Volkswagen

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Volkswagen

Volkswagen AG (VW) is a German-based automotive manufacturer. The umbrella Volkswagen AG includes companies such as VW, Audi, Skoda, Seat, Lamborghini, Bentley, Ducati, Scania, MAN etc. with 12 brands in total, producing both cars, motorbikes, trucks, and busses. In addition, VW offers a wide range of financial services, including leasing, dealer and customer financing, banking and insurance activities, and fleet management. The Group employs 592,586 people in total and sales reached €202.5 billion in 2014 while profit after tax equaled €11.1 billion (Volkswagen 1, 2015). The automotive category accounted for 78% of revenue, and commercial vehicles and consumer finance accounted for 12% and 10% respectively (Appendix 1).

VW is the bestselling carmaker in Europe with 25.1 % market share (Volkswagen 1, 2015), and was the 2nd best worldwide in 2014, only outperformed by Toyota (Bloomberg 1, 2015). The company is competing in a highly competitive market and has turned to concentrated diversification through acquisitions as growth strategy. This aligns with the maturity of the firm in relation to company life cycle theory (Filatotchev, Toms, and Wright, 2006). The business model has proved to be sustainable until now, maybe because entry barriers are high since especially capital and technology requirements prevents new market entries. VW's competitive advantages are size, know-how, economical robustness, the well-known brand, and affordable quality products.

On September 18th 2015, a crisis broke out at VW. The emissions scandal (also called dieselgate) saw the light of the day after the Environmental Protection Agency disclosed that a defeat devise (software) had been developed to falsely report lower CO_2 emissions tests for 4-stroke engine, diesel vehicles (Cars.com, 2015). The crisis evolved further and a stunning 8.5 million cars – and that is only in Europe – have now been recalled (Reuters, 2015). Consequently, the share prices has dropped drastically (Appendix 2) and heads have been rolling at VW. Former CEO Martin Winterkorn resigned on September 23rd and was replaced by former CEO of Porsche, Mathias Müller (Appendix 3). US CEO, Michael Horn, encapsulated the depth of the crisis very well when he already on September 21st 2015 said: "We have totally screwed up" (Business Insider, 2015).

Ownership structure

VW runs a single class share system where stock, though, is split into two categories: preferred stock and ordinary (common) stock. The first comes with only cash flow rights (profit), whereas the other comes with both voting (one share-one vote) and cash flow rights (Appendix 4). VW's three largest block holders – Porsche SE, Qatar LLC, and the State of Lower Saxony – account for 59.20% of all subscribed capital but has 87.73% voting rights. It is especially important to notice that the Porsche and Piëch family members (Appendix 5) control the supervisory board (Appendix 6) as they hold 50.73% voting rights through Porsche SE. This imperial system is highly damaging to shareholder democracy where minority holders are cut off from having a say on corporate matters. Eventually, outside parties have no chance of affecting VW's strategy, which is why this agency type II problem between majority and minority shareholders is highly problematic. The block holder family is fully protected through this very effective takeover defense. Here the guardians are guarding themselves. Normally it is the shareholder's task to vote for and against the board member candidates, which the board then appoints, but former chairman of the board, Ferdinand Piëch, demonstrated the family's power when he had his fourth wife, Ursula, a kindergarten teacher, elected to the board despite her lacking knowledge and independency (NY Times, 2015).

Another thing to notice is that foreign institutional investors accounts for 26.3% of VW's shares whereas German institutional investors only own 2.1% (Appendix 4) This might indicate that the national institutions already knew that something was wrong at VW from a corporate governance perspective; they had seen the smoke.

Board size and structure

VW has a 2-tier board system with a management (also called management board) and a supervisory board. German law requires total separation of the two with no allowance for CEO duality or other duality. The supervisory board is considered large with 20 members in total. Average boards are around half the size. However, when comparing to BMW and Daimler it becomes clear that they have the exact same number of supervisory board members.

Currently four family members of the Porsche clan sit on the board, namely Kiesling, Piëch, Oliver Porsche, and Wolfgang Porsche (CEO interlock). The two families have been center of much dispute. The relationship is at best described as destabilizing and dysfunctional. Porsche once tried buying out VW. Porsche failed and the take-over attempt left the company with a net debt of €10 billion in the process (Financial Times, 2009).

Also former chairman Ferdinand Piëch has contributed to his fair share of scandals with his turbulent private life. He has 12 children with 4 different women and two of these children are the result of an affair he had with his cousin's wife, Marlene Porsche (Spiegel, 2009). In April 2015 his attempt of ousting Martin Winterkorn as CEO backfired and both he and his wife resigned from the board. Former VW CFO was appointed as chairman of the board (NY Times, 2015).

Furthermore, the State of Lower Saxony is entitled to elect two politicians as board members. That way VW may avoid some agency type I problems between shareholder and management, at least specifically regarding the share that they are holding. In exchange for influence and given that the CEO performs with respect to jobs, said CEO is as good as free to do what suits his tastes. The two politicians possess a whole other set of priorities as they value number of jobs over profitability at any given time (Business Spectator, 2015). At Daimler and BMW, there is no such thing as politicians on the supervisory board (The Guardian, 2015). That is something to keep in mind.

Finally, employee representation is to account for at least 50% of the supervisory board when a German company has more than 2000 employees (Thomsen and Conyon 1, 2012). These co-determination principles are the result of a law called the Mitbestimmungsgesetz, which follows a stakeholder approach and empowers German unions at the same time. In the case of VW, 10 out of 20 supervisory board members must be employees or alternatively union members (Business Spectator, 2015). In my opinion, this might be overdoing it a little. Many companies outside Germany or just smaller German firms without representative requirements are considered well governed. However, I do acknowledge that employees have special demands that have to be met and that they have hands on experience, which might effectually help shorten the distance that knowledge travels across strategic, tactical, and operational levels.

Representatives from the workforce and the State of Lower Saxony has one common goal: Full employment and protecting jobs. In doing so, they are willing to let the CEO rule nearly as he wishes to (The Guardian, 2015).

The board structure can be characterized as ineffective and not really value creating. The ratio of insiders to outsiders is far above any reasonable level. Falkengren is sadly considered the only, truly independent board member (CBNC, 2015). Misbehavior must have been inevitable and the board cannot rightfully be expected to act in the company's best interest. Professor Ferdinand Dudenhöffer, automotive expert at the University of Duisburg-Essen said: "In Daimler and BMW, you have a supervisory board that is controlling the CEO. But at VW you have no such authority" (The Guardian, 2015).

This unusual hybrid of family control, government ownership, and labor/union influence has weakened the supervisory board to an extend where it limits control with management. The function of the board has been statutory and reflects the prototypical image of an ineffective board. The powerful, autocratic CEO's decisions are rubber-stamped by the board and non-executives have little to say if anything at all (Thomsen and Conyon 2, 2012).

Industry observers and former executives at VW interviewed by Reuters described the management style under Winterkorn as 'one that fosters a climate of fear', and this authoritarianism went unchecked partly due to a company structure that is unique in the German motor industry (The Guardian, 2015).

Executive compensation

Winterkorn received €15,861,478 in remuneration per year (Volkswagen 2, 2014). That is more than the CEOs of Daimler (Dieter Zetsche) and BMW (Harald Krüger) receive when adding up their paychecks of €8,364,000 (Daimler, 2014) and €7,245,159 (BMW, 2014). Combined with a low fixed salary of €1,617,025, which makes up only one tenth of the total compensation package, this short-term incentivized compensation leaves plenty of space for Winterkorn to deviate from the best interest of the company.

Even the supervisory board may have had problems with short-term incentives. For meeting six times a year supervisory board members are compensated €12,149,450 in total. Hereof, only €808,500, equaling 7% of remuneration, is fixed (Volkswagen 3, 2014). Comparisons with Daimler and BMW again show that VW pays strictly more. At Daimler, the supervisory board gets €3,563,455 in remuneration (Daimler, 2014), whereas the supervisory board of BMW gets paid €4,764,622 of which 41.7% is fixed (BMW, 2014). This could to some extend indicate that board members are ‘paid to keep quiet’ at VW. In that case, the ‘rule of man’ would be well applied and theory on profit maximizing individuals would prove to hold.

Recommendations

Seen in the lights of the recent events it is clear that extensive corporate governance failures are at play. The overarching corporate governance issues are board structure complications. This is partly due to the Mitbestimmungsgesetz, partly due to the owner structure. Those two factors have led to a lack of independency, which in turn has resulted in a lack of monitoring. In addition, especially the monitoring process is crucial for a company in the mature stage (3rd quadrant) of the life cycle matrix (Filatotchev, Toms, and Wright, 2006).

The board should be cut down to a point where free riding is minimized. A smaller board would be more efficient. The one thing to strive for on a new board with the resisting number would then be independency, so that fresh and unbiased eyes can supervise management.

Firstly, employee representation is a massive German corporate governance issue. It is a build-in problem that employees sitting on the board (insiders) are dependent per definition. That makes it impossible to reduce group think. In this case, technocracy would have outperformed democracy in the long-run measured on firm value. Co-determination might be based on good intensions, yet in reality it undermines the board and its effective decision making. Nevertheless, it is hard to do something about the number of employee representatives, though, as it is a state level decision and since German unions will not give up their influence without fight (NY Times, 2015).

Instead, VW should focus on what they actually can do something about: There are too many family members on the board in my opinion. Some of them might be competent but they are far from independent. The board structure can be characterized as a family tragedy. Instead of sitting on the board, family members could exercise their power by taking an activist shareholder approach or using their skills actively in the company. The company would be better off without the family conflicts that have a negative impact on firm performance and value creation. The same holds for the two Lower Saxony politicians. The board might be better off without them, and they can still affect the company through their jobs and as shareholders if they wish to do so.

The supervisory board could really use some diversity regarding age, gender, nationality, background and experience. Only three non-national German/Austrians are on the board (Falkengren, Al-Abdullah, Al-Bakar) which is by coincidence also the number of women on the board (Falkengren, Fröhlich, and Kiesling). Average tenure is around 5 years after the recent rotation (Appendix 6) and the average age is around 56 years (Bloomberg 2, 2015), so there are plenty of parameters to improve on.

Finally, the compensation packages could be changed to incentivize more long-term approaches for management and board members. The implementation of a vesting period – limiting the amount of profits that can be realized within a certain period – together with a restriction on performance pay could possibly get rid of the current quarter-to-quarter way of thinking. A percentage-wise higher fixed salary should be balanced, though, so that management and board are neither short-term oriented (too high incentives), neither paid like bureaucrats (missing incentives).

Buy or sell share

It is hard to predict the future trading price but it is my best guess that it will go up over time. The crisis taken into consideration, and even though VW is not too well governed, it is still a robust, well-performing company. It is going to be tough for VW to regain trust from consumers and VW will not get rid of all corporate governance issues from one day to another. Investors, though, are not solely looking for perfect companies; they search for return on investment. At this point, though, I would recommend waiting for a potential ‘double dip’. However, the drop in VW share price has dragged other automotive share prices down, making them undervalued. At this point, I would suggest investing in *those* companies instead.

Appendix 1 – Revenue composition

Bloomberg. VOW GR Equity. Bloomberg Terminal Database accessed at CBS Library [October 14, 2015]

Appendix 2 – Share price

Volkswagen, 2015. *Investor relations: Shares – Volkswagen*. [ONLINE] Available at: http://www.volkswagenag.com/content/vwcorp/content/en/investor_relations/share.html. [Accessed: 14 October 2015]

Appendix 3 – Management board

Chairman of the Board of Management of Volkswagen AG


Matthias Müller

Members of the Board of Management of Volkswagen AG


Dr. Herbert Diess
Chairman of the Board of Management of the Volkswagen Passenger Cars brand


Dr. rer. pol. h. c. Francisco Javier Garcia Sanz
Functional Responsibility 'Procurement'


Prof. Dr. rer. pol. Dr.-Ing. E. h. Jochem Heizmann
Functional Responsibility 'China'


Prof. h. c. Dr. rer. pol. Horst Neumann
Functional Responsibility 'Human Resources and Organization'


Andreas Renschler
Functional Responsibility 'Commercial Vehicles'


Prof. Rupert Stadler
Chairman of the Board of Management of Audi AG


Frank Witter
Functional Responsibility 'Finance and Controlling'

Volkswagen, 2015. *The Group: Senior management – Volkswagen.* [ONLINE] Available at: http://www.volkswagenag.com/content/vwcorp/content/en/the_group/senior_management.html. [Accessed: 14 October]

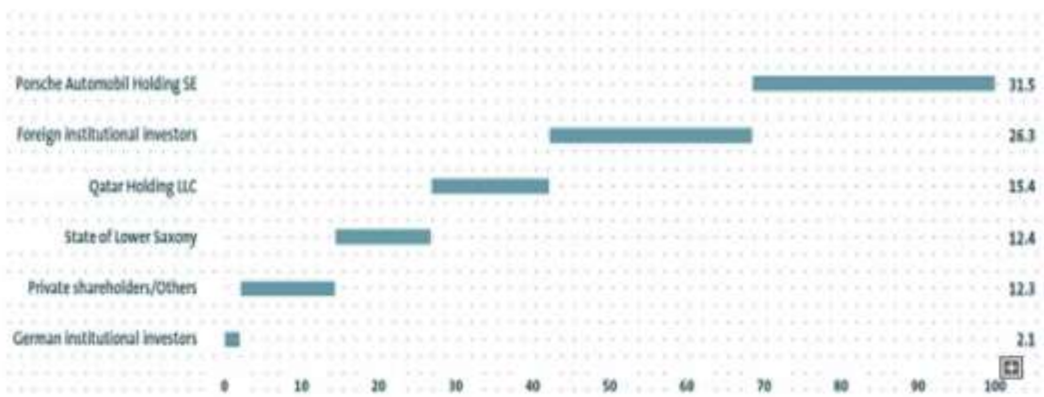
Appendix 4 – Ownership structure

Number of outstanding shares (as at December 31, 2014)

Preferred shares	180,641,478
Ordinary shares	295,089,818

564 preferred shares were created in the first three months of 2015 from the exercise of mandatory convertible bonds. As per 31 March 2015, the subscribed capital was composed of 295,089,818 ordinary shares and 180,642,042 preferred shares.

In percent of subscribed capital* (as at December 31, 2014):



**All figures shown are rounded, so minor discrepancies may arise from addition of these amounts.*

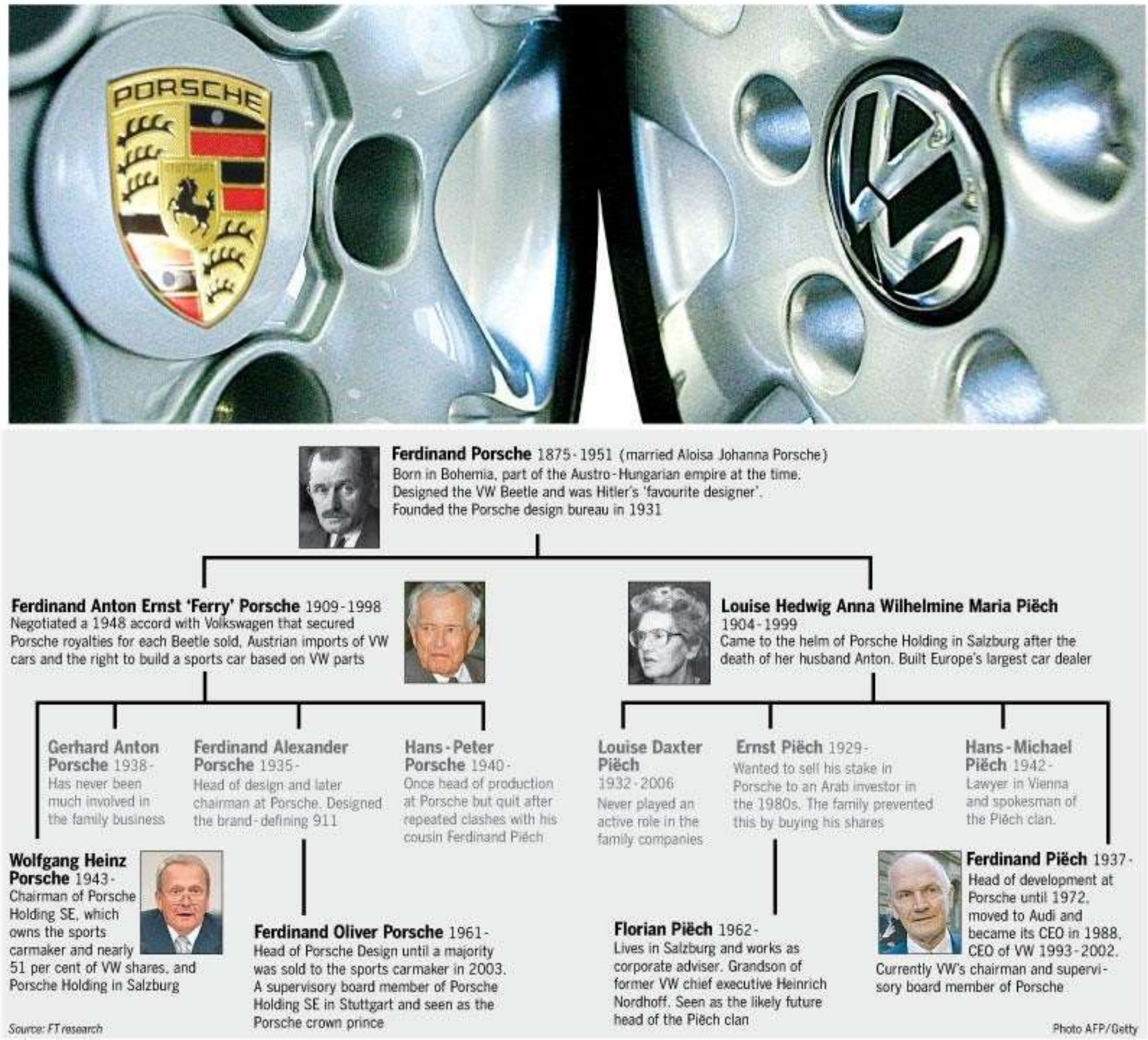
Current voting rights distribution* (as at December 31, 2014)

50.73%	Porsche Automobil Holding SE, Stuttgart
20.0%	State of Lower Saxony, Hanover
17.0%	Qatar Holding
12.3%	Others

**All figures shown are rounded, so minor discrepancies may arise from addition of these amounts.*

Volkswagen AG, 2015. *Investor relations: Shares: Shareholder Structure – Volkswagen.* [ONLINE] Available at: http://www.volkswagenag.com/content/vwcorp/content/en/investor_relations/share/Shareholder_Structure.html. [Accessed: October 2015]

Appendix 5 – Family tree



Financial Times, 2009. *Just another week at the office for Piëch – Financial Times.* [ONLINE] Available at: http://www.ft.com/intl/cms/s/0/f94c8e7e-787c-11de-bb06-00144feabdc0.html#axzz3oZPtDAgt. [Accessed: 15 October 2015]

Appendix 6 - Supervisory board

SUPERVISORY BOARD

The Supervisory Board is responsible for monitoring the Management and approving important corporate decisions. Moreover, it appoints the Members of the Board of Management.

The Supervisory Board of Volkswagen AG comprises 20 members and conforms to the German Co-determination Act.

Members of the Supervisory Board

Hans Dieter Pötsch
Chairman
October 7, 2015*

Dr. Hussain Ali Al-Abdulla
Vice Chairman of Qatar Holding LLC
April 22, 2010*

HE Akbar Al Baker
Minister of State, Qatar
May 5, 2015*

Annika Falkengren
President and Group Chief Executive of Skandinaviska Enskilda Banken AB
May 03, 2011*

Dr. Hans-Peter Fischer
Chairman of the Board of Management of Volkswagen Management Association (VMA)
January 01, 2013*

Uwe Fritsch
Chairman of the Works Council at the Volkswagen AG Braunschweig plant
April 19, 2012*

Babette Fröhlich
IG Metall,
Department head for coordination of Executive Board duties an planning
October 25, 2007*

Berthold Huber
IG Metall
May 25, 2010*

Uwe Hück
Chairman of the General and Group Works Council of Dr. Ing. h. c. F. Porsche AG
Juli 01, 2015*

Dr. Louise Kiesling
April 30, 2015*

Olaf Lies
Minister of Economic Affairs, Labor and Transport for the Federal State of Lower Saxony
February 19, 2013*

Hartmut Meine
Director of the Lower Saxony and Saxony-Anhalt Regional Office of IG Metall
December 30, 2008*

Peter Mosch
Chairman of the General Works Council of AUDI AG
January 18, 2006*

Bernd Osterloh
Chairman of the General and Group Works Councils of Volkswagen AG
January 01, 2005*

Dr. jur. Hans Michel Piëch
Lawyer in private practice
August 07, 2009*

Dr. jur. Ferdinand Oliver Porsche
Member of the Board of Management of Familie Porsche AG Beteiligungsgesellschaft
August 07, 2009*

Dr. rer. comm. Wolfgang Porsche
Chairman of the Supervisory Board of Porsche Automobil Holding SE
Chairman of the Supervisory Board of Dr. Ing. h. c. F. Porsche AG
April 24, 2008*

Stephan Weil
Minister-President of the Federal State of Lower Saxony
February 19, 2013*

Stephan Wolf
Deputy Chairman of the General and Group Works Councils of Volkswagen AG
January 01, 2013*

Thomas Zwiebler
Chairman of the Works Council of Volkswagen Commercial Vehicles
May 15, 2010*

* The date indicates the effective date of appointment to the Supervisory Board.

Volkswagen, 2015. *The Group: Senior management – Volkswagen.* [ONLINE] Available at: http://www.volkswagenag.com/content/vwcorp/content/en/the_group/senior_management.html. [Accessed: 14 October 2015]

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