

REPORT

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The I.M.U. is an institute of
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STRONG CODETERMINATION – STABLE COMPANIES

An empirical analysis in lights of the recent financial crisis

Marc Steffen Rapp / Michael Wolff

AT A GLANCE

- Companies with codetermination (i.e., board-level employee representation) were not only more robust during the financial and economic crisis, but also recovered more quickly from its consequences.
- Companies with codetermination laid off fewer employees both during and after the crisis than companies without codetermination.
- During the crisis companies with codetermination maintained their investments in research and development and in fixed assets at a higher level than companies without codetermination.
- For the duration of the financial and economic crisis companies without codetermination raised less outside capital and indulged more in share buybacks, while companies with codetermination tended to do the opposite.
- Companies with codetermination instigated fewer strategic adjustments during the financial and economic crisis. Such companies were also less active in company takeovers.
- During the period under examination companies with codetermination registered higher profits and exhibited less capital market volatility. Company valuations were subject to less drastic deterioration than in the case of companies without codetermination.
- Return on assets among companies with codetermination decreased (during and after the financial and economic crisis) less than among companies without codetermination. Return on sales among companies with codetermination maintained their pre-crisis level during the crisis, all things being equal.

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INTRODUCTION

This Codetermination Report provides a brief outline of the project 'Effects of codetermination in the supervisory board on corporate governance' commissioned by the Hans-Böckler-Stiftung.

The project examines the role of board-level employee representation (codetermination) in German firms with regard to company performance and decision-making during the recent financial and economic crisis.

Motivation

The background of the project was the fact that, even though the Codetermination Act came into force more than 40 years ago, company codetermination in the supervisory board of German corporations is still an object of repeated criticism. Advocates, on the other hand, increasingly counter by pointing to the robust development of the German economy within the framework of the financial and economic crisis. A link is often made with German codetermination, which is usually based on anecdotal evidence, while critics present their own anecdotal evidence to reject it. The quest is still on for empirically valid findings.

Information on the project can be found here:



<https://www.boeckler.de/11145.htm%3Fprojekt%3D2018-29-13>

The aim of the research project is to close this gap. It provides systematically developed empirical

data and findings with regard to the effects and role of company codetermination during the financial and economic crisis.

The detailed findings of the project, together with a detailed presentation of the methodology and the database can be downloaded at:



https://www.boeckler.de/pdf/p_study_hbs_424.pdf

1 RESEARCH DESIGN

The basis of the study comprises German corporations (AG) listed in the **Prime Standard** segment of the Deutsche Börse, together with selected comparable European companies chosen by means of the **propensity score matching method** along the dimensions of company size, industry classification and level of diversification. The idea here is to disaggregate the effect of codetermination from a potential scale effect. This is a necessary condition for the clearest possible identification of the codetermination effect because the kind of codetermination applied depends on company size, under German law.

This specific research design is aimed – in conjunction with **multivariate regression analysis** – at tackling the methodological weaknesses of earlier studies on codetermination and enhancing the validity of the present study. **Figure 1** presents the research questions and stages of the analysis.

Figure 1

Dimensions of the analysis



2 RESULTS

The aim of the research project is to shed some light on the effects of company codetermination on company performance during the financial and economic crisis. A distinction is drawn within the performance framework between capital market performance and operational performance, while under company decision-making attention is divided between employment, investments, financing and strategy.

The results of the analysis of company performance present a relatively unambiguous picture: companies with codetermination were not only more robust during the financial and economic crisis, but also recovered more quickly from its effects. This applies to both capital market and operational performance. As regards *capital market performance* companies with codetermination registered higher profits over the period under examination (2006–2013), exhibited less capital market volatility and experienced a less drastic downturn in the wake of the financial and economic crisis.

As regards *operational performance*, the results show that for companies with codetermination the return on assets (ROA) fell to a lesser extent – both during and in the wake of the financial and economic crisis – and return on sales (ROSI) at least maintained its pre-crisis level. Companies without codetermination, by contrast, suffered a decline during the same period.

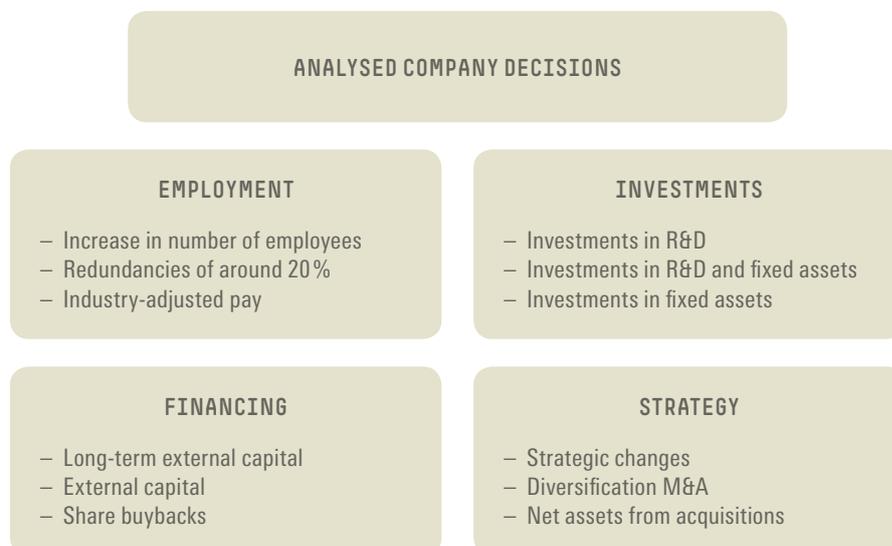
The results of the analysis of company decision-making show that during the financial and economic crisis important decisions were taken differently in companies with codetermination than in companies without it. In companies with codetermination a stronger orientation towards the company's long-term interests is apparent. This effect is present across all the dimensions of company decision-making we looked at.

In the *employment* dimension it can be seen that companies with codetermination, during and subsequent to the financial and economic crisis, laid off fewer employees and in particular refrained from mass redundancies. In parallel with this, companies with codetermination were able, even during the crisis, to implement wage adjustments, whereas companies without codetermination were able to do so only in the wake of the crisis. This may well be a key factor in the constant employment figures achieved by companies with codetermination, which enabled them to achieve higher production capacities rapidly subsequent to the crisis.

In the *investment* dimension it emerges from the analysis that companies with codetermination maintained their investments in research and development (R&D) and fixed assets at a higher level during the financial and economic crisis than companies without codetermination. Maintaining essential investments in the future of the company could be another key in-

Figure 2

Overview of company decisions analysed



indicator of why companies with codetermination were able to resume previous performance levels more quickly than their counterparts.

In the *financing* dimension, it turns out that during the period of the financial and economic crisis companies without codetermination engaged less in external borrowing and a lot more in share buybacks, while companies with codetermination tended to do the contrary. After the crisis they generally stabilised at their pre-crisis level. Because of their continuing investments companies with codetermination also appear to have retained a relatively constant need for financing during the crisis, in contrast to companies without codetermination.

Turning to the strategy dimension, the findings indicate that companies with codetermination instigated fewer strategic changes during the financial and economic crisis. This also resulted in lower **mergers and acquisitions (M&A)** volumes, as well as a smaller number of diversifying M&As in comparison with companies without codetermination. In common with the other dimensions of company decision-making companies with codetermination, during the period of the crisis, also adjusted their portfolios to a lesser extent, thus exhibiting higher continuity.

3 SUMMARY AND CONCLUSIONS

In general, the present study underlines the potential of company codetermination for coping with the consequences of external shocks, such as the financial and economic crisis. As regards the debate on modern corporate governance structures

in general and the role of codetermination in particular we can draw the following conclusions:

- In the context of increasingly volatile economic conditions company codetermination can be regarded as an element of modern corporate governance well suited to mitigating the potential risks of strategic transformation processes. The empirical findings show fairly clearly that during the recent financial and economic crisis company codetermination made it possible to curb short-termist behaviour and resume growth mode more quickly.
- In the course of fundamental transformation processes company codetermination can be an important instrument for striking a balance or reaching a compromise between the demands of company performance and safeguarding employee interests. The nature of this compromise is evident in the fact that both the capital-market and the operational performance of companies with codetermination were better during the financial and economic crisis, while in the case of company decision-making the emphasis continued to be on long-term survival.
- Given these empirical findings, calls to curtail company codetermination, especially with regard to future transformation processes, need to be examined in a critical light. Ultimately, employees' participation in the supervisory board within the framework of necessary transformation processes should generally be regarded not as an obstacle, but as an opportunity to identify and implement necessary compromise. This should be taken into account in future legislative initiatives, especially at European level.

Mergers & acquisitions

Mergers & acquisitions designate, in particular, strategically motivated purchases or amalgamations of companies or parts of companies and their subsequent integration or resale. This is accompanied by the transfer of management, control and directive competences. An M&A transaction can have a wide range of configurations.

See: <https://www.mitbestimmung.de/html/mergers-acquisitions-welche-rolle-spielt-5197.html?code=76a40bbfbbebde688ba5b3efafe784f2c&c=&cmsid=#> [13.05.2019]

Multivariate methods of analysis

Multivariate methods of analysis deal with multi-dimensional data (characteristic values). Multivariate or multidimensional means here that an object is marked by more than one characteristic. In other words, multivariate methods of analysis make it possible, for example, to test a suspected connection between data (duration of unemployment and training level) or even reveal one for the first time (is there a connection between the observed data?).

See: <https://www.faes.de/Basis/Basis-Lexikon/Basis-Lexikon-Multivariate/basis-lexikon-multivariate.html> [13.05.2019]

Prime Standard

The highest level of transparency for listed companies, beyond the statutory minimum requirements of the Regulated Market. The Prime Standard is tailored to the companies on the Regulated Market that also want to orient themselves towards international investors. They have to comply with high international transparency requirements over and above the level of the General Standard. For example, they have to report on a quarterly basis (quarterly financial report or quarterly statement), publish ad hoc statements also in English and hold at least one analysts' conference at year. Only companies trading on Prime Standard can be listed on the selective indexes Dax, MDax, TecDax or SDax.

See: <https://boerse.ard.de/boersenwissen/boersenlexikon/prime-standard-100.html> [13.05.2019]

Propensity-score-matching method

Propensity score matching is a procedure by means of which observations of treatment and control groups can be combined across different characteristics. Based on the propensity score, which indicates how probable it is that the treatment will be encountered for the respective observation, one or more control observations are identified for each treatment observation. Thus the observations that have been made differ as little as possible or not at all in terms of their selected features (for example, company size, branch affiliation and/or level of diversification) and merely regarding the treatment variable.

See: <http://doku.iab.de/discussionpapers/2007/dp2207.pdf> [17.05.2019] or https://en.wikipedia.org/wiki/Propensity_score_matching [17.05.2019]

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