Corporate Governance Exam – Volkswagen

Name

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Georg Wernicke
Bsc. International Business '17
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Introduction

With a history closely tied to the Bundesrepublik Deutschlands, Volkswagen AG has grown to be among the largest players on the international automotive industry. Based in Wolfsburg and owning several well-known brands such as Volkswagen, Audi, Porsche and Skoda, the company has achieved a strong position in various segments globally. (Marketline, 2014, 2015a, b, and c)

Financially, Volkswagen is doing well, with growth in Sales and Profits on average in the past 5 years. (Volkswagen 2015a). The company is superior to peers such as BMW and Daimler in terms of absolute revenue and net income. On the other hand, the company is financially and operationally outperformed in terms of relative profitability, with an operating margin and ROE lower than peers.

	Volkswagen AG	***BMW AG***	***Daimler AG***
Market			
Market Cap (15-10-16)	€55.37 billion	€56.45 billion	€78,29 billion
Financial Statement 2014			
Revenue Net	€202 billion	€80.40 billion	€129.872 billion
Income Operating	€10.847 billion	€3 billion	€6.962 billion
margin Total	6.28%	10.87%	8.01%
Assets	€351.209 billion	€182,72 billion	€189.635 billion
Total Equity	€90.189 billion	€37,43 billion	€44.584 billion
Return on equity (ROE)	12.7%	15,7%	17.8%
Dividend Yield % (5 year average)	2.24%	3.27%	4.52%
Debt/Equity Ratio	1.19	2.32	1.95
Valuation			
Price to Earnings Ratio (15-10-16)	6.03	9.97	9.57

Table 1: Volkswagen, Financial Peer Comparison (Volkswagen 2015a, Daimler AG 2015, BMW Group 2015, Bloomberg 2015)

However, what is currently interesting investor is, rather than profitability, the current emission scandal, which has exposed many years of corporate misconduct to the world, leading to the CEO Martin Winterkorn stepping down.

The aim of this paper is neither to articulate the details of the emission scandal, nor to clarify who is guilty and who is not. Instead, it is to investigate the underlying problem in the governance structure, allowing such misconduct. The two main aspects of this analysis is the ownership structure, and the supervisory board. With a shareholder-oriented view, the aim of this paper is to assess whether the governance structure makes the share attractive from a minority shareholder's point of view. Finally, the paper proposes what could improve share attractiveness

Ownership structure and its impact on control

The history of Volkswagen AG exhibits extensive upheavals in ownership structure. Subsequent to a period state control, Volkswagen prospered and was IPO'ed in 1961. (Volkswagen AG, 2011)

In the following, I will walk through the ownership structure and the three main shareholders, and argue how this has a negative impact on the efficiency of the governance structure.

The company applies a dual-class stock structure, where preferred stock gives no voting rights, while ordinary stock gives a vote per share. Hence, an investor's amount of invested capital is not necessarily proportional to influence. (Volkswagen, 2015a)

Currently, 3 major block holders of different character, and with different objectives, hold dominating shares of the voting rights. These are Qatar Investment Authority, The State of Lower Saxony and Porsche SE. They hold more than half of the dividend rights, while leaving only 12,3% of voting rights to other parties. Not only does controlled structure mean that new shareholders only have a very limited say in company affairs, also this has left the actual control of the company in the hands of a very small group of related people. (See Appendix 4, for on overview over share-class structure)

As the 3rd largest shareholder, Qatar Investment Authority (QIA) holds a 17% stake in the company. QIA bought into Volkswagen, as additional capital was needed in Porsche SE's takeover. (The National, 2009). As a sovereign wealth fund, QIA's interests in the company can be assumed as mainly financially motivated. The picture is rather different when looking at the, rather unusual, 2nd largest shareholder. After privatization more than 50 years ago, a 20,2% voting share was still held by The State of Lower-Saxony. Until 2013, where a special German law stipulating an 80% agreement on Volkswagen shareholder resolutions, was set out of effect by EU, Lower Saxony held a veto right. (Sander, 2008) Until then, this has functioned as an anti-takeover mechanisms, and the threat of takeovers has thus not been able to function as a disciplining, governance mechanism. (Andrade, Mitchell and Stafford, 2001) With a massive employee base, and VW's revenues being equal to about 8% of Germany's GNI, Lower Saxony is arguably more interested keeping the firm at its current size and shape, rather than profitability and shareholder value.

With a 52,2% voting stake in Volkswagen as of 2015, Volkswagen is today effectively a subsidiary of Porsche SE. (See Appendix 4) As the EU acted against the special law, Porsche increased its holding. As the control of Porsche SE is 100% held by the Porsche-Piëch family, this makes Volkswagen AG a family-owned company. (Stewart, 2015) The Porsche-Piëch family has been tightly knit to the company, since it was founded. Ferdinand Piëch, a family member, was the Volkswagen CEO in the 90's, after which he maintained close ties to management, as he was the supervisory board chairman until 2015. (Hawranek and Kurbjuweit, 2015)

In its daily activities, Porsche SE is controlled by family members, but to a large extent also by current and present Volkswagen AG executives, such as newly appointed CEO Mathias Müller, and former CEO Martin Winterkorn. (See Appendix 2)

Porsche's takeover has changed the corporate structure to a 3-tier pyramid structure. Porsche SE as the primary holding company, controls Volkswagen AG that in turn controls the various operating companies, namely the companies running the various brands. (See appendix 1) As depicted by scholars as Holmen and Hogfeldt (1999) Bianco (1998), such pyramid structures often lead towards agency costs. Bebchuk Kraakman and Triantis (2000) argues that such structures often are not beneficial from a minority shareholder's point of view. Though effective in expanding the firm, it is not necessarily value-creating from to a minority shareholders, who might rather benefit from a diversified the stock-portfolio. This is supported by, Volkswagen increasing total assets since 2010, amounting to a 17,8% increase in total assets, while return on equity is stagnated (Volkswagen 2015a)

In sum, it is very difficult as a minority shareholder to have influence of the company's business conduct, due to the ownership structure. However, large blockholders should in theory be incentivized and have the ability to monitor management, and therefore the ownership structure itself does not explain what allowed corporate misconduct. This will be answered by looking at the supervisory board.

Supervisory board and monitoring

Volkswagen follows a 2-tier board-system, with a supervisory board consisting of 20 members, of which most 85% are men. In accordance with the German laws of codetermination, the employees of Volkswagen are entitled to appoint half of the board members. Following the corporate governance life-cycle, as presented by, (Filalotchev, Toms, and Wright, 2006) the essential board roles differ between stages in the life-cycle. As a large developed firm, the available resource-base is extensive, and thus the firm needs the board to monitor. In the following, I will show, how the board is ineffective in doing so.

Mirroring the ownership structure, the board consists of an unusual combination of family-owners, a government institution and also employee representatives. The board is generally characterized as staggered, the board members represent widely different interest, and most importantly, the actual control is centralized around few people, namely the Porsche-Piëch family.

Firstly given the co-determination, and secondly due to the largest share of stock held by block holders, it is almost impossible to get a foot in the door. This is only more evident, as board members are elected for a period of 4 years. (Volkswagen, 2015b)

Looking at the different board members, there arise major conflict of interest between on the first hand the representatives of the workers and of Lower Saxony, and on the other hand of Porsche SE. Employee representatives are likely to oppose cost-reduction that might reduce the number of employees. Of political reasons, the same is likely to be true to the State of Lower Saxony, that favors economical stability. This is likely to conflict with Porsche's interests in reputational and financial recovery of the group. This shows how the board is more interested in playing a managerial role, than a supervisory role. (Schwartz-Ziz and Weisbach, 2013) This is a key element in the board's lacking ability to monitor.

This leads to another major concern, namely the independence of the board. Among the board members, 17 are either local politicians, union representatives or related to the Porsche-Piëch family. 3 of these are family members. Comparing the supervisory board of Volkswagen to the Management Board and Supervisory Board of Porsche SE, one will find several overlaps. 7 members of the Volkswagen supervisory board serve on one of the Porsche SE boards, (See Appendix 2) and the newly appointed Chairman of the Volkswagen supervisory board, Hans Dieter Pötsch, is a manager of Porsche SE. Firstly, this shows a general lack of independence, compromising the board's ability to monitor. Secondly, this proves the continuing entrenchment of a small powerful circle related to the Porsche-Piëch family. With boards tightly tied to ownership, the governance structure lacks transparency. With the appointment of Volkswagen CEO, Mathias Müller, who is closely tied to Porsche SE (see appendix 2), one can question the actual governance in this structure. Where the 2-tier system is intended to ensure strong governance and objective monitoring, the governance is basically in the hands of Porsche SE, hence the Porsche-Piëch family.

Recommendations

The current scandal aside, there are several governance issues that make the Volkswagen AG stock unattractive to shareholders. The controlled ownership makes it very hard to gain any influence. Meanwhile the ownership is tightly knit to a supervisory board with extremely low independence, hence with a weak ability to monitor properly. The incentives of the owners to give up power are very small, hence, it is unlikely that investors will be willing the gain influence in Volkswagen AG in the coming years. In addition, it appears that peer companies are financially better performing.

However, there are initiatives that would not only make the stock more attractive, but also be in the interest of the current owners. This because it can be assumed that it is in the owners interest to avoid another scandal, and because a more attractive share, would make it easier to raise capital in the future. This would not give a minority shareholder much increased influence, but it will lay the foundation of a sustainable perfor- mance of the stock. These initiatives include:

- Appoint actual *independent* members to the Volkswagen AG supervisory board. Firstly, this will clear out the non-transparent governance structure, more clearly dividing board and management. Most importantly, this will improve the board's ability to monitor objectively. By comparison, the board of Directors of the Maersk Group includes directors from various other industries and countries. This could be imitated, possibly with directors from Germany's large IT and telecommunication industry. The Maersk Group also applies a dual-class structure to protect family ownership, and manages to do so while creating shareholder-value. (Maersk Group, 2015)

- Increase *board diversity,* by including more women on the board. A study from 2009, (Adams & Ferreira, 2009) identifies some valuable characteristics of female board members. Though not directly linking female board members to firm performance, the study identifies how women are tougher monitors than male directors. As a consequence, gender diversity on boards appears to be particularly valuable to firms with weak governance. Also, female board members generally show a higher alignment of interest with shareholders.
- Build an internal *whistleblower* system, allowing employees to anonymously state concerns on misconduct. Where Volkswagen's *Ombudsmen* system (Volkswagen AG, 2015) currently works to oppose corruption, this should concern unethical business in general. This system could possibly be run by the Audit Committee, preferably by an independent member, as material ties could bias judgment. This should impact the culture throughout the organization, while also signal to the stock market.

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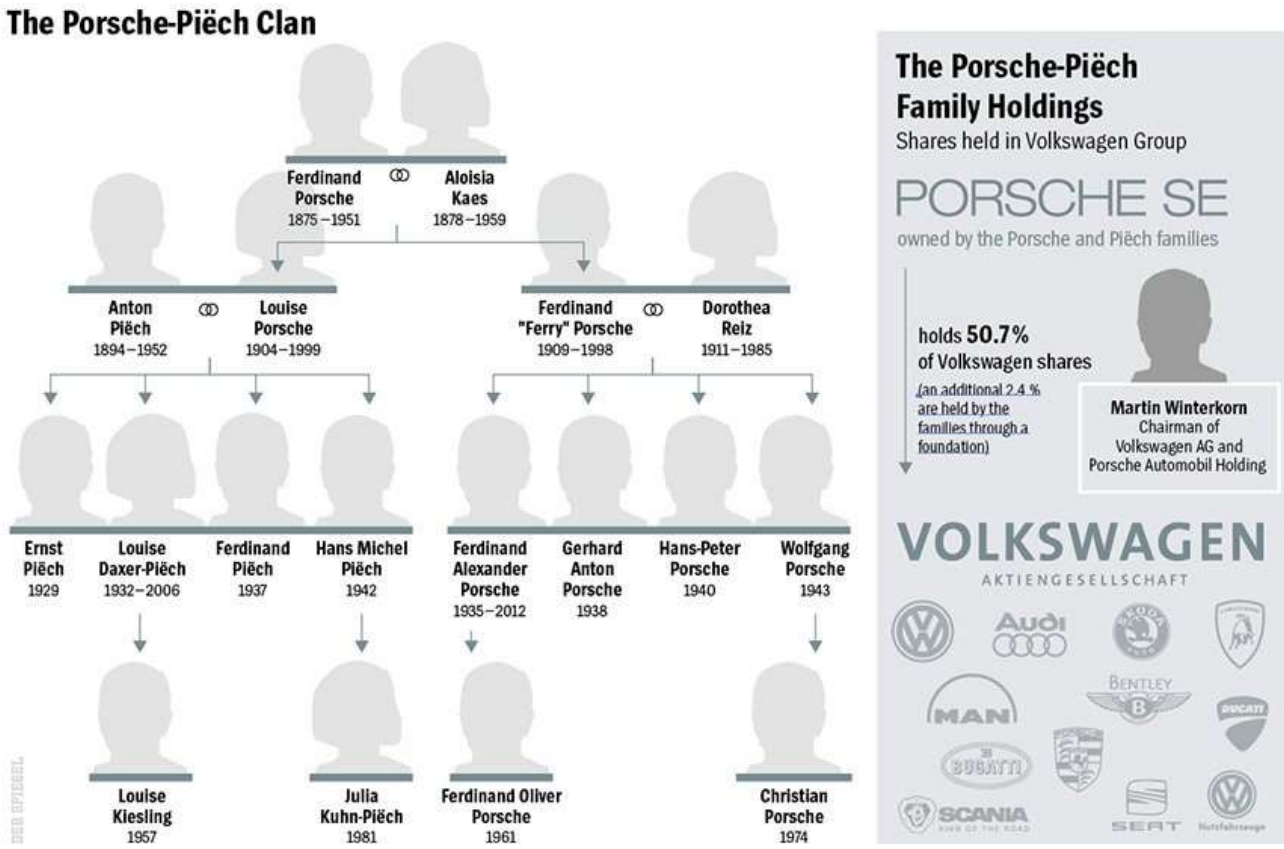
Appendix 1: Ownership Structure (Volkswagen 2015a)

Appendix 2: Management and Supervisory Boards (Volkswagen, 2015a)

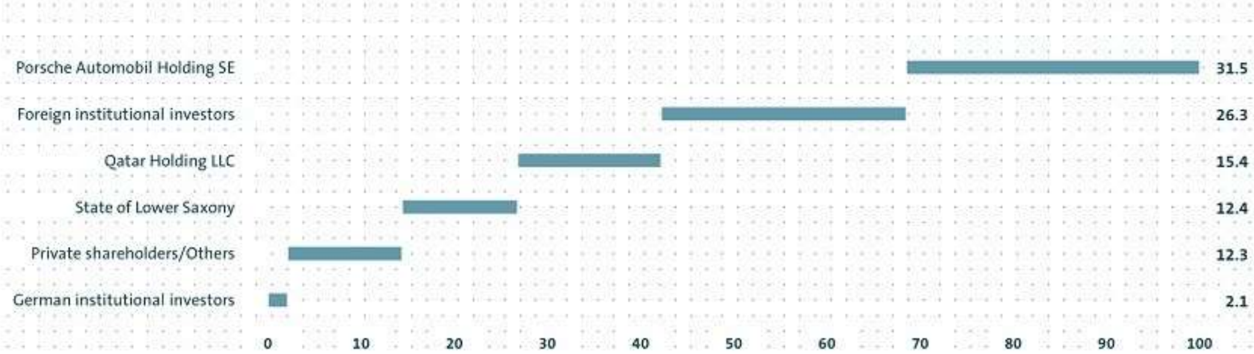
Family members are written in bold letter.

Porsche SE	***Volkswagen AG***
Management Board	
Matthias Müller	Matthias Müller (CEO)
Martin Winterkorn (CEO)	Herbert Diess
Hans Dieter Pötsch (CFO)	Francisco Javier Garcia Sanz
Philipp von Hagen	Jochem Heizmann
	Horst Neumann
	Andreas Renschler
	Rupert Stadler
	Frank Witter
Supervisory Board	
Wolfgang Porsche	**Wolfgang Porsche**
Uwe Hück	Uwe Hück
Hans Michel Piëch	**Hans Michel Piëch**
Peter Mosch	Peter Mosch
Ferdinand Oliver Porsche	**Ferdinand Oliver Porsche**
Bernd Osterloh	Bernd Osterloh
Berthold Huber	Berthold Huber
Ferdinand K. Piëch	Hans Dieter Pötsch
Hans-Peter Porsche	Stephan Weil
Prof. Dr. Ulrich Lehner	Stephan Wolf
Hansjörg Schmierer	Thomas Zwiebler
Werner Weresch	Hussain Ali Al-Abdulla
	Akbar Al Bakar
	Annika Falkengren
	Hans-Peter Fischer
	Uwe Fritsch
	Babette Fröhlich
	Louise Kiesling
	Olaf Lies
	Hartmut Meine

Appendix 3: the Porsche-Piëch Family (Hawranek and Kurbjuweit, 2015)



Appendix 4: Stock Class Structure (Volkswagen AG, 2015a)



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%	Other

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