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The Impact of Dual Equity Structure on the Financial Performance of Firms

-- Jingdong as an Example

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Abstract

Dual equity has attracted much attention for a while because of its special equity structure, which can attract large amounts of financing and ensure the stability of corporate control. In order to investigate the impact of dual equity structure on the economic behavior and financial performance of enterprises in depth, this paper takes Jingdong as an example and firstly explains the concept, characteristics and the relationship between various aspects of dual equity and financial performance. We then analyze the motivation of adopting dual equity structure within Jingdong, and conduct a comparative analysis with a number of financial performance indicators before and after the listing of Jingdong to explore the specific impact of dual equity on corporate financial performance. Finally, we summarize the advantages and disadvantages of a dual shareholding structure from a corporate perspective to provide lessons learned, and suggest ways in which companies should respond to these effects.

Keywords

Dual Equity; Financial Performance; Jingdong.

1. Quotes

Along with the rapid development of big data and information technology, Internet companies are becoming more and more competitive, and the demand for capital is getting higher and higher. In the context of the traditional co-equity system, ordinary corporate financing brings capital injection but also makes the founder team's equity diluted, and has much impact on the founder team's corporate control. In this context, the dual shareholding structure has become a hot topic of public attention, providing many founders who want to firmly grasp the control of the company with new ideas and ways to design the shareholding, but at the same time, the disadvantages of dual shareholding should not be ignored. In order to further investigate the effect of dual equity structure in enterprises and its impact on enterprise performance, this paper takes Jingdong as an example to explore the changes in its financial performance before and after the adoption of dual equity structure and summarizes the conclusions to provide experience reference for the practice of dual equity structure.

2. Overview of Dual Equity Structure

2.1. Concept of Dual Equity Structure

Dual shareholding structure refers to the shareholding structure of a listed company that adopts the "same share with different rights" system, dividing the shares issued by the company into two classes, A and B, and distinguishing the two classes of shares in terms of voting rights and conversion rights. Of these, Class A shares are normally held by the general shareholders, one Class A share corresponds to one vote and is not convertible to Class B shares under any circumstances. Class B shares, on the other hand, are generally held by a small number of executive shareholders, and one share of Class B stock is entitled to multiple votes and is convertible into Class A stock. There is a significant difference in voting power between the two classes of stock, generally ranging from 2-10 times more voting power for Class B stock than for Class A stock, but there is no difference in returns between the two classes. The dual shareholding structure is based on the opposite side of the mainstream corporate governance principle of "one share, one vote" and helps to separate ownership and control of a listed company, and to equate cash flow rights with voting rights within the company. This also allows the company to go through multiple rounds of financing without the control of the founding team being weakened or lost due to equity dilution, which to some extent also has an impact on the financial performance of the company.

2.2. Characteristics of Dual Equity Structure

The most important feature of the dual shareholding structure is that it allows for the separation of cash flow rights and control rights to meet the needs of different shareholders. It divides the company's stock into two classes, A and B, and assigns different voting rights to them, which also divides the company's shareholders into two classes. One class owns Class A stock, has cash flow rights and is entitled to corporate dividends, but does not have much say in various general meetings and thus has less control over the business. One class owns Class B stock, and although the percentage of dividends is small, due to the nature of Class B stock, such shareholders have a firm grip on corporate control, thus effectively separating and differentiating corporate cash flow rights from control rights to corporate shareholders.

2.3. Literature Review

What are the unique features of dual ownership, the advantages or disadvantages for companies, and the impact on financial performance and other aspects of the company? Based on previous experience and scholarly research findings, we briefly summarize them here. On the investment side, as early as 2009, Arugaslan suggested that when a company's single-tier equity structure is transformed into a dual-tier equity structure, the activity of the company's capital will also be greatly enhanced and the probability of investors being attracted will increase[1]. In terms of control and corporate development, Gompers (2010) suggests that because the dual shareholding structure has stable corporate control, it has a unique advantage in terms of anti-takeover[2]. According to Song (2016), the stability of corporate control brought by the dual shareholding structure is conducive to the long-term stable development of the company[3]. Zhang Jide and Liu Zhuo (2018) argue that dual equity can promote corporate growth while reducing the cost of acquiring control by the founding team [4].

In terms of corporate governance, Zhenming Peng and Xiaolu Cao (2016) stated that corporate governance under a dual shareholding structure is more efficient than a single-tier shareholding structure [5]. Li, H. Y., and Li, S. H. (2017) suggested that under dual equity, the sense of responsibility and mission of corporate founders can restrain them from abusing their control and thus maximize the benefits of corporate governance [6]. Jiajia Du and Yingxia Wu (2018) suggested that the flexibility of dual equity is beneficial to meet the needs of different shareholders thus achieving efficient corporate governance [7]. In terms of corporate financial performance, Sun Wenyan (2017) argues that the correlation between dual equity and financial performance needs to be viewed dialectically [8]. Gui, Lin (2019) empirically analyzed that the same-share disparity system facilitates the improvement of firm performance [9]. Using Tobin's Q instead of financial performance, Le Yu Ma (2020) analyzed that the dual equity structure is beneficial to Xiaomi's financial performance improvement and corporate longevity using a combination of quantitative and qualitative analyses [10]. Guohui Hu and Yiming Zhao (2021) construct a multiple regression model to empirically demonstrate that dual equity has a significant positive effect on the growth of corporate financial performance, which is

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beneficial to the gains of both the founder team and the external shareholders, using a sample of Chinese stocks listed in the United States[11].

3. History of the Development of Jingdong's Dual Equity Structure

3.1. Jingdong Corporate Profile

Jingdong was founded in 1998 by Liu Qiangdong in Zhongguancun, Beijing. Initially, the company's main business was offline sales of electronic products, but later changed its direction to enter the field of e-commerce, and quickly gained a competitive advantage in the market with its low-price marketing strategy and efficient logistics services. In 2007, Jingdong received a $10 million investment from Today Capital and completed its first round of financing, followed by venture capital from Tiger Fund and many other companies, which led to the growth of Jingdong's business. At this time, Jingdong's various rounds of financing were still conducted through the issuance of preferred shares, which did not have an impact on the founding team's control of the business. In 2011, in order to meet higher capital requirements, Jingdong began to issue common stock for financing, first attracting Tiger Fund to obtain $1.5 billion in financing, and later exchanging 15% of its shares for $200 million in financing from Tencent. After going through multiple common stock financing, the founder Liu Qiangdong's equity in his hands was continuously diluted, eventually securing his control over Jingdong with 55.90% of the voting power with a slight advantage. In May 2014, Jingdong was officially listed on NASDAQ in the U.S. The enterprise implements the same share and different rights system, and makes it clear that one Class B share enjoys 20 votes. Therefore, Liu Qiangdong only has 23.1% of the equity but occupies 83.7% of the voting rights of the enterprise. The equity and voting shares of Jingdong's founding team before and after the IPO are shown in Table 1. Since then, Jingdong has continued to explore the financial and logistics sectors and created a new Internet retail model, and is now the largest self-run e-commerce company in China.

Table 1. Founders' Equity and Voting Rights Before and After Jingdong's IPO

Rights	Time	Percentage
Equity	Pre-listing	23.7%
	After listing	23.1%
Voting Rights	Pre-listing	55.9%
	After listing	83.7%

3.2. Motivation for Jingdong to Adopt a Dual Equity Structure

Guarantee founder control. Since its founding, Jingdong has used equity financing rather than debt financing to obtain funds for its rapid growth, including the sale of common stock to raise capital. Such a financing method certainly can quickly expand the size of the enterprise, but the number of common shares greatly increased, the founders led by Liu Qiangdong will face the problem of dilution of shares, which will also lead to the loss of control of the enterprise. In order to ensure his control over the business, Liu decided to adopt the same share and different rights system.

Prevent malicious acquisition by others. It is indisputable that a dual shareholding structure can ensure the stability of corporate control, and in addition, this shareholding structure can effectively prevent the occurrence of a hostile takeover. In the case of Jingdong, even if a hostile acquirer acquires enough common shares, the hostile acquirer would still not be able to gain control of the company because the company's founder, Liu Qiangdong, holds Class B equity, or super voting rights, and even Jingdong's board of directors would be deemed ineffective without Liu's participation.

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4. Impact of Dual Equity Structure on Jingdong's Financial Performance

The dual shareholding structure has an impact on corporate development and corporate governance by determining corporate control and the company's management team, which ultimately manifests itself directly in corporate performance. In order to visually explore the impact of Jingdong's dual equity structure on corporate financial performance, this paper starts from three aspects, namely debt-servicing capacity, operating capacity and profitability, and selects several indicators from 2012-2016, i.e., two years before and after Jingdong's IPO, for comparative analysis to draw conclusions.

4.1. Debt Service Capacity

Table 2. Changes in debt-servicing capacity indicators of Jingdong, 2012-2016

Reporting date (year)	2012	2013	2014	2015	2016
Current Ratio	137.2%	134.8%	172.2%	119.4%	102.1%
Quick Ratio	95.8%	96.8%	130.2%	77.4%	74.5%
Gearing ratio	64.2%	64.5%	43.6%	63.9%	74.3%

The current ratio is calculated to be equal to the current assets of a company divided by its current liabilities, and this indicator reflects the short-term solvency of a company's debt. The higher the value of the current ratio indicator, the better the company's short-term debt-servicing ability. The quick ratio is calculated to be equal to a company's quick assets divided by its current liabilities and reflects the quickest liquidity of a company's debt. The higher the value of the quick ratio indicator, the better the company's ability to pay off its debts most quickly. As can be seen from Table 2, the values of both current ratio and quick ratio of Jingdong reached the maximum during 2014, which is related to the large amount of capital acquired by raising funds during the listing of Jingdong in 2014. Compared with the period before the listing, Jingdong's current rate and quick ratio have slightly decreased after the listing, but still maintain a good and stable level, and reflect a high short-term debt service capacity, which is also the result of the large amount of financing brought by Jingdong's dual equity. The gearing ratio is obtained by dividing total liabilities by total assets and is an important indicator of the long-term solvency of an enterprise. The higher the value of the gearing indicator, the weaker the long-term solvency of the enterprise. As can be seen from Table 2, Jingdong's gearing ratio has been at a high level, which also reflects Jingdong's weak long-term debt service capability. Except for the IPO in 2014 when it received a large amount of financing, Jingdong's gearing ratio exceeded 60% in all other years, meaning that the ratio of external funds exceeded Jingdong's own funds. After the IPO, Jingdong's gearing ratio has increased significantly, and it is in a state of debt operation, which also indicates that its demand for capital is very large and growing with the scale of the enterprise. The advantage of dual equity can both attract large amounts of financing and ensure the concentration of control can effectively alleviate the problem of Jingdong's need for capital.

4.2. Operating Capacity

Table 3. Changes in Jingdong's operating capacity indicators, 2012-2016

Reporting date (year)	2012	2013	2014	2015	2016
Inventory turnover rate (times/year)	10.2	11.3	10.9	9.6	8.8
Receivables turnover rate (times/year)	118.5	153.4	83.3	34.6	20.8
Current asset turnover ratio (times/year)	3.2	3.6	3.2	3.3	3.2

Turnover rate is a measure of the efficiency of the operation of the assets of the enterprise.The higher the turnover rate, the faster the flow of an asset and the more efficient the operation.

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Jingdong's inventory turnover ratio has slightly decreased after the IPO, but is still at an industry-leading level, which is closely related to the fact that Jingdong has a self-operated logistics system. Jingdong's logistics system, for one thing, ensures that goods can be sent out quickly and are not affected by third-party transportation. Second, Jingdong logistics has always been known for "rapid", and the goods can basically guarantee the next day delivery. The combination of "fast shipping" and "fast delivery" ensures that Jingdong's inventory turnover rate remains high. Jingdong's receivables turnover ratio, on the other hand, has decreased significantly since the IPO, which seems inconsistent with the increase in Jingdong's corporate size and thus receivables. However, the fact that Jingdong opened Jingdong White Stripe after its IPO, which allows users to "spend first and pay later", has lowered Jingdong's current profit receivables and ultimately led to a lower receivables turnover rate. Jingdong's low level of current asset turnover is mainly due to excessive accounts receivable, but it also shows that accounts receivable bring great profit to Jingdong. This is still thanks to the dual shareholding structure, under which the founding team of Jingdong has the power to decide on the opening of Jingdong White Label and attract more users to spend to bring profit.

4.3. Profitability

Table 4. Changes in profitability indicators of Jingdong, 2012-2016

Reporting date (year)	2012	2013	2014	2015	2016
Gross sales margin	8.4%	9.9%	11.6%	12.2%	13.7%
Operating Margin	-4.6%	-0.7%	-4.9%	-1.2%	-0.2%
Return on Net Assets	-78.7%	-2.7%	-25.2%	-26.1%	-10.0%

Gross margin of sales = (sales revenue - cost of sales) / sales revenue. Jingdong's gross profit margin is at a good level both before and after the IPO, and has increased significantly after the IPO, indicating that Jingdong has certain profitability and its products are highly competitive, and that the public recognizes the business model and sales method of Jingdong's products. Operating margin = operating profit / operating revenue. During 2012-2016, Jingdong's operating margin has been showing negative numbers, indicating that Jingdong has been losing money, which is related to the huge amount of capital investment in Jingdong as an Internet company. The operating margin of Jingdong has increased after the listing, and also mostly for the turnaround brought by the access to financing funds. Return on net assets = net income / average net assets. Jingdong's return on net assets is negative for the period 2012-2016, consistent with the loss status shown by the operating margin, which shows that Jingdong is less efficient in its use of assets. However, Jingdong's NAV has tended to become positive after its IPO, also because it no longer needs to raise large amounts of capital after its IPO. Jingdong flourished under the leadership of Liu Qiangdong and others, with improved corporate performance and an increasing ability to benefit from its assets, and later became a leading Internet company.

5. Conclusion

5.1. Dual Equity is Beneficial to Improve Corporate Financial Performance

Since going public in 2014 using the dual-equity system, with the guidance of Liu Qiangdong and other founders and the support of financing capital, Jingdong's business scale has grown, all financial and performance indicators have risen, and business conditions have continued to improve. As a result, the management value of the founder will be more recognized and will play a greater role in the operation of the company, and will also be more effective in improving the financial performance of the company. The dual shareholding structure ensures the

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concentration of corporate control while being more conducive to the improvement of corporate financial performance and the growth of corporate value.

5.2. Dual Equity is Beneficial to the Long-term Development of the Enterprise

As an Internet company, Jingdong has a very high demand for capital, and sufficient capital to maximize the talent of the company's founder team and corporate effectiveness. Compared to a normal single-tier equity structure, a dual equity structure can help the founding team and the entire business raise a large amount of capital quickly without losing control, greatly reducing the difficulty and cost of raising capital. The founding team thus has more resources to implement long-term strategies, and it is easier to increase the value and scale of the business. In addition, the stability of corporate control brought about by dual ownership avoids malicious takeovers, internal disputes and events that are detrimental to the development of the company such as some investors seeking quick profits through short-term shareholding operations, ensuring that the company achieves stable revenue and long-term development.

5.3. Dual Equity May Infringe on the Rights and Interests of Ordinary Shareholders

Under the dual equity system, the founding team controls Jingdong with a small amount of equity, and other executives have little involvement in the management of the business. On the one hand, the probability of the founding team using their power to infringe on the interests of other shareholders to maximize their personal interests from their own interests will increase. On the other hand, the binding and supervisory power of ordinary shareholders on the founding team is reduced, which is contrary to the shareholder governance structure of modern enterprises and is not conducive to the protection of minority shareholders' rights and interests. Unlike a single-tier equity structure, a company with a dual equity structure will have more related-party transactions. If the deal goes bad or the founder wants to exit the business, external oversight can easily fail and the founder has more voting power, and the rights of common shareholders can be more violated.

6. Recommendations

6.1. Reasonable Choice of Equity Structure

Jingdong has implemented a dual equity structure, which brings in a large amount of capital while ensuring that control of the business does not fall by the wayside and eliminates worries for Jingdong to carry out financing. Thus, dual shareholding structures offer a new way of thinking for companies that want to keep a firm grip on control of the business but also want access to financing. However, at the same time, it is also important to pay attention to the disadvantages it brings, to prevent the problem of corruption in the management of the founding team caused by excessive centralization of control, where the talents of the founding team are not played and the duties they should perform are not fulfilled, which is detrimental to the development of the company instead. Therefore, companies should choose whether to implement a dual shareholding structure in light of their actual situation and as needed.

6.2. Strengthen Enterprise Internal Supervision

The fundamental reason why dual shareholding can infringe on minority shareholders' rights is because the B shares held by B shareholders have super voting rights and corporate control is firmly in the hands of the founding team. There is no way for minority shareholders to stop inappropriate decisions made by B shareholders, and there are no measures or solutions to stop their rights from being violated. To address this situation, companies can constrain the number of B shares and the degree of voting rights in relation to the actual situation, and impose certain power constraints on B shareholders. It is also most important to improve the internal

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oversight system of the company and to hold B-shareholders accountable for the consequences of inappropriate decisions while compensating ordinary shareholders.

6.3. Proactive Disclosure of Relevant Information

In order to better select companies for investment, investors currently obtain information about companies from their financial statements and media disclosures and make judgments about whether they are worth investing in. In fact, this information alone does not provide investors with the most current and accurate picture of a company. Under the dual shareholding structure, the fact that only the shareholders of the company know the current status and development trend of the enterprise is more and more prominent, which undoubtedly increases the difficulty for investors to obtain information about the enterprise. Lack of clarity and low acceptance of management decisions related to the company by external investors. This makes it more hesitant and difficult for relevant investors to invest in companies with dual equity structures. Therefore, companies should take the initiative to disclose relevant information, clarify relevant regulations and meet information disclosure requirements to attract investment.

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