Volkswagen: Influential, Inefficient Owners

BSc International Business

Corporate Governance

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Home Assignment

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Introduction

Volkswagen AG is the world's biggest car manufacturer (Bloomberg 2015a) with 202 billion euros in sales revenue in fiscal year 2014 and 11 billion euros in after tax profits (Volkswagen AG 2014). Recently the company has come under worldwide scrutiny following the exposure of hidden software installed in diesel cars specifically designed to cheat emission tests (Economist 2015). To underscore the magnitude of this scandal, the free fall of the share price have evaporated almost 30 billion euros of market value for Volkswagen AG and the cost of recalling affected cars and settling legal claims could amount to 32 billion euros (Bloomberg 2015b). However, the systematic emission fraud is merely a smoke screen obscuring the real corporate governance issue at Volkswagen AG.

The scope of this assignment will be identifying the overarching corporate governance issue at Volkswagen AG, analyzing the issue it self and how the collateral damage of this corporate governance failure affects other parts of the organization. To support the argumentation, the analysis will draw upon relevant corporate governance theories and frameworks. Furthermore, recommendations on how to address both the issue it self, as well as the collateral damage caused by it, will be made. A limitation to this assignment is the fact that details about the systematic emission fraud is still being uncovered and therefore it is too early to know who is directly responsible for it.

Analysis

The overarching corporate governance issue at Volkswagen AG is the ownership structure and especially the far-reaching influence of the Porsche-Piëch family and the State of Lower Saxony. Before becoming more specific about the issue at hand, it is important to create an overview of the ownership structure and voting rights. The Porsche-Piëch family owns 100% of the voting rights of Porsche SE (2014), a holding company, which in turn owns 50.73% of the voting rights in Volkswagen AG (Appendix 1). Furthermore, Porsche AG, which produces the Porsche cars, is fully owned by Volkswagen AG (Forbes, 2012). This pyramid ownership structure is a mechanism that allows the family to stay in control of the companies although the family has given away a substantial part of its cash flow rights (Thomsen & Conyon 2012). It creates a type two agency problem, majority vs. minority shareholders, because the wedge between control and cash flow rights further undermines the ability of minority shareholders to affect the direction of the company. In theory, major shareholders internalize more of the deviation from shareholder value, which

aligns interests with minority shareholders to maximize firm value (Ibid.). However, several factors support the argument that the current ownership structure imposes constraints on firm value maximization.

The State of Lower Saxony holds 20% of the voting rights and government owners often have different objectives than shareholder value maximization (Ibid.). In Wolfsburg, one of major economic centers in Lower Saxony, Volkswagen AG employs 72,000 out of 120,000 inhabitants (CNBC 2015). Furthermore, Volkswagen employs around 600,000 people to produce 10 million cars, whereas Toyota only employs 340,000 to produce around 9 million cars (NY Times 2015). This could be an indication that Volkswagen AG employs more workers than needed due to the incentive of Lower Saxony to maximize employment in the region. Thus, from a shareholder view, it could potentially be beneficial to lay off workers and outsource production to lower cost countries, but that would increase unemployment in Lower Saxony and therefore Lower Saxony would oppose it. Moreover, Lower Saxony holds 20% of the voting rights it can effectively veto any major decisions as these require more than 80% majority to pass (Wall Street Journal 2011). However, the vast influence of Lower Saxony in Volkswagen AG also extends to other parts of the organization.

The nomination committee in Volkswagen AG is responsible for proposing suitable candidates for the Supervisory Board (Volkswagen AG 2015b). The nomination committee currently consists of two members, Wolfgang Porsche and Stephan Weil (Volkswagen AG 2015c). Stephan Weil is the Minister-President of Lower Saxony (Volkswagen AG 2014). To understand the influence of the nominating committee, it is necessary to explain the function of the Supervisory Board. In contrast to the United States, Germany has a mandatory two-tier board system (Thomsen & Conyon 2012). The purpose of the Supervisory Board is to review the performance of the company, to monitor the performance of managers and to approve important decisions (Ibid.). It is split in two so that half of the Supervisory Board are employee representatives and the other half are shareholder representatives. As long as Lower Saxony holds more than 15% of the voting power, Lower Saxony can elect two members of the ten shareholder representatives (Volkswagen AG 2014). The employee representatives are only elected by German employees so non-German employees do not have any voting rights (Thomsen and Conyon 2012). The implication of this is that twelve members, and thus a majority of the Supervisory Board, will have strong incentives to maximize employment in Lower Saxony, which again, is not necessarily aligned with shareholder value maximization. The other member of the nominating committee, Wolfgang Porsche, is likewise

influential. He is Chairman of the Supervisory Board at Porsche SE, the holding company that owns the majority of Volkswagen AG, as well as a shareholder in Porsche SE. Therefore, in theory, he would have strong incentives to maximize the shareholder value of Volkswagen AG. However, the feud with the Piëch family as well as the lack of independent directors on the Supervisory board suggests otherwise.

Out of the ten shareholder representatives on the Supervisory Board four of them are from the Piëch and Porsche family (Volkswagen AG 2015d), (Appendix 2). This has lead to internal conflicts at Volkswagen AG. Ferdinand Piëch, the leader of the Piëch family, plays a powerful role behind the scenes as he prevented Martin Winterkorn, the former CEO, from succeeding him as Chairman of the Supervisory Board in September with Volkswagen AG (Reuters 2015). Ferdinand Piëch was forced to leave his post as Chairman of the Supervisory Board in April after an attempt to discredit Martin Winterkorn (Ibid.). Furthermore, Wolfgang Porsche supposedly deems the Porsche family a worthier owner of Porsche than Piëch (Spiegel Online 2015). Therefore, both members of the nominating committee, Stephen Weil and Wolfgang Porsche, have private agendas that might lead them to make biased decisions when nominating members for the Supervisory Board. This, in turn, might be the reason that no independent members are currently on the Supervisory Board. The only potential independent director would be Annika Falkengren, CEO of the Swedish bank SEB. However, SEB is currently part of several funding programs with Scania (Scania 2015b), which is fully owned by Volkswagen AG (Volkswagen AG 2014). Thus she is a dependent director because she has had a material relationship with Volkswagen AG within the last three years (Thomsen & Conyon 2012). The lack of independent directors is an issue for several reasons. Homogeneous boards are prone to ‘groupthink’ which can lead to directors quickly reaching consensus without a healthy debate because of the similarities between group members (Ibid.). Moreover, research by Gani and Jermias (2006) concluded that independent directors on the board had a significantly positive effect on companies pursuing a cost efficiency strategy. They argue this could be because companies pursuing a cost efficiency strategy benefits from independent directors because they monitor management more effectively. Furthermore, Volkswagen AG would arguably be in the 3rd quadrant of the life-cycle model (Appendix 3). Firms in this quadrant are described as mature public firms. Monitoring is especially important in this quadrant to prevent managerial opportunism (Ibid.). Moreover, an alternative governance mechanism to prevent managerial slack and opportunism such as hostile takeovers are non-existent in Germany, as there have only been three hostile takeovers in Germany since World War II (Thomsen and Conyon 2012). Given the premise

that independent directors are more objective and effective at monitoring management, Volkswagen AG could potentially benefit from more independent directors on the Supervisory Board.

Recommendation

The overarching governance problem in Volkswagen AG is the ownership structure and more specifically the influential positions of the Porsche-Piëch family and the State of Lower Saxony, who both have private agendas that constrains firm value maximization. To address this, a capital increase by issuing common stock with voting rights to outside investors could benefit Volkswagen AG. The chance of a capital increase happening is estimated above fifty percent by some analysts (Bloomberg 2015b). It would accomplish two objectives. A capital increase could raise money to cover some of the costs of recalling affected diesel vehicles and compensation fees estimated to be around 32 billion euros. (Ibid.). Porsche SE, Lower Saxony and Qatar Holding LLC currently possess 87.73% of the voting rights (Appendix 1). Thus the three bloc holders could potentially agree to be diluted 7% as this would keep their collective voting rights above the 80% threshold for making major decisions in the company (Wall Street Journal 2011). As long as the voting rights of Lower Saxony does not drop below 15% they would still keep their two positions in the Supervisory Board. Thus, it is a realistic solution to mitigate some of the adverse effects of the ownership structure.

The collateral damage of the owner structure is the monopoly of the Porsche-Piëche family and the State of Lower Saxony on the nomination committee and, as a result, a Supervisory Board with only dependent directors as shareholder representatives. To address this, it is recommended to appoint two independent members as shareholder representatives. Futhermore, these independent directors should replace Wolfgang Porsche and Stephen Weil on the nomination committee to ensure a more unbiased selection process for the Supervisory Board. In the long run, this could potentially lead to more independent directors being appointed. Lastly, the fact that only German employees can currently vote for employee representatives is strengthening the agenda of Lower Saxony to maximize local employment. To the extent that it complies with the German law of Mitbestimmungsgesetz, it it recommended that non-German Volkswagen AG employees should vote with equal weight of the German workers to elect employee representatives on the Supervisory Board. A fair representation of the global workforce would reduce the current preferential treatment of the German workers. Combined these initiatives would address the key governance issue, as well as some of the collateral damage caused by it, to ensure that firm value is maximized.

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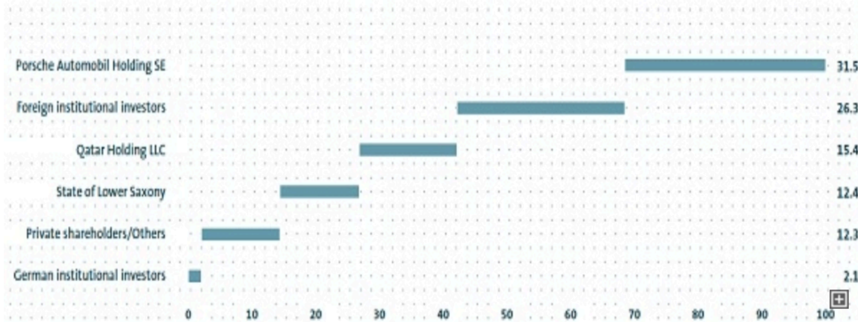
Appendices

Appendix 1

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.*

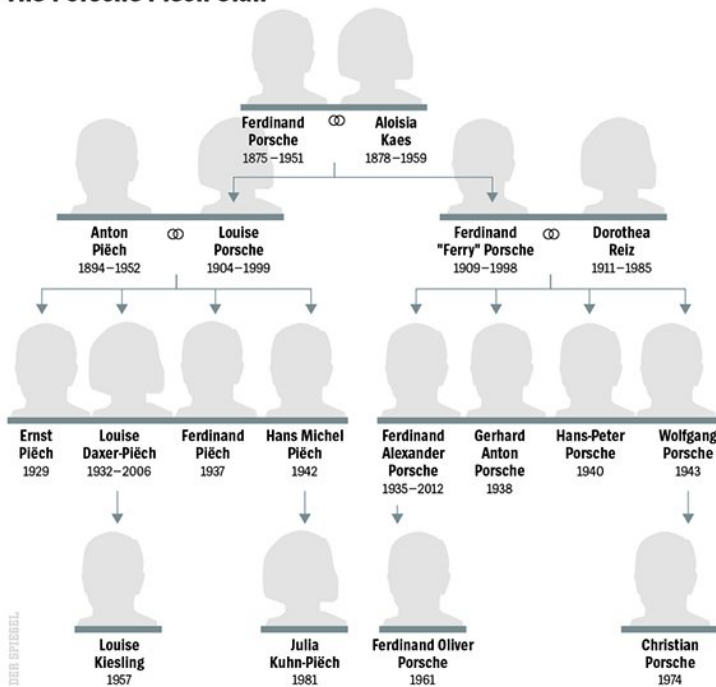
Current voting rights distribution* (as at December 31, 2014)

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 2015a)

Appendix 2



(Speigel Online 2015)

Appendix 3

		Governance Objectives	
	High "Velocity"	***Wealth creation***	***Wealth protection***
Strategic Environment		*Quadrant 1* *Founder/IPO threshold* **Governance functions:** • Monitoring: low • Resource: high • Strategy: high	*Quadrant 2* *IPO/maturity threshold* **Governance functions:** • Monitoring: medium • Resource: medium • Strategy: high
	Low "Velocity"	*Quadrant 4* *"Re-invention" threshold* **Governance functions:** • Monitoring: low • Resource: medium • Strategy: medium	*Quadrant 3* *Maturity/decline threshold* **Governance functions:** • Monitoring: high • Resource: low • Strategy: low

(Filatotchev et al. 2006)