership data has two major problems of overlaps and preferred shares, Dlugosz et al. (2004) corrected these errors by comparing Compact Disclosure data with the original proxy statements obtained from Livedgar. The blockholder data from WRDS includes outside block holdings, which are mostly composed of data on institutional and/or corporate blockholders.

The primary data sample of this paper includes 4219 non-financial, non-utility, non-dual-class firm-year observations from 1996 to 2001. Firm-year observations are included in the sample only when the firms are included in COMPUSTAT annual dataset, COMPUSTAT EXECUCOMP data set, IRRC governance dataset, and WRDS blockholder dataset. Financial institutions (SIC codes 6000-6999), regulated utilities (SIC codes 4900-4999), and regulated phone companies (SIC codes 4813) are excluded from the sample. Among these observations, 457 are identified as firms taking acquisition activities, where the M&A data set are from Akbulut and Matsusaka (2003).⁹ This is the secondary data sample used for the empirical analysis.

⁹ Their data set in this time period is originally obtained from SDC.

This paper classifies the blockholders of the sample into two major categories: same-industry (SI) and different-industry (DI) blockholders. If a firm has at least one SI blockholder, then it is classified as a firm with an SI block. If not, then it is grouped into firms with DI blocks. DI blockholders include non-financial firms, institutions, banks, insurance firms, brokerage firms, and et al.

This paper identified 326 firm-year observations with SI blocks, among which only 18 firm-year observations have more than one SI blockholder. The profiles of blockholders are first searched through Hoover’s Online and Million Dollar Database to check if the blockholders are running in the same industry as held firms using 4-digit SIC codes.¹⁰ If the information on blockholders are not provided, then I searched Yahoo finance to check if the blockholders are defined within the same industry as held firms. Among different-industry blockholders, bank and insurance, investment banking, mutual fund and pension fund are also identified. The following is an example on how to check SIC codes of firms and blockholders.

Table B: An example on Tom Brown Inc, 1999

	Blockholders	Share held	SIC	Industry
Firm: Tom Brown Inc	-	-	1311	Crude petroleum & natural gas
Blockholders:				
Compression Inc	SI	11.1%	1311	Crude petroleum & natural gas
KN Energy HC Inv. Inc	DI	18.4%	5172	Petroleum, ex bulk statn-whsl
FMR Corp	DI	5.2%	6282	Investment & investment advice

Information on these SI blockholders are further collected through several data sources including Factiva and Hoover’s Online. Among 326 firm-year observations with SI blockholders, 56 firm-year observations are identified as having SI blockholders as the

¹⁰ SIC codes of both primary business and other segments of blockholders are examined, as done in the same way for the held firms. About 85% of SI blockholders are found in Hoover’s Online and Million Dollar Database while the information of the rest 15% blockholders are obtained through Yahoo Finance, most of which are from overseas. 2- and 3- digit SIC codes are also used to check the robustness and results would not change.

suppliers or customers of the held companies, among which 47 have them as customers while 14 have them as suppliers of the held companies. Particularly, for 44 observations whose SI blockholders are publicly traded firms, 14 have SI blockholders as customers while 5 have them as suppliers of the held companies.

Firm characteristics variables are collected from COMPUSTAT annual dataset. These control variables include Tobin's Q, firm size, sales, earnings, debt, and payout yield. Dividend yield is used to calculate the payout yield. Dividend yield is defined as cash dividends on common stock divided by market value of common stocks. To eliminate special dividends, the dividend payout is truncated from the above at 10%. This is consistent with the literature (DeAngelo et al., 2000; Fenn and Liang, 2001). The repurchase yield, defined as the actual dollar repurchase of common shares divided by market value of stocks, is also obtained in order to calculate the total payout yield. The total payout yield is defined as the sum of dividend yield and repurchase yield divided by the market value of common shares outstanding. The governance index is from IRRC which has dataset in 1995, 1998 and 2000. For years (1996, 1997, 1999, and 2001) during which there is no dataset, I follow the literature (E.g., Qiu, 2004) to use the most adjacent data as a proxy. A higher governance index reflects weaker shareholder rights.

The secondary data sample is on firms' M&A activities. There are 457 observations in this secondary data sample. The abnormal return is calculated as the firm event stock return minus the market value-weighted return with [-2, +2] windows.¹¹ Three payment methods are all possible, cash, stock, and mix of cash and stock. Two dummy variables are used to define payment methods. If it is cash payment, then the cash dummy variable is defined as equal to one; other wise it is equal to zero. If it is cash payment, then the cash dummy variable is defined as equal to one; other wise it is equal to zero. Other dummy variables on tender offer, hostile, and competition are defined according to SDC.

¹¹ [-5, +5] event window is also used to check the robustness of results but patterns do not change (not reported).

Summary statistics are presented on Table 1. Panel A is for the primary data sample used in the paper, which includes 4219 firm year observations of blockholders data. Panel B is for the secondary data sample, which includes 457 observations of acquiring firms with blockholders. For each variable, the mean, median, standard deviation, minimum, maximum, and selected percentile values are provided.

Panel A of Table 1 shows the average of SI blockholdings is 1.56 percent. This is the average of all firms including SI firms and other types firms. 326 of 4219 firm years are SI firm years while the remaining 3893 are other type firms. The average of SI blockholdings among these 326 observations is 19.08% with 15.65% other blocks (not reported in the table). The mean of DI blockholdings among all 4219 observations is 19.40%. The average of 3893 DI blockholdings observations is 19.73% (not reported in the table). Comparing two groups, the averages of each own type block holdings are close. The averages of total payout yield are 3.62%. The average of managerial equity ownership is 2.65% with averages 2.01% for firms with SI blocks and 2.71% for firms without SI blocks (not reported).

Similar as shown in Panel A of Table 1, Panel B shows that the average of SI blockholdings is 1.33% and the mean of DI blockholdings is 20.36%. The average of acquirer abnormal returns over $[-2, +2]$ is -1.78% and the mean of target abnormal returns over $[-2, +2]$ is 22.39%. The averages of dividend yield and total payout yield are 1.05% and 2.76%, respectively.

4. Empirical Results

4.1 Tobin's Q

The results of differences on Tobin's Qs between firms with and without SI blocks are reported in Table 2. The first column of Table 2 shows that, measured by Tobin's Q, the firms with SI blocks perform better than other firms. The coefficient of dummy1 is 0.35, significant at the 1% level, meaning that when there is an SI blockholder in the firm the

firm value is 0.35 higher than other firms. Considering an average 2.05 of Tobin's Qs for firms without SI blocks, this means about 17% higher in Tobin's Qs for firms with SI blocks, all else equal. Similarly, the second column shows that the coefficient of dummy1 is 0.23, significant at the 1% level.

As an alternative explanation to patterns of this paper, it may be possible that corporate governance drive these patterns. Using governance index from IRRC and controlling for 4-digit SIC industry dummies¹² and year dummies, I find that patterns remain the same, implying that patterns are not driven by corporate governance or industry effects. The coefficient of dummy1 is 0.16, significant at 5% level.

In summary, the (H1) hypothesis that firms with SI blocks tend to have higher Tobin's Q is failed to be rejected.

4.2 *Corporate payout and Managerial equity ownership*

The first and second columns of Table 3 show that when there is an SI blockholder in the firms payout yield of firms with SI blocks are much smaller than those of other firms. The corresponding significant coefficients are -0.93% and -1.09%, respectively. Earnings exert positive impacts on payout with the coefficients of 0.06% and 0.06%, respectively. Considering the 3.62% sample averages of total payout yield in Table 1, the -1.09% coefficient implies that corporate payouts for firms with SI blocks are about one-third less than those for other firms, all else equal. Another interesting variable is dummy1*(earnings/assets, %), which imposes significantly negative impacts on payout yield. The significant coefficients are -0.05% and -0.05%. This means that when there is an SI blockholder in the firm and the firm is making more earnings, the payout yields are much smaller. This is consistent with the existing literature on agency costs and corporate payouts (E.g., La Porta et al., 2000), meaning that if the firm tends to have more agency costs then the corporate payouts are greater since the shareholders may force managers disgorge cash.

¹² 2- and 3- digit SIC codes are also used, but result patterns hold (not reported).

Table 3 also reports the results of regressions of managerial equity ownership. In the third column, the managerial equity ownership when there is an SI blockholder in the firm is -0.48%, statistically significant at the 1% level, smaller than when that there is not. Controlling for more firm characteristics, industry and year dummy variables, the result is similar in the fourth column. The coefficient on SI dummy variable is -1.35%, significant at 1% level. It is likely that there are cluster effects for managerial equity ownership due to its stickiness across time, but the regression results with controlling for cluster effects remain the same (not reported).

Finally, to control the possible endogeneity of managerial equity ownership and Tobin's Q, I run simultaneous equations with both managerial equity ownership and Tobin's Q as dependent variables. The first column of Panel B of Table 3 says that firms without SI blocks tend to have 1.94% more managerial equity ownership than firms with SI blocks. The second column shows a significant positive 0.23% increase in Tobin's Q for firms with SI blocks, which is also consistent with the (H1) hypothesis. Including corporate governance and other institutional blockholder types does not change the results.¹³

In short, this paper fails to reject the (H2) hypothesis that firms with SI blocks tend to have lower corporate payouts and managerial equity ownerships.

4.3 *Target premium and returns in M&A*

I examine, but do not report, the differences of some variables between firms with SI blocks and firms without in M&A data. The average of Tobin's Q for firms with SI blocks is 3.10, much higher than 1.90 of firms without SI blocks. The difference is 1.20, significant at 5% level. The average target returns of firms with SI blocks are 13.06%, 10.04% lower than 23.10% of firms without SI blocks. The difference is significant at 1%

¹³ Results are similar using previous regressions with controlling for other institutional blockholders (not reported).

level. While acquirer returns of firms with SI blocks are insignificant, those of firms without SI blocks are -1.82% , significant at 1% level.

The first column of Table 4 says when there is an SI blockholder in the acquirer, Tobin's Q is 1.47 higher than when there is not. The significance level is 1% level. This means that acquirers with SI blocks tend to have higher firm values than other firms. By finding that higher premium leads to a higher probability of bidding success for large firms but failing to find any relation for small firms, Moeller, Schlingemann and Stulz (2004) argue that this is because a large premium tends to reflect overpayment for large firms than small firms. Following their paper, I also use premium as a proxy to the overpayment. Following Officer (2003), I obtained premium as the difference between the deal value and the market value of the target 50 days prior to the announcement day, divided by the market value of the target 50 days prior to the announcement day, truncated between zero and two.¹⁴ Table 4 shows that the premium is significantly lower when an acquirer has an SI block than otherwise. The coefficients are -21.45% in the column 2 regression and -23.73% in the column 3 regression. Following Moeller, Schlingemann and Stulz (2004), Table 4 shows that acquirers with SI blocks, having higher Tobin's Qs, tend not to over pay the targets, measured by the lower premium.

Table 5 reports results of abnormal returns. In Panel A, when the target return is the dependent variable, the target return in the presence of SI blocks in the acquirers is 9.01% significantly lower than otherwise, which is consistent with the lower premium of these firms. The cash payment signals 9.38% increase in target returns while the stock payment exerts no impact on target returns. The last column of Panel A reports the relation between acquirer returns and acquirer blockholder types. The coefficient on the SI dummy variable is 0.56% , but not significant. This is not surprising given that many existing literature document insignificant results on buyer returns. Governance has no significant effects on returns. Panel B of Table 5 shows that when other blockholder types are included in the regressions, the patterns remain the same after controlling for tender offer, hostile and competition. When the target return is the dependent variable,

¹⁴ The patterns remain the same without truncation (not reported).

the target return in the presence of SI blocks in the acquirers is 3.86% significantly lower than otherwise. In addition, unlike Qiu (2004), I fail to find the relation between public pension fund blocks and returns.

In summary, Table 5 shows that in corporate M&A activities, acquirers with SI blocks tend to have lower agency costs, and therefore higher firm values, and they tend not to over-pay targets, resulting in lower target returns and higher buyer returns. These patterns are not driven by firm characteristics and other institutional blockholders. Therefore, the (H3) hypothesis that in corporate M&A activities firms with SI blocks, having higher Tobin's Qs, tend not to over-pay targets, resulting in lower target returns and higher acquirer returns, is failed to be rejected.

4.4 *Endogeneity*

This paper has shown that there is a significant positive relationship between the presence of SI blockholders and the firm values. This paper argues that the existence of SI blockholders increase firm values, not that the firm with high values attract SI blockholders. This section is to examine the issue of the endogeneity.

To examine this endogeneity issue, I obtained the block trade data first from SDC from 1996 till 2004, which originally contains 679 observations. For each observation, I obtain the identity information on both block sellers and buyers of the target firms provided by SDC.¹⁵ After that, I then search Hoover's Online, Million Dollar Data Base, and Yahoo Finance to identify their business.¹⁶ The data sample is categorized into two different groups of firms according to the following criterion. The first group is the one in which the target firms started to have an SI blockholder after the transaction while there was no SI blockholders before the transaction. The second group is the one there was no SI blockholders both before and after the trade in the target firms.

¹⁵ For some observations SDC does not directly provide the identities of block sellers and buyers, but the relevant information can be found through the Full Synopsis in SDC. Still many observations do not provide the information on both the block sellers and block buyers, and thus not considered.

¹⁶ The process is similar to what have been described in Section 3.

To check whether the target firms have SI blockholders before and/or after the transaction, I read the proxy statements of target firms through Compact Disclosure¹⁷ to spot the blockholders and check their SIC codes using Hoover's Online, Million dollar database and Yahoo Finance. Other data variables are from COMPUSTAT.¹⁸ The final data sample in this Section 4.4 has 283 observations, in which there are 137 observations in the first group and 146 observations in the second group. The following table is an example on a block trade between a financial institution and a pharmaceutical entity in AVI Biopharma Inc. that occurred on 12/23/1999. This observation is classified as one of the first group.

Table C: Blockholders of AVI Biopharma Inc. before and after 12/23/1999

	Share held	SIC	Industry
Firm: AVI Biopharma Inc.	-	2834	Pharmaceutical preparations
Blockholders before 12/23/1999:			
Barclays Global	5%	6282	Investment advice
Millennium Management	6.2%	6531	Real estate
Smithfield Fiduciary	5.5%	6282	Investment advice
Michael Roth	7.4%	-	-
Blockholders after 12/23/1999:			
Barclays Global	5%	6282	Investment advice
Millennium Management	6.2%	6531	Real estate
Michael Roth	7.4%	-	-
SuperGen Inc.	7.5%	2834	Pharmaceutical preparations

Empirical results are reported in Table 6 and Table 7. Table 6 reports the regression results of firm performance between the two groups before the block trades. Dummy1 is equal to one if a firm started to have an SI block in the next year after the transaction. Industry Q and ROE are controlled in the regressions. Using Tobin's Q as the dependent variable, the coefficient on dummy1 is -0.13, insignificantly different from zero. Using

¹⁷ For some observations I have to use Edgar to find the information on ownership of the firms.

¹⁸ Only observations without missing variables are considered.

return on equity (ROE)¹⁹ as the dependent variable, the coefficient on dummy1 is 0.02, also insignificantly different from zero. Table 6 shows that before the block trade transaction, there is no difference in firm performance between these two groups of target firms.

Table 7 reports the regression results of firm performance after the transaction between these two groups of target firms. Dummy1 is equal to one if a firm started to have an SI block at a particular year. The dependent variables are the differences of firm values between one year after the transaction and one year before the transaction, denoted by $Q_{+1} - Q_{-1}$, and $ROE_{+1} - ROE_{-1}$, respectively. Using $Q_{+1} - Q_{-1}$ as the dependent variable and controlling for the industry average change in Q , the coefficient on dummy1 is 1.25 and 1.36, both significant at 1% level. Using $ROE_{+1} - ROE_{-1}$ as the dependent variable and controlling for the industry average change in ROE, the coefficient on dummy1 is 0.09 and 0.11.²⁰

In short, results of Table 6 and 7 are consistent with the argument that it is that SI blockholders improve firm values, not that high-value firms attract SI blockholders. Therefore, the endogeneity problem is not a big concern in the findings of this paper.

6. Conclusion

Shleifer and Vishny (1986) suggest that large blockholders can effectively monitor top managers and therefore reduce the agency costs between the shareholders and managers. However, as Holderness (2003) points out, the existing literature documents both consistent evidence (McConnell and Servaes, 1990; Denis et al. 1997; Qiu, 2004) and inconsistent findings (Dlugosz et al., 2004; Qiu, 2004), depending on by which type of blockholders firms are held.

¹⁹ Return on assets is also used. Results remain the same.

²⁰ Although 0.09 is not significant and 0.11 is only significant at 10% level, the signs of these coefficients partially indicate the improvements of firm values after the target firms acquire SI blocks.

This paper seeks to explore the role of one type of blockholders – same-industry blockholders (SI) blockholders – versus different-industry blockholders in monitoring the managers. An SI blockholder has an informational advantage in monitoring managers and reducing agency costs, because they usually hold stocks in the same industry they operate. The main argument of this paper is that the SI blockholders monitor managers more effectively than other blockholders and accordingly such firms tend to have lower agency costs and higher values since the information asymmetry problem between blockholders and managers is likely to be much less severe for firms with SI blocks and therefore monitoring costs are lower for firms with SI blocks.

Consistent with this argument, this paper shows that firms with SI blocks tend to have higher firm values and lower corporate payouts and managerial equity ownership than other firms, *ceteris paribus*. In addition, this paper also finds that in corporate acquisition activities, acquirers with SI blocks, having higher values, tend not to over-pay targets, resulting in lower target returns and higher buyer returns. Finally, using block trade data, this paper finds it is that SI blockholders increase firm values, not that high-value firms attract SI blockholders.

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Table 1: Descriptive statistics on primary variables

The primary data sample of panel A has 4219 observations between 1996 and 2001. Same-industry blockholders are defined using 4-digit SIC codes. Different-industry blockholders include non-financial corporate, institutions, banks, insurance firms, brokerage firms, and et al.. Managerial equity ownership is from EXECUCOMP, equal to managerial stock holdings divided by total outstanding shares. The total payout yield is defined as the sum of dividend and repurchase payouts divided by the market value of common shares outstanding. Tobin's Q is calculated as the market value of total assets divided by book value of total assets. 457 observations at panel B on acquirers are obtained from the primary data sample. Returns are market-adjusted returns over [-2, +2] event window.

Panel A: Descriptive statistics on primary data sample

Variables	Mean	Median	Std. Dev.	Min	Max
Same-industry block holdings, (%)	1.56	0.00	6.89	0.00	82.20
Different-industry block holdings, (%)	19.40	17.70	13.16	0.00	94.72
Managerial equity ownership, (%)	2.65	0.00	6.46	0.00	52.60
Total payout yield, (%)	3.62	2.21	4.95	0.00	54.86
Ln(total assets)	7.72	7.65	1.41	3.58	13.31
Tobin's Q	2.06	1.52	1.74	0.15	27.09

Panel B: Descriptive statistics on secondary data sample on acquirers

Variables	Mean	Median	Std. Dev.	Min	Max
Same-industry block holdings, (%)	1.33	0.00	5.70	0.00	44.00
Different-industry block holdings, (%)	20.36	17.16	13.06	0.00	73.12
Acquirer [-2, +2] abnormal return, (%)	-1.78	-1.19	6.97	-31.70	16.21
Target [-2, +2] abnormal return, (%)	22.39	19.85	22.43	-126.61	95.98
Total payout yield, (%)	2.76	1.89	3.43	0.00	29.30
Ln(total assets)	2.11	2.12	0.19	1.55	2.53
Tobin's Q	1.98	1.16	2.44	0.57	32.07

Table 2: Tobin's Q

This table reports regression results of Tobin's Q on blockholder types. Same-industry (SI) blockholders are defined using 4-digit SIC codes. Different-industry blockholders include non-financial corporate, institutions, banks, insurance firms, brokerage firms, and et al.. Tobin's Q is calculated as the market value of total assets divided by book value of total assets. Industry Q is the value weighted mean of Qs on 4-digit SIC codes. The payout yield is defined as the sum of dividend and repurchase payouts divided by the market value of common shares outstanding. Governance index is from IRRC. Significance levels are indicated as follows: * = 10%, ** = 5%, and *** = 1%.

	(1)	(2)	(3)
Dummy1=1 if a firm has an SI block	0.35*** (0.08)	0.23*** (0.07)	0.16** (0.07)
Ln(assets)	0.30*** (0.02)	0.39*** (0.02)	0.99*** (0.02)
Industry Q	0.19*** (0.01)	0.14*** (0.02)	0.09*** (0.02)
Debt / assets, (%)	-0.04*** (0.00)	-0.03*** (0.00)	-0.01*** (0.00)
R&D / assets, (%)	0.03** (0.00)	0.02** (0.00)	0.01** (0.00)
Ad Expenses / assets, (%)	0.01** (0.01)	0.01* (0.01)	0.00 (0.00)
Total block, (%)		0.01* (0.00)	0.01* (0.00)
Ln(Herfindahl)		-0.12*** (0.01)	-0.47*** (0.01)
Governance			-0.01 (0.01)
Industry Dummies (4-digit SIC)	No	No	Yes
Year Dummies	No	No	Yes
N	4219	4219	4219
R ²	0.46	0.49	0.69

Table 3: Corporate Payout and Managerial Equity Ownership

This table reports regression results of corporate payout and managerial equity ownership on blockholder types. Same-industry (SI) blockholders are defined using 4-digit SIC codes. The payout yield is defined as the sum of dividend and repurchase payouts divided by the market value of common shares outstanding. Industry payout yield and managerial equity ownership are the value weighted means on 4-digit SIC codes. Governance index is from IRRC. Significance levels are indicated as follows: * = 10%, ** = 5%, and *** = 1%.

Panel A

	Payout Yield, (%)		Mgr. equity ownership, (%)	
	(1)	(2)	(1)	(2)
Dummy1=1 if a firm has an SI block	-0.93*** (0.22)	-1.09*** (0.26)	-0.48* (0.30)	-1.35*** (0.33)
Ln(assets)	-0.03 (0.05)	-0.38*** (0.10)	-0.66*** (0.06)	-0.66*** (0.13)
Industry payout yield, (%)	80.86*** (1.77)	80.06*** (2.33)		
Industry mgr. equity ownership, (%)			0.76*** (0.02)	0.75*** (0.04)
Tobin's Q	-0.09** (0.05)	-0.01 (0.06)	0.27*** (0.06)	0.32*** (0.08)
Earnings / assets, (%)	0.06*** (0.01)	0.06*** (0.01)	0.01* (0.00)	0.01 (0.01)
Debt / assets, (%)	0.01*** (0.00)	0.01 (0.01)	-0.01 (0.01)	-0.00 (0.01)
R&D / assets, (%)	0.03*** (0.01)	0.02 (0.02)	-0.14*** (0.02)	-0.10*** (0.02)
Ad Expenses / assets, (%)	0.08*** (0.02)	0.07*** (0.02)	-0.10*** (0.02)	-0.21*** (0.03)
Dummy1*(Earnings / assets, (%))	-0.05*** (0.01)	-0.05*** (0.01)		
Total block, (%)		-0.01 (0.01)		-0.05*** (0.01)
Ln(Herfindahl)		0.23*** (0.05)		-0.05 (0.07)
Governance		0.02 (0.03)		-0.39*** (0.04)
Industry Dummies (4-digit SIC)	No	Yes	No	Yes
Year Dummies	No	Yes	No	Yes
N	4219	4219	4219	4219
R ²	0.38	0.39	0.31	0.38

Panel B

	Simultaneous equations	
	Mgr. equity ownership, (%)	Tobin's Q
Dummy1=1 if a firm has an SI block	-1.94*** (0.36)	0.23** (0.12)
Tobin's Q	0.47*** (0.13)	
Managerial equity ownership, (%)		0.05* (0.03)
Ln(total assets)	-0.94*** (0.08)	0.38*** (0.02)
Sales / assets, (%)	0.00 (0.00)	
Debt / assets, (%)		-0.04*** (0.00)
Cash Flow /sales, (%)		-0.03*** (0.00)
Industry Q	0.20** (0.09)	
Shares held by a bank, insurance or financial firm, (%)	-0.04* (0.02)	0.01 (0.01)
Shares held by an investment banking or brokerage, (%)	-0.06 (0.04)	-0.01 (0.01)
Shares held by a private pension fund, (%)	-0.10 (0.13)	-0.03 (0.03)
Shares held by a public pension fund, (%)	-0.26*** (0.06)	0.01 (0.01)
Shares held by a mutual fund, (%)	-0.06*** (0.01)	0.00 (0.01)
Total blocks, (%)		0.02** (0.01)
Governance	-0.50*** (0.04)	-0.04*** (0.01)
N	4219	4219
R ²	0.10	0.37

Table 4: Acquirer's Q and Target Premium

This table reports regression results of premium. Same-industry (SI) blockholders are defined using 4-digit SIC codes. Different-industry blockholders include non-financial corporate, institutions, banks, insurance firms, brokerage firms, and et al.. Premium is defined as the difference between the deal value and the market value of the target 50 days prior to the announcement day, divided by the market value of the target 50 days prior to the announcement day, truncated between zero and two. The dummy variable of conglomerate takes values one for acquisitions of firms in another 2-digit SIC code than the acquirer. Dummy variables of tender offer, hostile, and more than one bidder are defined according to SDC. Pheld is the fraction of the target's common stocks owned by the acquirer on the announcement date. Significance levels are indicated as follows: * = 10%, ** = 5%, and *** = 1%.

	Dependent variables		
	Acquirer's Q	Premium, (%)	
		(1)	(2)
Dummy1=1 if an acquirer has an SI block	1.47*** (0.52)	-21.45** (9.05)	-23.73*** (9.02)
Ln(MV of acquirers assets)	0.33*** (0.09)	2.71* (1.67)	2.81* (1.66)
Acquirers' Tobin's Q		1.72* (1.07)	1.65* (1.00)
Ln(MV of targets assets)		-2.53** (1.30)	-2.55** (1.29)
Targets' Tobin's Q		0.48 (1.44)	0.36 (0.30)
Dummy2=1 if conglomerate	-0.79** (0.39)		9.36 (6.63)
Dummy3=1 if tender offer	0.10 (0.30)		11.54** (5.15)
Dummy4=1 if hostile	0.06 (0.92)		13.51 (19.02)
Dummy5=1 if more than 1 bidder			5.17 (13.93)
Dummy6=1 if Pheld is greater than 5%	0.01 (0.01)		-5.03* (3.03)
Total blocks of acquirer, (%)	-0.02 (0.02)	0.37 (0.26)	0.36 (0.26)
Acquirers' governance	-0.12* (0.07)	0.56 (3.35)	0.03 (3.30)
N	424	424	424
R ²	0.05	0.03	0.04

Table 5: Target Returns and Acquirer Returns

This table reports regression results of market adjusted returns of buyers and sellers from acquisitions over a [-2, +2] window. Same-industry (SI) blockholders are defined using 4-digit SIC codes. Different-industry blockholders include non-financial corporate, institutions, banks, insurance firms, brokerage firms, and et al.. Returns are market adjusted returns over a [-2, +2] window, measured as percentage (%). The dummy variable of conglomerate takes values one for acquisitions of firms in another 2-digit SIC code than the acquirer. Pheld is the fraction of the target's common stocks owned by the acquirer on the announcement date. Significance levels are indicated as follows: * = 10%, ** = 5%, and *** = 1%.

Panel A

	Dependent variables	
	Target returns, (%)	Acquirer returns, (%)
Dummy1=1 if an acquirer has an SI block	-9.01*** (3.44)	0.56 (1.18)
Ln(MV of acquirers assets)	1.31* (0.79)	0.80 (0.88)
Acquirers' Tobin's Q	0.77 (0.54)	-0.11 (0.19)
Ln(MV of targets assets)	-1.83** (0.74)	-0.72*** (0.24)
Targets' Tobin's Q	0.05 (0.17)	-0.04 (0.20)
Premium, (%)	0.31*** (0.02)	-0.01* (0.01)
Dummy2=1 if conglomerate	2.28 (2.45)	0.21 (1.03)
Dummy3=1 if cash payment	9.38*** (2.30)	0.77 (0.97)
Dummy4=1 if stock payment	1.48 (2.02)	-0.28* (0.17)
Dummy6=1 if Pheld is greater than 5%	0.03 (0.02)	0.02 (0.02)
Total blocks of acquirer, (%)	0.04 (0.10)	0.02 (0.04)
Acquirers' governance	0.81 (1.04)	-0.13 (0.43)
N	424	424
R2	0.24	0.06

Panel B

	Dependent variables	
	Target returns, (%)	Acquirer returns, (%)
Dummy1=1 if an acquirer has an SI block	-3.86** (1.91)	0.38 (1.47)
Ln(total assets of acquirers)	1.17* (0.68)	0.78 (0.74)
Acquirers' Tobin's Q	-0.87* (0.54)	-0.12 (0.19)
Ln(total assets of targets)	-1.78** (0.75)	-1.03*** (0.24)
Targets' Tobin's Q	0.34 (0.60)	-0.06 (0.04)
Premium, (%)	0.30*** (0.02)	-0.01* (0.01)
Dummy2=1 if conglomerate	1.34 (2.48)	0.64 (1.05)
Dummy3=1 if cash payment	19.12*** (2.42)	0.69 (1.02)
Dummy4=1 if stock payment	1.46 (2.07)	-0.18* (0.12)
Dummy5=1 if tender offer	0.32 (2.12)	0.26 (0.91)
Dummy6=1 if hostile	0.32 (2.12)	2.61 (3.01)
Dummy7=1 if more than 1 bidder	-2.17 (5.13)	0.43 (2.18)
Dummy6=1 if Pheld is greater than 5%	0.03 (0.02)	0.00 (0.00)
Shares held by a bank, insurance or financial firm, (%)	0.10 (0.13)	0.43 (2.18)
Shares held by an investment banking or brokerage, (%)	-0.06 (0.13)	0.11 (0.08)
Shares held by a public pension fund, (%)	0.56 (0.79)	-0.09 (0.34)
Shares held by a mutual fund, (%)	0.25* (0.15)	0.06 (0.06)
Total blocks of acquirer, (%)	0.03 (0.10)	0.03 (0.01)
Acquirers' governance	0.49 (1.10)	-0.04 (0.47)
N	424	424
R ²	0.25	0.07

Table 6: Firm Performance before Block Trades

This table reports regression results of Tobin's Q and ROE on blockholder types one year before the transaction. Same-industry (SI) blockholders are defined using 4-digit SIC codes. Tobin's Q is calculated as the market value of total assets divided by book value of total assets. Industry Q and ROE are the value weighted means on 4-digit SIC codes. Significance levels are indicated as follows: * = 10%, ** = 5%, and *** = 1%.

	Tobin's Q	ROE
Dummy1=1 if a firm started to have an SI block in the next year	-0.13 (0.22)	0.02 (0.03)
Ln(assets)	-0.15** (0.07)	0.02*** (0.01)
Industry Q	0.24** (0.12)	
Industry ROE		0.72** (0.35)
Tobin's Q		0.04*** (0.01)
Debt / assets, (%)	-0.01** (0.00)	0.00 (0.00)
R&D / assets, (%)	0.01** (0.00)	-0.01** (0.00)
Ad Expenses / assets, (%)	0.01 (0.03)	0.00 (0.00)
Year Dummies	Yes	Yes
N	283	283
R ²	0.14	0.30

Table 7: Firm Performance after Block Trades

This table reports regression results of changes in Tobin's Qs and ROEs on blockholder types. Same-industry (SI) blockholders are defined using 4-digit SIC codes. Tobin's Q is calculated as the market value of total assets divided by book value of total assets. Industry average changes in Qs and ROEs are the value weighted means on 4-digit SIC codes. Significance levels are indicated as follows: * = 10%, ** = 5%, and *** = 1%.

	Q ₊₁ - Q ₋₁		ROE ₊₁ - ROE ₋₁	
	(1)	(2)	(1)	(2)
Dummy1=1 if a firm started to have an SI block at 0	1.25*** (0.46)	1.36*** (0.49)	0.09 (0.07)	0.11* (0.68)
Ln(assets)	-0.19 (0.13)	-0.20 (0.15)	0.03 (0.02)	0.02 (0.03)
Industry average of Q ₊₁ - Q ₋₁	0.25 (0.16)	0.19 (0.18)		
Industry average of ROE ₊₁ - ROE ₋₁			0.22 (0.41)	0.16 (0.45)
Tobin's Q			-0.02 (0.02)	-0.04 (0.03)
Debt / assets, (%)	0.01 (0.00)	0.01 (0.01)	-0.01* (0.01)	-0.00 (0.00)
Sales / assets, (%)		-0.00 (0.00)		-0.00 (0.00)
R&D / assets, (%)		-0.00 (0.01)		0.00 (0.00)
Ad Expenses / assets, (%)		0.02 (0.05)		0.01 (0.01)
SI block after transaction, (%)		0.02 (0.02)		0.00 (0.00)
Ln(Herfindahl)		0.38 (0.32)		-0.04 (0.06)
Year Dummies	No	Yes	No	Yes
N	283	283	283	283
R ²	0.03	0.03	0.02	0.02