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The role of capital markets in the automotive sector

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Introduction

Nowadays, we live in a globalized world where firms, to be competitive, need to access capital markets. Companies can no longer base their activities solely on their own forces. To finance themselves they have to give up some of their decisional power. Moreover, searching for external sources of financing will lead to agency problems. Financing sources can come both from debt and equity issues in capital markets.

In the first chapter it will be described what capital markets are. In order to give a better understanding of how do they work, the difference between primary and secondary markets will be examined in depth. The argumentation will follow with a discussion of the literature sustaining that the value of a firm is independent of the firm's capital structure. Having a good knowledge of capital markets we understand that they affect the corporate governance of firms in different ways. As a matter of fact, it is acknowledged that the debt to equity ratio and the ownership structure can have a positive or negative influence on a firm's governance. Different ownership structures can render monitoring either easier or more difficult. Moreover, they can lead to other agency problems that will be discussed together with the strategies to reduce them in the second chapter.

There will then be a focus on the European corporate governance system and in particular the analysis of the French, German and Italian models, aiming at understanding better in which context the firms that will be taken in analysis operate. The thesis then converges to the practical implications of the above said on four different automotive firms: FIAT, Volkswagen, Renault and PSA.

The third chapter will start with a description of how automotive firms finance themselves and their ownership structure. It will proceed with the implications for corporate governance and the agency problems that can be observed in this sector. The above listed four firms have been taken as example on the one hand because they have been among the most important automotive firms of the last century. On the other hand, they represent a variegated sample to investigate, in particular regarding their different capital nature, which characterizes them and represents the main topic we are analyzing in this thesis. PSA and FIAT are mainly family driven companies, Renault is basically

a state owned company, while Volkswagen, is the company which has undergone the most radical changes in its ownership structure, passing from being a publicly owned company to the actual Volkswagen Group, dominated by Porsche AG.

Chapter 1 – Capital Markets

1.1 An Overview

Capital markets are at the basis of the correct functioning of a globalized economy. They enable people to afford vital goods or services, such as high quality education, houses, or even to expand their businesses. The scope of capital markets is the efficient allocation of capital, through the creation of a connection between demand and supply of funds. Just like any other kind of market, they are made of buyers and sellers. Both can be individuals or institutions. On the one hand, buyers are those who *invest* in funds. They might invest their savings in order to gain a financial return. Furthermore, buyers may use capital markets to seek for protection from macroeconomic trends or hedge the risks of specific companies. On the other hand, sellers are those who *raise* funds. Their aim is to raise cash and reinvest it in other kinds of projects. Sellers also use capital markets to go public.

Hence, there are different actors in capital markets, who can act both as buyers or sellers. These are entrepreneurs, companies, governments and investors, as listed below.

Entrepreneurs initially raise funds privately. As the enterprise expands, they need more capital and they will sell their assets to obtain it. Additionally, entrepreneurs will sell their assets in order to allow employees and early investors to monetize their shares. They will issue debt or equity in order to extend ownership and create a market value of the company. Selling assets also allows them to create a "currency" for further investments or acquisitions. Nevertheless, entrepreneurs can also act as buyers. They can buy their own shares or invest in a publicly traded company. The latter can be a strategic partner or part of an acquisition strategy.

Companies buy and sell to manage their portfolio risk or even to raise funds. Moreover, companies use capital markets to sell foreign currencies they have acquired through operations, or to manage the risk related to the fluctuations of such currencies. Another use of capital markets by companies is the trade of shares. They can re-buy

their stock or buy shares of another company. They can also sell their own shares to raise funds or restructure ownership. Shares can also be sold for expansion matters.

Governments include central banks, municipalities, multinational institutions and state-owned companies / investment funds. Capital markets, especially debt markets, are used by governments to finance long term projects for the good of the country. Alternatively, they act as buyers, as we have seen in the other cases, to generate a financial return.

Investors can be both individuals and institutions. They sell assets to exit investments and to gain financial returns. Thus, investors wish to remain short and realize investments as soon as they can. On the contrary, borrowers need funding to last as long as possible. J. Hicks (1939) refers to this divergence of interests as the "constitutional weakness" of financial markets.

Capital markets can work through direct or indirect channels. As the name suggests, financial intermediaries are needed in the indirect channel, while the direct one works even without them. The role of financial intermediaries is to facilitate transactions and help the parties to efficiently allocate capitals. Financial intermediaries can also assume an active role in the transaction in case there is not any buyer or seller available. If the transaction happens in asymmetric market conditions, where there are assets with different features involved, financial intermediaries can hold the asset or use their capital, until they find another counterparty. In this way, transactions are always instantaneous. There are three types of financial intermediaries: Depository Institutions (Banks), Contractual Saving Institutions (CSIs) and Investment Intermediaries.

Depository Institutions

Commercial banks are a type of depository institution. They carry the traditional banking operations. Which means that their primary source of funding are deposits, which in turn are used to make loans. Also Mutual Saving Banks and Credit Unions are kinds of depository institutions. In fact, their *modus operandi* is very similar to commercial banks.

Contractual Saving Institutions – CSIs

Moving to contractual saving institutions, we find insurance companies. Their primary source of funding are the policy premiums, which are then reinvested in mortgages and in corporate / government securities. Also Pension Funds are a subset of CSIs. They raise funds thanks to payroll contributions and invest them in corporate securities. Besides that, they serve to pay retirement income via annuities.

Investment Intermediaries

Investment banks are part of the Investment Intermediaries. Their role is to give financial advice to companies or investors. They also deal securities and underwrite public offerings. The largest investment banks are: Goldman Sachs, Morgan Stanley, JP Morgan Chase, Bank of America Merrill Lynch and Deutsche Bank.[1] The most important intermediaries in capital markets are Investment Funds. These are collective investments made by investors who maintain control on their portion of shares. Investment funds provide a great variety of investment opportunities, considerable know-how and lower fees than individual investors would incur by investing by themselves. In fact, individual investors simply choose which fund is better to invest in, according to fees, risks and other factors. If they were to invest by themselves, they would have to choose the components and amount of their portfolio of investments.

Mutual funds are driven by money managers, whose aim is to generate financial returns by structuring the portfolio of investments as planned in its prospectus. They allow investors with small amounts of capital to gain access to high quality managers, thanks to collective investments. Each investor will risk its share of capital. The most known type of investment fund, especially after the 2008 financial crisis, is the Hedge Fund. Differently from mutual funds, hedge funds use a wider range of financial instruments and techniques, that allow them to make profits even in failing markets. These are derivatives, futures and short selling. Moreover, hedge funds are very flexible in passing to different sectors or geographical areas. It is no coincidence that

[1] http://www.businessinsider.com/bloomberg-markets-magazine-the-20-investment-banks-that-took-in-the-most-money-in-2011-2012-3?op=1&IR=T

they are called *Hedge* funds, since their scope is to *hedge* portfolio risk and gain an absolute return, irrespective of market trends. Managers have a critical role in hedge funds, given the complexity of strategies adopted in order to gain consistent returns. In fact, investors usually choose the hedge fund on the basis of who manages it, since returns are given by managers' competencies rather than luck or market trends. Hedge funds accept a limited amount of people. To enter one has to be a "qualified purchaser", other than investing a minimum (usually conspicuous) amount of money, depending on local laws.[2] Hedge funds adopt different strategies. They can pursue a market neutral strategy, which implies a low correlation with market trends, or a directional strategy, which bets on the trend of a specific market. Moreover, decisions can be taken systematically with computer based models, or they can be discretionary, with the ultimate decision taken by managers. As mentioned before, another strategy used by hedge funds is the long-short strategy. This enables them to increase the leverage and to gain both on overvalued and undervalued securities. In order to substantially reduce market risk, hedge funds choose two closely linked securities. Then, they go long on the undervalued and short on the overvalued security. Another strategy undertaken by hedge funds are event driven investments. In other words, hedge funds anticipate the effects of corporate mergers or bankruptcies. The risk, and thus the gain, is to invest in companies that have announced a merger but it is not sure that this will take place.[3]

[2] Understanding Hedge Funds Guide, Products & Solutions and Alternative Investments, ABN AMRO, 2010

[3] An introduction to Hedge Funds, Gregory Connor and Mason Woo, International Asset Management, The London School of Economics and Political Sciences, 2004

1.2 Primary and secondary markets

Capital markets are divided in primary and secondary markets. On the one hand, primary markets are managed by investment banks. Their role is to generate new securities to be sold to big investors. On the other hand, secondary markets are where securities are traded between investors.

Primary markets is where stocks or bonds are sold for the first time to the public. The process of issuing new securities is called Initial Public Offering. IPOs can be made both by small firms and by big companies who wish to go public. To help issuers identify the best timing, price and type of offering, an underwriting firm is in charge. Sometimes, it happens that the security is sold at its first trade at a price which is higher than the offer price and this is called underpricing. Beatty and Ritter (1985) argue that there is a positive relation between the ex-ante uncertainty of the value of a stock and its underpricing. Investment bankers are in a situation of trade-off when deciding the offering price, since if they underprice too much they will lose future issuers; at the same time, if the underprice is too little they will lose future investors. Nevertheless, Ibbotson (1975) demonstrates that IPOs are usually underpriced. Investment banks will not take all the risk by underwriting the IPO by themselves. They will instead form a syndicate of underwriters, with one leading bank, with the purpose of reducing risks. In order to issue an IPO, the company must fill out a preliminary prospectus indicating its forecasts and the issue's details. The final prospectus is legally binding and must be authorized by local regulators. Investing in an IPO is very risky, since historical data of the issuing firm are usually not available. Moreover, IPOs usually happen during the expansionary period of relatively new established companies. To gain access to an IPO is extremely difficult. Underwriters aim at "big fishes" like institutional investors. For a "normal investor" to get involved it has to have a considerable account and be a frequent trader of one of the investment banks appertaining to the syndicate of underwriters. In other words, unless the IPO is not attractive, it is practically impossible for a common investor to enter the offering. However, companies can also go public after the IPO in order to raise additional funds.

Similarly to IPOs, the Public Offering Price is decided by the investment bank and the company as mutually agreed. As a matter of fact, Mello and Parsons (1998)

believe that going public is a long and difficult process. They state that at the time of an IPO the company has to have clear in mind its future ownership structure and shape it in subsequent offerings of “controlling blocks”. Also Zingales (1995) agrees with the opinion that at the basis of offerings there are issues of corporate control and the best way to proceed is to divide the offering in different stages. Under the assumption of perfect information, he believes that sellers have greater bargaining power on passive investors than on investors seeking control. To maximize seller’s revenue, the offering company should first sell to passive investors and then move onto “control seeking” investors.

Secondary markets involve the trade of previously issued securities. Examples of secondary markets are national stock exchanges such as: New York Stock Exchange, Borsa Italiana or London Stock Exchange. We can further divide secondary markets into dealer and auction markets. Dealer markets operate through electronic networks. Dealers trade securities within each other and gain a profit through the spread between the buy and sell price. Capital will be efficiently allocated thanks to the competition between dealers. On the contrary, auction markets have all the traders to aggregate in one area and announce their “bid” and “ask” prices. In this case, efficient capital allocation is achieved thanks to the fact that traders publicly announce their prices.

Hence, the division and regulation of capital markets is crucial to achieve an efficient allocation of capital among parties involved. Both primary and secondary markets can trade stocks or bonds.

1.3 Debt vs. Equity

The Modigliani Miller Theorem (MM) assumes that in a perfect economy, with symmetric information, no taxes and no agency costs, the capital structure of a firm does not affect its value. Therefore, the cost of capital is independent of the company's debt to equity ratio. This implies that investment decisions can be undertaken independently from the firm's capital structure. However, these assumptions do not hold in the real world. In a paper written 30 years after the theorem, Miller (1988) states that showing what doesn't matter can also show, by implications, what does. In other words, with their theorem they have shown that the value of a company is not affected by its capital structure under a defined set of assumptions. Since these assumptions do not hold in the real world, they have shown, by implication, that capital structure *does* affect the value of a firm.

Fama and French (2002) declare that there is a trade-off between debt and equity. As a matter of fact, companies finance themselves both with debt and equity, with different proportions depending on the cost-benefit analysis. Financing through debt is advantageous thanks to the "tax shield". That is, capital raised through debt goes into liabilities and, therefore, it is not taxable. Whilst, if the same amount was financed through equity, the company would have had to pay taxes on it. Furthermore, contrarily to dividends, interest payments are often deductible. Nevertheless, the marginal benefit of issuing debt decreases with the actual increase of the debt itself. An increasing debt increases the risk of bankruptcy. Equity instead, even if initially more costly, does not imply financial risks like issuing debt does. In fact, the value of a firm is the sum of the value if it was all equity financed and the present value of the tax shield, minus the present value of the costs of financial distress.

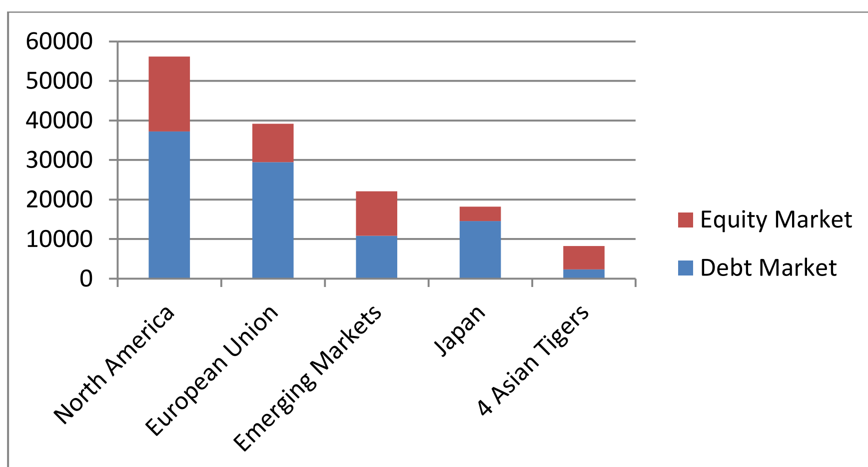
Other than the trade-off theory, we have to take in consideration the pecking order theory, that starts from the assumption of asymmetric information between managers and investors. Asymmetric information will put debt issues above equity issues in the pecking order. This because of the uncertainty linked with the value of equity. The preferred pecking order puts in first place internal sources of founding, followed by new issues of debt and, as a last resource, new issues of equity. Rajan and Zingales (1995) found the four main factor on which the capital structure depends. They

are: size (larger firms, lower debt ratios), tangible assets (higher fixed assets ratios, higher debt ratios), profitability (more profitability, less debt ratios) and market-to-book (higher market-to-book ratios, lower debt ratios). The best thing for a company is to stay as high as possible of the pecking order. In other words, it is important to have financial slack. That is, having the cash or the debt capacity to grab good investments as they appear.

However, according to Easterbrook (1984) and Jensen (1986), managers and security holders have divergent interests. In fact, free cash flow is badly invested by managers. Debt and dividends discipline managers, since they oblige them to pay out cash in excess. However, we will go in depth of agency problems in the next chapter. Now let us see what are debt and equity and how are they used among different economies.

Hence, capital markets are further divided into Equity (stock) Markets and Debt (bond) Markets. On the one hand, equity markets allow the issuance and trade of equity shares. In other words, the trade of companies' ownership stocks. On the other hand, debt markets allow the issuance and trade of debt. That is, they are simply loans, made to corporations or governments. The graph below gives you an idea of the magnitude and division of capital markets.

Figure 1.1 – Capital Markets (in billion $)



Sources: FT Global 500, Financial stability report (IMF, 2012 data, p. 169)

Equity markets are key to the correct functioning, not only of capital markets, but also of a capitalistic economy. They allow companies in search of financing to give up part of their ownership in exchange for capital. As a matter of fact, equity markets are used both by start-ups and well established companies to fund growth. Below we can find total (billion) dollars raised through IPOs in the six major US sectors of 2012.

Figure 1.2 – Billion dollars raised through IPOs

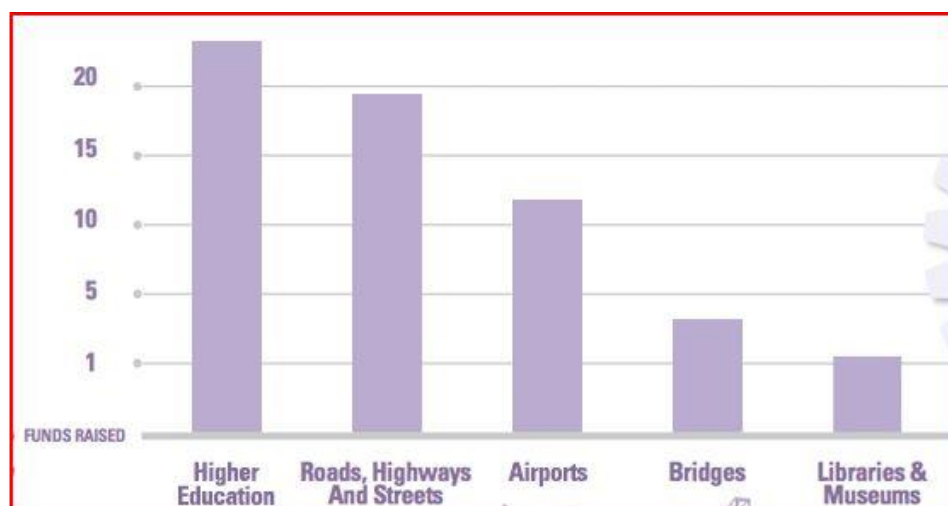
Source: Market 2012 Annual Review (Renaissance Capital, January 2, 2013 p. 3)

There are two different types of stocks: common and preferred. Common stockholders have less claims on company's assets and earnings than preferred stockholders. This means that in case of an excess in cash, preferred stockholders are the first to which dividends are paid, while in case of insolvency, common stock holders are the last to be repaid their credits towards the company. Preferred stocks also assure certain and guaranteed dividend payments as they fluctuate less than common stocks. The latter, do not assure fixed payments, since it is discretion of the board of directors whether to pay or not dividends to common stockholders. However, whilst common stockholders are entitled of voting rights, preferred stockholders are not. Hence, preferred stocks have a mix of features both of common stocks and of bonds.

The bond market allows corporations, banks and governments to issue debt. The latter are the largest actor of bond markets. Governments use debt markets to finance national projects and affairs. Furthermore, other than borrowing money, governments

can act also as lenders. For example, in case of an excess of foreign currency due to international trade, governments will buy part of that country's debt in order to hedge risk. However, buyers can also be individual investors, corporations or whoever wants to invest money in the bond market. Below we can find an example of how municipal bonds are used in different areas of the US economy.

Figure 1.3 – Municipal bonds use in billion dollars



Source: U.S. Municipal Credit Report, 2012 Q4 and Full Year (SIFMA, U.S. 2012 Data p. 9)

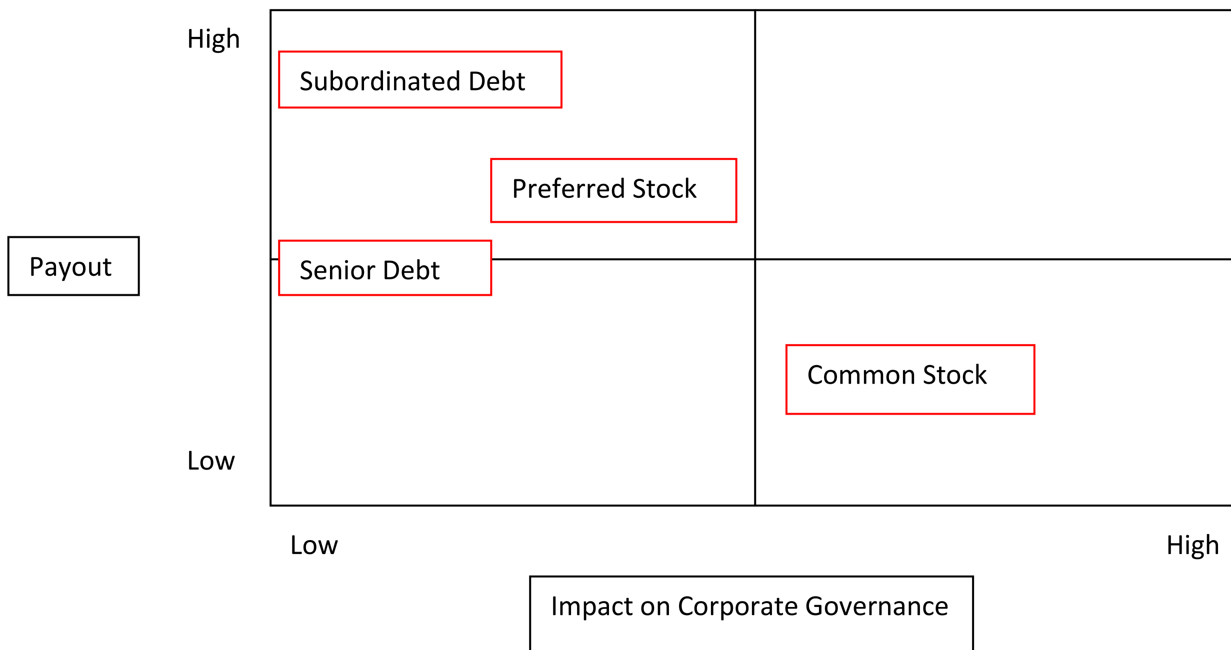
Similarly to stock markets, also in bond markets we find different kinds of debt. The concept of seniority holds here too. The highest the level of seniority the higher the priority to get repaid. This means that Senior Debt has priority over Subordinated Debt in case of a bankruptcy. As a matter of fact, subordinated debt has a higher yield than senior debt, since it is riskier. However, in the worst of the scenarios, it is not sure that senior debtholders get back the whole of their invested capital, even if they are paid before everyone else.

Chapter 2 – Corporate Governance

2.1 General principles of corporate governance

The capital structure impacts on how a firm is managed. Both shareholders and debt holders influence corporate governance. Whenever a firm issues debt or stocks of ownership to raise capital, it gives up to part of its decisional power. Depending on the type of financing sources, the impact on corporate governance and payouts differ.

Figure 2.1 – The Governance Matrix



A third dimension can be added to this graph, that of risk. From the firm's point of view, senior debt is riskier than subordinated debt, given the fact that whilst senior debt must be paid, subordinated debt can be avoided in case of a loss on the annual balance sheet. Similarly, since preferred stocks imply guaranteed dividend payments, they are riskier than common stocks. The latter are the last to be paid in case of bankruptcy. I will now explore the corporate governance's fundamentals.

Corporate governance is the set of rules and processes that discipline the way a firm carries on its businesses. These guidelines are periodically reviewed and approved by the Board of Directors. Corporate governance also serves to specifying rights and duties of the company's stakeholders. Regarding this aspect, a key task is to decide how power is distributed among them. The main stakeholders are considered to be: shareholders, board of directors and managers. Usually, small shareholders' interests are loomed by majority shareholders. A good corporate governance aims at giving the same importance to all shareholders, no matter their stake. Also other kind of stakeholders' such as employees, customers, creditors or suppliers should have their interests protected by a good corporate governance system.

Another important aspect to take into consideration are ethical issues. These are very important for the achievement of a long term success since the non-fulfillment could lead to considerable problems, let them be civil or even legal. Corporate governance focuses on transparency to boost investors' confidence and create a better working environment for all stakeholders. However, during the lifespan of a firm, problems can occur.

2.2 Agency Problems

Agency problems arise when there is a separation between ownership and control. In this case, conflict of interests may arise between the agent, which acts in behalf of shareholders, and the principal, the shareholders. This is commonly known as the "Principal-Agent" problem. In other words, the agent will pursue its own interests, careless of shareholders, if appropriate measures are not taken. Jensen and Meckling (1976) view the firm as a set of contractual relations. Therefore, they believe to provide agents with contracts that incentivize correct decision making, in order to minimize agency problems. There are several reasons for which shareholders and top management need to commit tasks and decisions to a third party. One of them, is that there would be too many projects to analyze every day and it would be impossible to follow them all contemporarily and know enough to carry them on correctly. Moreover, it is assumed that "agents" know more than "principles" on the specific topics, otherwise there wouldn't be the need to engage representatives. "Principles" could carry on specific tasks by themselves.

Principle-agent problems usually arise during the capital budgeting process.[4] Managers could put *reduced effort* over a project if they are not adequately stimulated and incentivized. Firms may run the risk that he/she will be unwilling to work properly, thus taking wrong or careless decisions.

Moreover, decisions may be influenced by *perquisites*. Managers who do not follow business ethics, continuously seek for additional bonuses, even if they are not pecuniary. These bonuses can be called "private benefits", and they can be: holidays, invitations to sports events, preferential entrance or accommodation in clubs or restaurants, etcetera. These "perks", however, are not always inefficient. For example, a manager could be invited to a holiday with the representative of another company simply to strengthen commercial relations between the two companies. Therefore, the corporation would benefit from this "perk", even if it could be seen as "morally incorrect".

[4] Allen F., Brealy R. A., Myers S. C., 2011, "Principles of corporate finance", McGraw-Hill/Irwin, New York, pp. 291-292

Another problem that may arise during project analysis is the will of top management to **"***build an empire***"**. Large businesses are preferred to small businesses. Usually, managers' payoff and reputation depend directly on the firm's size. Thus, instead of thinking of the optimal allocation of resources and of shareholders' wealth, managers will take decisions with the sole scope of expanding the business.

Furthermore, managers could *invest in entrenching projects* that reward or necessitate the skills of existing managers. Along with "empire building", entrenching investments represent a situation of overinvestment. This usually happens when the firm is abundant of cash and has low investment opportunities (*free cash flow* problem).

At last, managers tend to *avoid risk***.** Assuming no bonuses, a manager would be reluctant to approve risky projects, even if economically convenient. In case the project is successful, the manager will not get any additional reward. However, if the project fails, the manager may risk his/her workplace. The sum of the above mentioned agency problems create agency costs, which are directly related costs plus the costs to enact strategies to overcome such issues.

Monitoring managerial activities may help to reduce the occurrence of problems such as perquisites or reduced effort. Still, monitoring has a cost and is subject to diminishing marginal returns. Thus, a company will be willing to spend for monitoring until the impact on agency costs will be greater than the cost of monitoring. However, there are still other agency problems that monitoring cannot avoid. Auditors cannot know if the manager is overinvesting or if he/she is acting diligently and pursuing shareholders' interests. For instance, auditors can check financial statements of a recently acquired company to understand if the manager acted in good faith. Yet, the decision to merge with another company may be subjective. There are infinite reasons for companies to undertake mergers and acquisitions, and auditors cannot know truly why a manager took specific decisions. Moreover, this kind of monitoring would be extremely costly and not always the benefits are greater than the costs.

Monitoring is duty of shareholders. Usually it is delegated to the board of directors, which represent shareholders' interests. The board of directors may also hire external auditors to control the alignment of financial statements with the Generally

Accepted Accounting Principles (GAAP). If the external auditor believes that something wrong is going on, it can negotiate changes in accounting procedure with the top management. If this doesn't happen, they can issue a *qualified opinion* which undermines the company's reliability and reputation towards investors.

If the ownership structure is concentrated on one dominant shareholder, then, monitoring will be more effective. Stoughton and Zechner (1998) agree on the concept that monitoring abilities differ among investors. They state that big investors have built-in institutional mechanisms and relationships that small investors do not have. As a matter of fact, when the ownership structure is dispersed in many independent shareholders, the company could incur into the so called "free-rider problem". That is, stockholders are in title of such a small amount of shares such that it does not justify the time and money spent on monitoring. Therefore each of them will be willing to delegate monitoring activities to other shareholders. It is also to be said that different "principles" have heterogeneous preferences. In order to harmonize their interests and give a specific set of goals to the agent, they will face "coordination costs". As the number of "principles" increase, delegation will assume a more important role. This leads to other agency problems, since the person entrusted to monitor may be linked in some way with the top management and it will therefore act in a biased way. To overcome this problem, an oversight board must be set up. As a consequence, the Sarbanes-Oxley act created the Public Company Oversight Board, having the specific task of monitoring auditors' activities.

Another strategy to undertake, in order to tackle agency problems, is designing a correct *Management Compensation* to give chiefs the right incentives and attract talented managers. T. A. John and K. John (1993) state that management's compensation is affected by the mix of debt and equity issued by the firm. If a firm has financed itself through equity and risky debt, linking managers' to shareholders' interests will reduce agency costs of equity. Nevertheless, this could lead to debt agency costs. As a matter of fact, by considering shareholders as residual claimholders and aligning managers' interests to debt holders' interests, the firm would reduce its debt agency costs, and with them agency costs on equity. Compensation should be made up of three main parts: the base, the target bonuses and long term incentives. The

lower the base and the higher the bonuses, the more incentives managers will have to operate properly. However, if the company lets chiefs influence their own payoff, other agency problems may arise. This can be avoided by giving to shareholders the right to vote on executive pay.

Remuneration should be proportional to the value added brought by the manager. This can be measured with different accounting methods. The most valid measure of corporate performance is Economic Value Added, EVA. It began to acquire international attention since Tully (1993) wrote an article on the Fortune magazine to promote the EVA adoption. It is equal to the income earned minus the income required. The latter can be calculated as the cost of capital times the investment. Monitoring is facilitated by the use of EVA. It motivates managers to invest in projects that let the company earn more than what they spent and renders cost of capital visible to them. Nevertheless, it does not measure Present Value and it rewards quick paybacks. Hence, EVA leads to the problem of short-termism of investments.

So, what counts more than the actual amount of remuneration is the *Incentive compensation*. The best combination of components of the payoff is the one that best aligns managers' and shareholders' interests. Therefore, as we said before, compensation must be founded on managers' performance. Another way to align "principal-agent" interests, is to implement managers' remuneration with stock options. In this way, they would be more cautious about overinvestments, since their payoff would be linked with the company's performance. Still, it would be difficult to distinguish good effort from luck.

Jerzemowska (2006), believes that another kind of problem that may occur, other than the "principle-agent", is the conflict of interests between shareholders and debtholders. The first are interested in the company's trend, whilst the second are interested in having their money back. Managers who decide to undertake debt policies incur in a reduction of free cash flow and in a loss of power, due to the increased pressure of capital markets. However, debt increases the financial leverage and consequently firm's market value, assuming managers are able to keep a low probability of bankruptcy.

2.3 A EU focus

In the European Union, corporate governance became significantly important since the 2006 European Commission directive, where all listed companies were obliged to publish a corporate governance statement.[5] Instead of targeting directly "business ethics", the EU focused more on regulating the financial services area. Weil, Gotshal & Mangers (2002) compared different corporate governance codes of the member states, from which it was concluded that there was a convergence of governance practices and there was not a need for a unique EU governance code. In fact, the Report of the High Level Group of Company Law Experts (2002), states that it is up to the member states to develop their own governance codes and the EU should just set basic guidelines in order to improve the members' codes convergence.

Concurrently, in the US, corporate governance became an important issue after the accounting and corporate scandals of 2002, when companies such as "Enron" and "WorldCom" filed bankruptcy. As a consequence, the US government issued a federal law (Sarbanes-Oxley act) to regulate and improve general accounting and corporate governance principles.[6] On the contrary, in the EU, the Corporate Governance Action Plan was introduced by the European Commission in 2003 as a deterrent for this kind of governance scandals.[7] Bolkestein (2004) said that: "as national corporate governance codes converge towards best practice, [it will be] easier to restore confidence in capital markets". In December 2012 the European commission published the new Corporate Governance Action Plan which focused on enhancing transparency, engaging shareholders and supporting growth and competitiveness. Still, business ethics themes are not considered explicitly.[8]

[5] Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006, Official Journal of the European Union
[6] http://www.soxlaw.com/
[7] European Commission, 2003, Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward
[8] EU Commission, 2012, Action Plan: European Company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies

Another theme on which there has been a great discussion in the last years, is that of the role of Corporate Social Responsibility (CSR). The key issue is if CSR has to be considered as a part of corporate governance or if a voluntary approach is preferred. Various "green papers" were published and discussion forums were organized to underline the issue. However, until now, the EU commission believes that there is no need to regulate CSR, since it is too diverse across member states. Thus, it encourages a prosecution of the voluntary approach.[9]

There are various reasons for which European governance codes are taking time to converge. One of these is the extension of the EU members to 28 countries. Thus, every time a new country enters the EU, it has to adapt its corporate governance codes to the European standards. Also this can take time, since each country has a different history and different ethical principles which may go in contrast with the EU guidelines. Moreover, countries differ for ownership structures and models, which are at the basis of corporate governance codes. Further on we will see how the different automotive firms differ for ownership structure. At last, each country varies also in board structures, favoring one-tier or two-tier board systems. It may also happen that some countries use both of them, as it is the case of France.

The *French model* follows the guidelines of two different codes. The Middlenext "Code de gouvernement d'entreprise" is directed to small and medium enterprises (Petit et Moyenne Entreprises, PME). It is based on the principles given by Pierre-Yves Gomez in its report on the "Guidelines for reasonable corporate governance". Caroline Weber, Middlenext's general director, said that the main reason for which they felt the need for a governance code also for SMEs, is that they have different problems from larger enterprises. For example, managers' remuneration and committees' power are secondary problems since usually the CEO is also one of the main shareholders. Moreover, SMEs are more sensible to protection of minority shareholders.[10] Larger firms, instead, follow the Afep-Medef Code, written by the

[9] A review of the ethical aspects of corporate governance regulation and guidance in the EU, pp. 16-17, Julia Casson, Institute of Business Ethics, 2013
[10] Middlenext, Code de gouvernement d'entreprise pour les valeurs moyennes et petites, December 2009

"Association Française des Entreprises Privées" (Afep) and by the "Mouvement des Entreprises de France" (Medef). It is aimed to listed companies, however, also other types of companies are recommended to follow this code.[11] The Middlenext Code mentioned above, in fact, is complementary to the Afep-Medef Code. As mentioned above, the French model allows both the use of the one-tier system and of the two-tier system. Companies can select between German or British style models. The first one is characterized by a supervisory board, which appoints and controls the management board, while the second one is a single governing body responsible for management and control, which is led by the President Directeur General (practically, the CEO).

The *German model* is based on the provisions of the German Corporate Governance Code, which regulates the governance of listed companies and sets the basic guidelines for good corporate governance practices (also non-listed firms are recommended to follow it). As each governance code, its aim is to enhance transparency and thus to promote trust of investors and companies' stakeholders. German stock corporations follow the two-tier system. The supervisory board is elected by shareholders at the general meeting and has the task to appoint and control the management board and it is directly involved in major company's decisions. German companies have also the faculty to adopt European company (SE), which allows companies to choose the one-tier model, that gives all the powers to the board of directors. Given the continuous interaction between the management board and the supervisory board, one-tier and two-tier models are converging. The code contains, other than mandatory provisions, also suggestions that increase the code's flexibility.[12]

The *Italian model* is regulated by the "Codice di Autodisciplina" written by the Italian committee of Corporate Governance. It is one of the most flexible in the EU, since its adoption by listed companies is voluntary. The code follows the "comply or explain" principle. In other words, provisions can be avoided. However, the company has to explain *why* it did so.[13] Nevertheless, there are specific guidelines that Italian

[11] Afep and Medef, Corporate governance code of listed corporations, June 2013
[12] Government Commission, German Corporate Governance Code, May 2010
[13] Comitato per la "corporate governance", Codice di Autodisciplina, July 2014

listed companies have to follow, which are written in the "financial act" (legge Draghi) of 1998. They are the following:

- Distinction between auditing (independent auditing firm or auditor) and business control (internal control body)
- New role of the control body (collegio sindacale), who supervises directors' operations
- New supervisory and intervention powers of Consob (Italian Securities and Investments Board) over the control body
- Express provision of Internal auditing systems.

Companies can choose between three different models: traditional, one-tier or two-tier. In the traditional system, shareholders appoint all the governing and controlling entities. Decisions are taken by the board of directors, while the board of auditors has the task of legal and financial control. The two-tier system works as the German model, with a supervisory board that appoints and controls the management board. Financial auditing is assigned to an auditing firm appointed by shareholders' meetings. At last, the Italian model allows also the one-tier system. The board of directors is appointed by shareholders and has the task to manage the firm and appoint the auditing committee.

Figure 2.2 – The Italian Governance Structure

ADMINISTRATION		**LEGALITY CONTROL**		**FINANCIAL AUDIT**	
Body	*Appointed by*	*Body*	*Appointed by*	*Body*	*Appointed by*
TRADITIONAL SYSTEM					
Board of Directors or Sole Director	General Shareholders' Meeting	Board of Auditors (Collegio Sindacale)	General Shareholders' meeting	Auditors, auditing firm, Board of Auditors	General Shareholders' meeting
TWO-TIER SYSTEM					
Management Board	Supervisory Board	Supervisory Board	General Shareholders' meeting	Auditors or Auditing firm	Shareholders' meeting
ONE-TIER SYSTEM					
Board of Directors	Shareholders' meeting	Auditing Committee	Board of Directors	Auditors or Auditing firm	Shareholders' meeting

Source: Fiori G.,Tiscini R., 2005, "Regolamentazione contabile e trasparenza dell'informativa aziendale", Franco Angeli

Although different kinds of corporate governance can be seen across the various EU members, they all recognize OECD's "Principles of Corporate Governance" as an international benchmark. An Ernst and Young study (2012) states that as globalization acquires a more substantial role, companies are adapting internationally recognized good practices to their governance framework. Bad corporate governance is seen as the cause of the financial crisis and the disparity of treatments is fomenting protest movements around the world. Top management is too frequently given rich bonuses after leaving companies in dramatic situations.

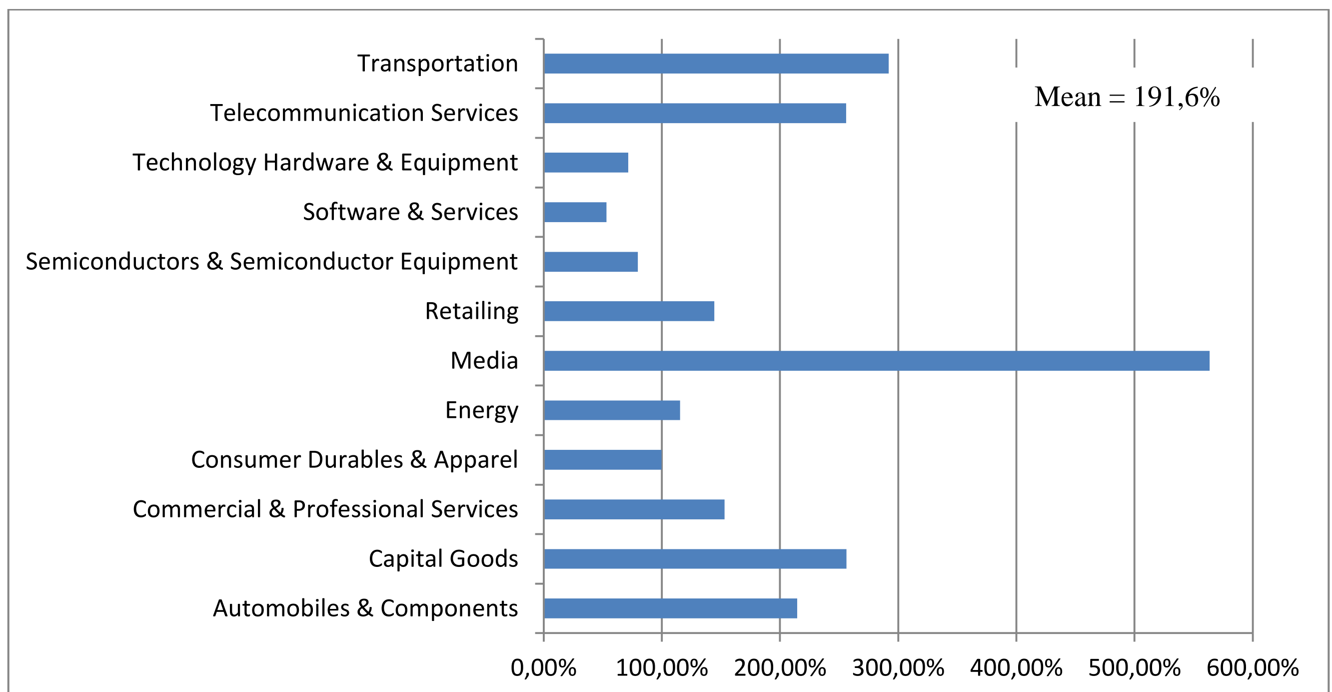
So, now that we have discussed about capital markets and corporate governance, we can apply the theory to real life. In the following chapter I will go through the above discussed themes, finding out their possible applications to the automotive sector.

Chapter 3 – Use of capital markets by automotive firms

3.1 How do automotive firms finance themselves?

The automotive sector represents 6% of the European Union's GDP[14]. Given its magnitude and its continuous globalization trend, capital markets play an important and necessary role in the development of the sector. We have seen that firms can choose to finance themselves both through equity and through debt issues. We have also acknowledged that capital structures *do* matter, since they influence both firm's corporate governance and value. Different companies choose different debt to equity ratios, majorly depending on the sector in which they compete. Moreover, we have understood that there are other factors that affect the capital structure of a firm. These are: size, tangible assets, profitability and market to book ratio. Below twelve different sectors are compared, including the automotive one, on the basis of the ratio of debt over equity.

Figure 3.1 – Debt to equity ratios cross-sector



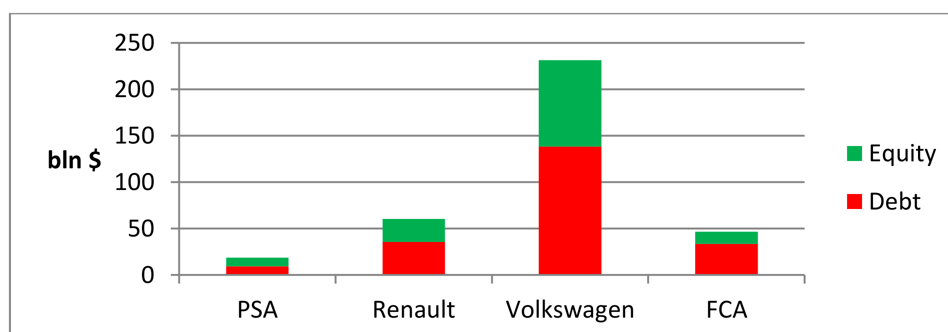
Source: Bloomberg Database, 2015

[14] http://www.acea.be/automobile-industry/facts-about-the-industry

Automotive debt to equity ratio (214.6%) is not far away from the mean of the sectors taken into consideration. Nevertheless, we can observe large deviations from the mean in some sectors. The “Media” sector has a capital structure with a debt 5.6 times bigger than equity. In this sector, investments usually happen through issuing debt rather than equity. Let us take Mediaset S.p.A. as an example. When it has to produce a movie, Mediaset will issue debt that will be immediately repaid as the movie is sold to televisions. Moreover, it has long term assets such as antennas, that can be used as securities for lenders. Therefore, given the low volatility of the sector and the possibility to offer long term assets in case of insolvency, the debt is sustainable. Contrarily, the “Software & Services” sector has the lowest debt to equity ratio, 53.1%. This could derive from the fact that it is a sector with few long term assets and highly volatile due to the rapid degree of innovation. Thus, a high debt to equity ratio would not be sustainable. Moreover, it is not necessary, if we consider the fact that its costs are mainly fixed and thus they would need to issue debt only in case of extraordinary expenses. In fact, the capital structure depends on the ability of firms to finance by themselves, on the necessary capitals to carry on the business and on the volatility of the sector.

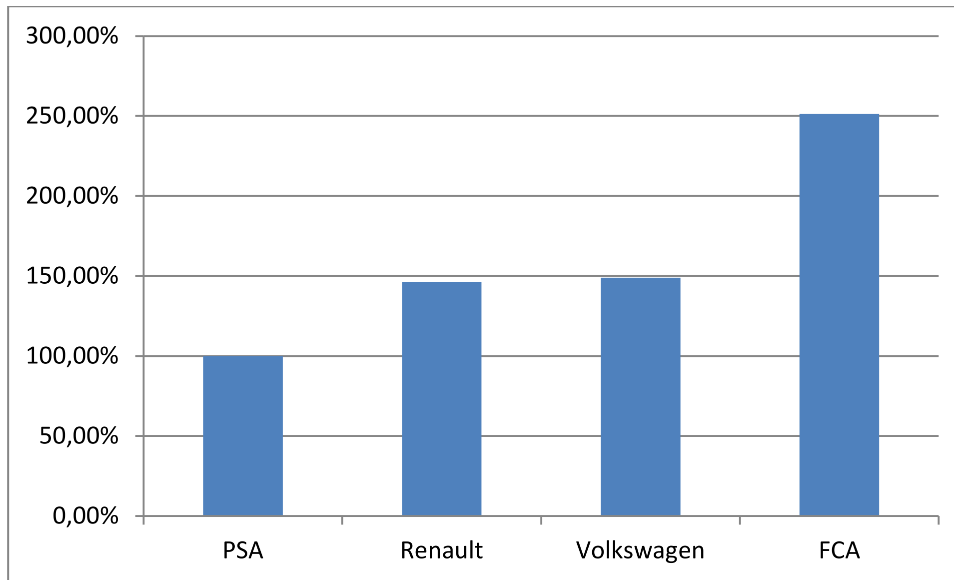
The automotive sector has a balanced structure of variable and fixed costs. It is an industry with many long term assets such as machineries and buildings. However, it has extremely high expenses, especially when new products are developed and commercialized for the first time. So, let us see more in depth how the automotive sector finances itself. In particular we will consider four different European automakers: FIAT (now FCA), PSA, Renault, and Volkswagen.

Figure 3.2 – Total debt and equity in the European automotive sector



Source: Bloomberg, Comparative valuation analysis for multiple securities

Figure 3.3 – Debt to Equity ratios in the automotive sector



Source: Bloomberg, Comparative valuation analysis for multiple securities

Apart from FCA, the other automakers taken into consideration lie below the Automotive & Components sector mean. Volkswagen is the firm which appeals to capital markets the most, and has a more or less balanced debt to equity ratio. Nevertheless, it is also the firm which sells the most units (10.2 million[15]) among the four mentioned. Renault has a similar debt to equity ratio respect to Volkswagen. However, its S&P credit ranking is much more risky than Volkswagen's (BBB- respect to A[16]). This means that Volkswagen's debt is considered more sustainable than Renault's, even though Renault manages to cover around 10% of worldwide sales, with almost eight and a half million units sold[17]. In addition to that, we can note that FCA strongly uses the financial leverage, given the high proportion of debt issued. FCA is the seventh largest car maker worldwide, selling 4.8 million units in 2014[18]. At last, PSA is the firm which sells the less among these four automakers (2.9 million units[19]). In fact, it has also poorly used capital markets as a source of financing. Still, it is the most balanced user of debt and equity.

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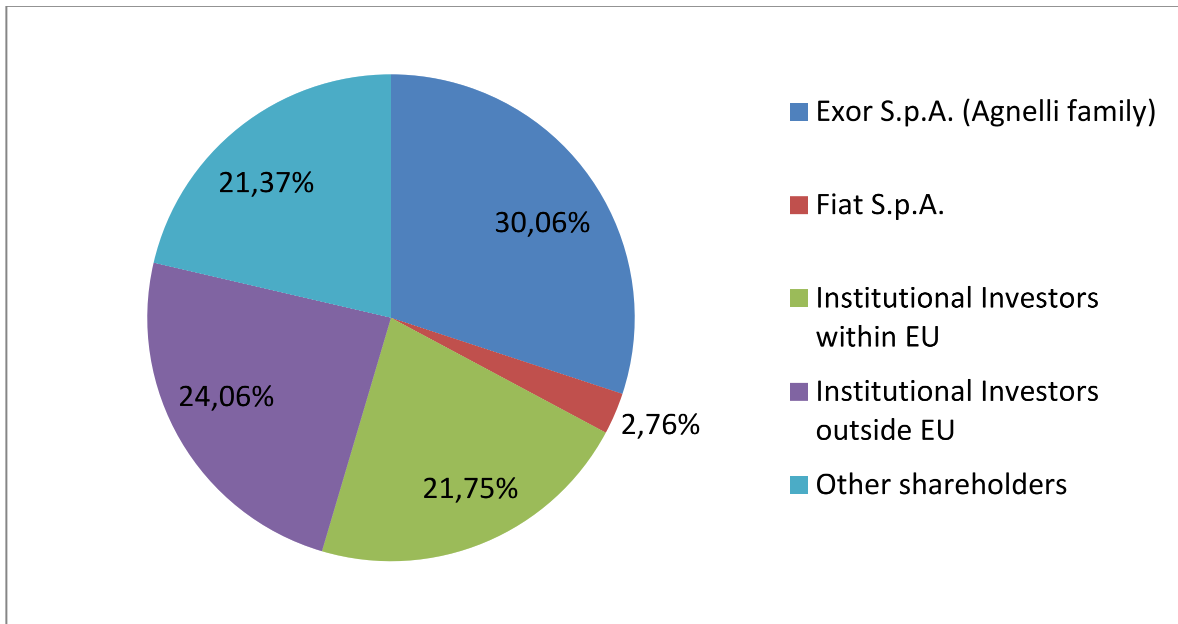
[15] Volkswagen annual report, 2014
[16] Bloomberg, Comparative valuation analysis for multiple securities
[17] Renault annual report, 2014
[18] FCA annual report, 2014
[19] http://www.psa-peugeot-citroen.com/en/media/press-releases/worldwide-sales-4-3-percent-2939-million-units-2014

Different debt to equity ratios will inevitably lead to different conducts by the top management. This is likely to happen because debt holders and stockholders put different kinds of pressure on the firm's decisions. On the one hand, debt holders ask the firm to maximize returns while minimizing the bankruptcy risk and are not interested in the firm's market value. On the other hand, shareholders ask for value creation and distribution of dividends. *De facto* they ask to minimize debt holders' payments and increase leverage to augment market value. So, let us look at how ownership is distributed among these auto makers.

3.2 The ownership structure in the automotive sector

Figure 3.4 – Ownership structure FCA



Source: FIAT Annual Report on Corporate Governance, 2014

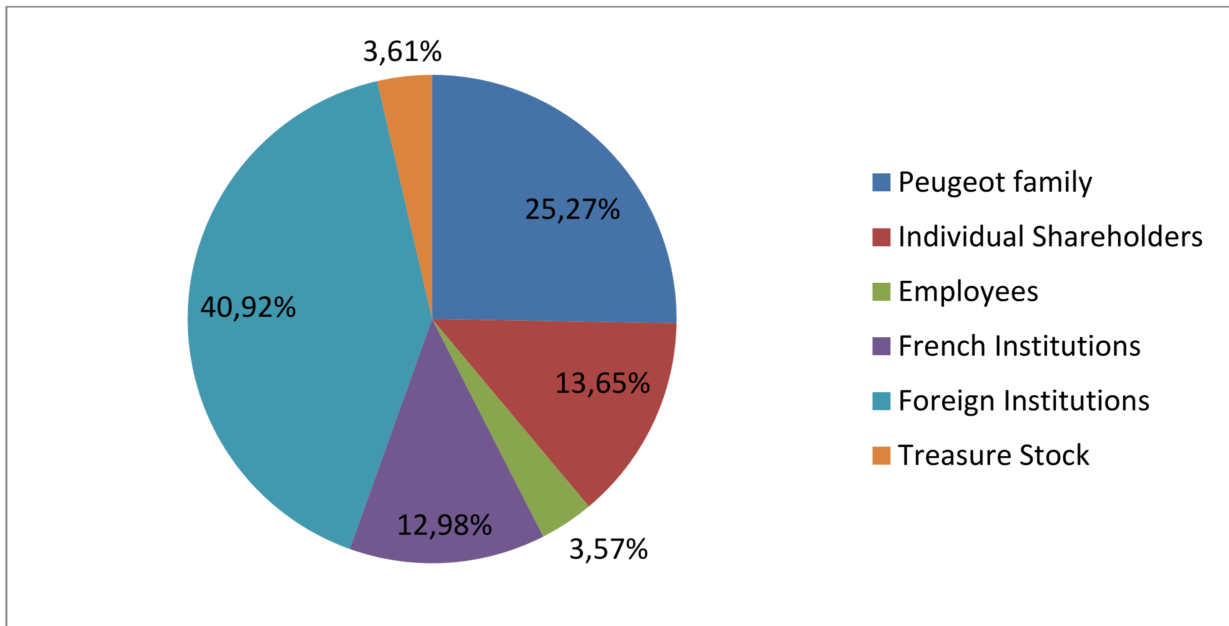
FIAT was founded in Turin in 1899. Since Giovanni Agnelli took its lead, in 1966, the company has been representative of a family driven form of capitalism. This model is followed by a vast number of Italian enterprises. In 2014, FIAT merged with Chrysler group, creating FCA, under Dutch jurisdiction and Britain tax based. Recently, FCA expressed the willing to separate Ferrari S.p.A. from the group in order to strengthen FCA's capital structure and to maximize shareholder's value[20].

With 30.06% of FCA's total shares and 44.31% voting rights[21], the Agnelli family (indirectly through their Exor company) still controls Fiat Chrysler Automobiles. Its ownership structure is then clearly divided between institutional investors and individual shareholders.

[20] http://www.fcagroup.com/it-IT/media_center/fca_press_release/FiatDocuments/2014/october/FCA_annuncia_l_intenzione_di_separare_Ferrari_S_p_A.pdf

[21] http://www.exor.com/it/home/EXOR/Portafoglio-Investimenti.html

Figure 3.5 – Ownership structure PSA

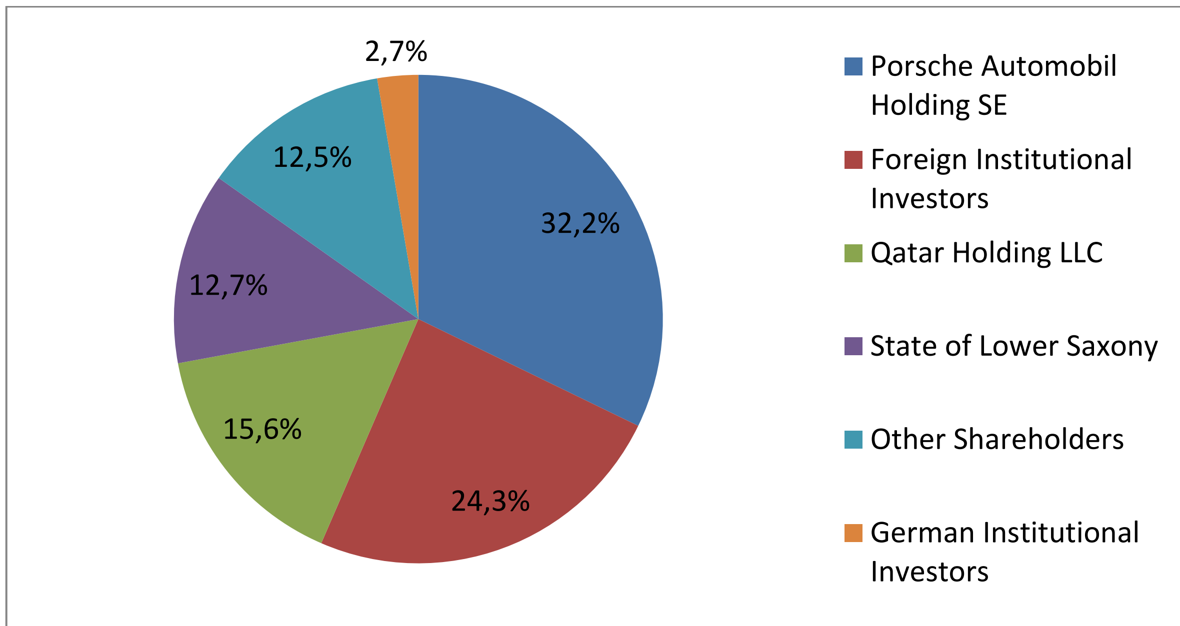


Source: http://www.psa-peugeot-citroen.com/en/finance/peugeot-sa-share/stockholder-structure

Similarly to FIAT, PSA is a family driven company. Peugeot was founded in Paris in 1896 and then, still in Paris, merged with Citroën in 1976. The Peugeot family is the dominant shareholder and has 37.89% of the voting rights[22]. PSAs ownership structure shows a strong influence of foreign institutions, that control more than 40% of the company. To internationalize the company and further expand into the Asian market, PSA is now willing to carry on its joint venture started last year with the Chinese auto-maker Dongfeng Motor Corporation. It wants to do so through the creation of a common technology platform for small cars.[23]

[22] http://www.psa-peugeot-citroen.com/en/finance/peugeot-sa-share/stockholder-structure
[23] http://www.reuters.com/article/2015/04/19/china-dongfeng-group-idUSL4N0XG0A820150419

Figure 3.6 – Ownership structure Volkswagen



Source: http://www.volkswagenag.com/content/vwcorp/content/en/investor_relations/share/Shareholder_Structure.html

Volkswagen has had a very particular history in terms of ownership structure. It was born in 1937 thanks to Adolf Hitler, who wanted a *"Volks-wagen"*, literally *"a car for common people"*. The project was committed to the engineer Ferdinand Porsche, founder of the homonym car maker. Since then, it has changed from *state company* to *stock corporation* (AG). To regulate this privatization, the German government, in 1960, enacted a set of federal laws named the "VW-Gesetz" or "VW-Act". The aim of this act was not only to regulate Volkswagen's privatization, but also to assure the role of dominant shareholder to the State of Lower Saxony also in the future. The key points are[24]:

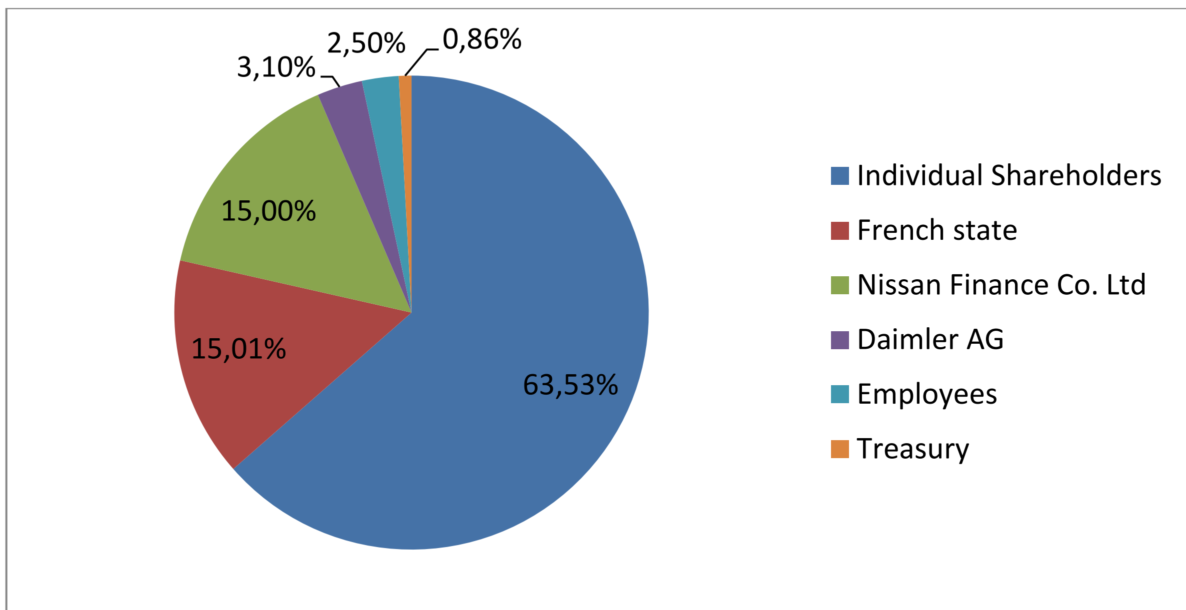
- "Any increase in shareholder ownership beyond 20% of total shares does not lead to further voting rights"
- "Decisions on new plants or plant relocation require a two-thirds majority on the supervisory board"

[24] Ulrich Jurgens, Yannick Lung, Giuseppe Volpato, Vincent Frigant, "The arrival of shareholder value in the European auto industry a case study comparison of four car makers", in "Competition & Change", 2002, Vol. 6(1), p. 65, Routledge

- "The VW Act requires banks to receive authorization for proxy voting from each shareholder in advance of each general shareholder assembly"

However, this couldn't last forever, since it limits the free flow of capital. As a consequence, the EU court declared the VW-Act illegal in 2007[25]. This has let Porsche AG to gradually acquire Volkswagen and gain its control. Indeed, Porsche AG now has 50.73% of the voting rights and has left the State of Lower Saxony with a consistent, but not dominant, 20% of shares[26].

Figure 3.7 – Ownership structure Renault



Source: Renault Annual Report, 2014

Similarly to Volkswagen, Renault has experienced a significant metamorphosis from its foundation. Its status of "state enterprise" saved it from failure during its years of crisis, between 1980 and 1986[27]. As a matter of fact, the French State is still the dominant shareholder and has denied voting rights to Nissan, no matter the shares they

[25] http://in.reuters.com/article/2013/10/22/court-germany-volkswagen-idINB5N0GL01K20131022
[26]http://www.volkswagenag.com/content/vwcorp/content/en/investor_relations/share/Shareholder_Structure.html
[27] Ulrich Jurgens, Yannick Lung, Giuseppe Volpato, Vincent Frigant, "The arrival of shareholder value in the European auto industry a case study comparison of four car makers", in "Competition & Change", 2002, Vol. 6(1), p. 65, Routledge

own[28]. An interesting feature to note about its ownership structure is the fact that over 60% of the firm is owned by individual shareholders.

[28] http://group.renault.com/en/finance-2/financial-information/key-figures/

3.3 The impact of financing and ownership structure on corporate governance

Ownership structure and the amount of debt issued are of key importance in a firm's governance. As above mentioned, they directly affect top management's decisions. The ownership structure also has an effect on the overall firm's value. In fact, as big blocks of owners enter the firm, they increase monitoring activities and corporate's efficiency. Consequently, the overall value of the firm rises. Let us now analyze the four different corporate governance systems and see how they are affected by shareholders' and debt holders' pressure.

FIAT's management and control system is based on two independent boards. One the one hand, the Board Of Directors is entitled of broad managerial power; it approves and monitor: important or risky transactions and plans made by executive directors; it also sets the guidelines for risk management and internal control framework. On the other hand, the Board Of Statutory Auditors controls the firm's compliance with laws and By-Law; it checks if the Governance code to which the firm adhered is correctly implemented.[29] The fact that the company is family driven impacts substantially on the firm's corporate governance guidelines. For example, now less than before, even at middle management level, employees held a sense of loyalty and identification with the firm's president: "l'Avvocato Agnelli", who died in 2003. This kind of ownership structure allowed the company to find "friendly" investors, in order to keep financial control whilst raising capital. For these reasons, corporate governance in FIAT cannot be seen from an exclusively capitalistic point of view.[30] However, its massive debt prevents it from being a solid automaker, since its earnings are consumed by it. A Bernstein Research analyst defined FCA as a "chronically leveraged company…with loads of cash and loads of debt"[31]. Marchionne (FCA's CEO) has issued another three billion debt in order to pay back part of its current debt with a

[29] FIAT Corporate Governance Report, 2014
[30] Ulrich Jurgens, Yannick Lung, Giuseppe Volpato, Vincent Frigant, "The arrival of shareholder value in the European auto industry a case study comparison of four car makers", in "Competition & Change", 2002, Vol. 6(1), pp. 62 and 64, Routledge
[31] http://www.forbes.com/sites/neilwinton/2015/04/29/fiat-chrysler-headline-profits-look-good-but-bernstein-research-worries-about-threat-from-debt/

lower interest rate[32]. Obviously, this situation is not sustainable for FCA and an alternative solution must be found in order to guide the company to a long term profitable horizon.

PSAs governance structure follows the two-tier model. It is composed of a Supervisory Board and a Managing Board. Last year has been the first year of profits after a few years of loss. The company had to close plants, cut jobs and R&D expenses to survive. However, contrarily to FCA, PSA managed to create 2.18 billion Euros of operating free cash flow, net debt free.[33] The alliance with Dongfeng Motor Corporation, previously mentioned, has been the key to the regeneration of PSA. Speaking of corporate governance models, PSA considers the Corporate Social Responsibility very important. As a matter of fact, the Chairman of the managing board, Carlos Tavares, founds its social and environmental responsibility policies on three clear pillars.[34]

1. Being pioneers of an environmentally sustainable mobility
2. Having an involved role in the regions where the Group operates
3. Being a responsible employer and initiate sustained social dialogues

Just like PSA, Volkswagen's governance structure is composed of a Board of Management and a Supervisory board, in compliance with the German Corporate Governance Code. Volkswagen's ownership structure impacts substantially on the firm's management. Its major objectives have radically changed with the arrival of Porsche AG as dominant shareholder, since it definitely passed from being a Public to a Privately owned company. We will see how this caused agency problems further on. A further important aspect of Volkswagen's corporate governance analysis is its relations with the company's labor force. There has always been a strong relationship between management and work councils, which have often highly influenced top managers' decisions. In fact, the plan of Ferdinand Piëch to save Volkswagen in 1993, was

[32] http://www.wsj.com/articles/fiat-chrysler-prices-3-billion-debt-offering-1428651680
[33] http://www.irishtimes.com/business/transport-and-tourism/psa-peugeot-citroen-posted-its-first-annual-profit-in-three-years-1.2108072
[34] Rapport sur le "Responsabilité sociale et environnementale", PSA Peugeot Citroën

strongly affected by the labor unions. Actually, one of the points was to reduce the weekly working hours instead of laying off thousands of employees[35].

Renault's governance is set up of a Board Of Directors, an Executive Committee and a Management Committee (that includes members of the executive committee).[36] Contrarily to Volkswagen, the 80's crisis has led to a breakup with labor unions. Over time, the state started to exit from the firm's policymaking, leaving more and more autonomy to managers.[37] Like PSA, Renault has put a considerable effort in social and environmental responsibility. In 2014 it was ranked first by OEKOM (an important German rating agency) for social, cultural and environmental responsibility among leading automakers worldwide.[38] Regarding capital markets, we have seen that Renault uses a low leverage. As a matter of fact, its upcoming strategy is to eliminate debt during the manufacturing process in order to improve credit rankings. Nevertheless, this strategy will lead to the layoff of 7500 French employees through 2016.[39]

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[35] http://ricerca.repubblica.it/repubblica/archivio/repubblica/1993/11/26/la-germania-cambia-orario.html
[36] http://group.renault.com/en/our-company/leadership/
[37] Ulrich Jurgens, Yannick Lung, Giuseppe Volpato, Vincent Frigant, "The arrival of shareholder value in the European auto industry a case study comparison of four car makers", in "Competition & Change", 2002, Vol. 6(1), p. 65, Routledge
[38] Renault Annual Report 2014
[39] http://www.bloomberg.com/news/articles/2013-02-14/renault-reports-better-than-expected-profit-as-debt-drops

3.4 Agency Problems in the automotive sector

Like other sectors, also the automotive one suffers of agency problems. As already said, when there is a high defragmentation of ownership, like in the case of Renault that has 63.53% of individual shareholders[40], agency problems arise more easily. Not only it is more difficult to control managers' activities (free-rider problem), but there can also be problems among different interests of shareholders. Denis, Sarin and Denis (1997) believe that a differentiated ownership will increase the risk of entrenching investments, other than benefiting managers' compensation and prestige. It is for these reasons that differentiated ownership can still be observed, even if it is said to decrease the firm's value.

Carrying on Renault's example, the French State is the dominant shareholder, however, the majority of ownership is hold by individual shareholders. The French State has long term objectives that go beyond mere profit-based logic. For example, it wants to keep production in France even if in some cases it is not economically convenient. Big industries are often subsidized by governments in order to keep work places safe, as for example it happened when the French State gave six billion euros in 2009 as a direct financial aid, to divide between Renault and PSA. This provided that the two companies committed to not delocalize and entertain more commercial relations with national component producers.[41] In contrast, individual shareholders usually aim at short term investments. Thus, they prefer to gain abnormal profits careless of where the company produces or where it will be in the long term. With this situation of dual and mutually exclusive interests, management inevitably goes against one group of shareholders (considering individual shareholders as a group even if they are not linked with each other). PSA happens to have similar problems since it has two blocks of shareholders, stable and institutional investors, that have opposite targets. *Ceteris paribus*, in PSAs case, stable investors are represented by the Peugeot family.[42]

Another agency problem that can arise is the one of "empire building". FCA's CEO, Sergio Marchionne, declared at Bloomberg that "When [he sees] a Range Rover

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[40] Renault Annual Report, 2014

[41] http://www.ilsole24ore.com/art/SoleOnLine4/Mondo/2009/02/finanziamenti-Renault-Psa-Peugeot-Citroen%20.shtml

[42] http://www.psa-peugeot-citroen.com/en/finance/peugeot-sa-share/stockholder-structure

on the street, [his] blood boils, because [FCA] should be able to do a thing like that, and [FCA] will [manage to do it]"[43]. Marchionne, who may leave FCA in 2017[44], risks to overinvest and not look after the actual benefits for the company to go after his personal interests. Also, since he may leave in a few years, he might take important decisions too quickly, in order to gain prestige for having done similar operations.

Taking as an example Volkswagen, it can happen that the CEO has to do directly with the company, causing conflict of interests. This is the case of Ferdinand Piëch, former CEO and nephew of Ferdinand Porsche. Piëch's decisions, willing or not, have been in some way affected by his links with Porsche SE, dominant shareholder of the Volkswagen Group. In fact, as Piëch decided to quit the last 25th of April, Volkswagen's share price outperformed other stocks of the DAX index. Investors believe that M&A risks (empire building) have now been reduced. Piëch was behind many recent acquisitions and has put many pressures for the acquisition of the Alfa Romeo brand, which he never managed to accomplish.[45]

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[43] http://www.bloomberg.com/news/articles/2015-05-13/jeep-plans-luxury-model-to-take-on-mercedes-suvs-and-range-rover
[44] http://it.reuters.com/article/topNews/idITMIEA0C01M20140113?pageNumber=1&virtualBrandChannel=0
[45] http://www.ilsole24ore.com/art/finanza-e-mercati/2015-04-27/vw-corre-le-dimissioni-piech-110415.shtml?uuid=ABSnyOWD

Conclusions

Searching for external financing is of vital importance for automotive firms. However, capital markets are a double-edged sword. If on one side they are a necessary instrument to remain competitive in a globalized economy, on the other side they inevitably lead to other problems. Agency costs are less visible in small firms, given that the top manager is usually also the major stake holder. This is much more difficult to happen in companies that capitalize billion dollars.

Both debt and equity have different and substantial implications. By financing mainly through debt the financial leverage will increase. However, as debt increases, other problems will occur, mainly in terms of risk perception. We have spoken about the debt-equity trade off, which explains that debt will be initially convenient with respect to equity. Nevertheless, it has to remain sustainable, otherwise the firm will incur in governance and agency problems. Moreover, we have analyzed a parallel theory that puts financing in a "pecking order" from which we can conclude that the more a firm stays on the top of this list the better it is.

In fact, the ability to find internal financing impacts on capital structure decisions. We have seen that PSA has been much better in this aspect with respect to FCA, even if it has come from a long period of loss. Other than on their actual capital structure, the debt to equity ratio to pursue is decided also on the basis of the context in which the firms operate. As a matter of fact, we have seen that Volkswagen finances itself with the same debt to equity ratio of Renault. However, the spread between their credit rankings is enormous and this is also due to the fact that the German context is seen as the most stable in Europe.

Also equity will affect the governance of a firm. Different ownership structures have been observed and we have understood that they imply different governance guidelines. For example, we have seen how the scope of Volkswagen has changed. It was born to produce cars for common people, since at that time there were no cars of that kind. Now its scope has become to merely make profits, since it changed into a privately owned firm.

The ownership structure also affects the value of a firm given its implications on agency costs and thus, shareholders profitability. An efficient capital market puts continuous pressures on family driven companies. Just think about the pressure that FCA has due to its enormous amount of debt issued. Capital markets put managers and existent stockholders in front of the dilemma: debt or equity?

We can therefore conclude that in the automotive sector this trade-off between debt and equity exists. Each firm will choose, on the basis of their actual capital structure and on their forecasts, which debt to equity ratio is best to use. They will also decide if it is better to maintain their actual ownership structure or to further access capital markets, changing their initial nature and scopes.

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