Ownership Structure and Corporate Performance: Evidence from India

Dr. Aman Srivastava
Associate Professor
Jaipuria Institute of Management, Noida, India,
Email: amansri@hotmail.com

Abstract

Ownership structure of any company has been a serious agenda for corporate governance and that of performance of a firm. Thus, who owns the firm's equity and how does ownership affect firm value has been a topic investigated by researchers for decades. Thus, the impact of ownership structure on firm performance has been widely tackled in various developed markets and more recently in emerging markets, but was less discussed before, in India in recent changing environment. This paper is a moderate attempt to address the relationship of ownership structure of the firm and its performance. It investigates whether the ownership type affects some key accounting and market performance indicators of listed firms. The 98 most actively listed companies on BSE 100 indices of Bombay Stock Exchange of India, which constitute the bulk of trading, were chosen to constitute the sample of the study as of end of 2009-10. The findings indicate the presence of highly concentrated ownership structure in the Indian market. The results of the regression analyses indicate that the dispersed ownership percentage influences certain dimensions of accounting performance indicators (i.e. ROA and ROE) but not stock market performance indicators (i.e. P/E and P/BV ratios), which indicate that there might be other factors (economic, political, contextual) affecting firms performance other than ownership structure.

Keywords: *Ownership structure, corporate performance, corporate governance, India*

1. Introduction

Ownership structure of any company has been a serious agenda for corporate governance and that of performance of a firm. Thus, who owns the firm's equity and how does ownership affect firm value has been a topic investigated by researchers for decades. Thus, the impact of ownership structure on firm performance has been widely tackled in various developed markets and more recently in emerging markets, but was less discussed before, in India in recent changing environment. Though the modern organization emphasizes the divorce of management and ownership; in practice, the interests of group managing the company can differ from the interests of those that supply the capital to the firm. Corporate governance literature has devoted a great deal of attention to the ownership structure of corporations.

Shareholders of publicly held corporations are so numerous and small that they are unable to effectively control the decisions of the management team, and thus cannot be assured that the management team represents their interests. Many solutions to this problem have been advanced, as stated previously i.e. the disciplining effect of the takeover market, the positive incentive effects of the management shareholding stake and the benefits of large monitoring shareholders. A different problem, however, arises in firms with large controlling shareholders. Since a large controlling shareholder has both the incentives and the power to control the management team's actions, management's misbehavior is a second order problem when such a large shareholder exists. Instead, the main problem becomes controlling the large shareholder's abuse of minority shareholders.

In other words, holders of a majority of the voting shares in a corporation, through their ability to elect and control a majority of the directors and to determine the outcome of shareholders' votes on other matters, have tremendous power to benefit themselves at the expense of minority shareholders. Thus, the type of owners as well as the distribution of ownership stakes will undoubtedly have an impact on the performance of firms. Most of the empirical literature studying the link between corporate governance and firm performance usually concentrates on a particular aspect of governance, such as board of directors, shareholders' activism, compensation, anti-takeover provisions, investor protection etc. This paper is a moderate attempt to examine the relationship of ownership structure and performance of firms in India.

The rest of the paper is organized as follows: Section 2 discusses on the literature review, where both theoretical and empirical studies on previous works are looked into. It also incorporates the corporate governance mechanism in India. In section 3, the methodology of this study is considered. Empirical results and discussions are made in section 4, while section 5 concludes the study.

2. Literature Review

The firm's equity and how does ownership affect firm value has been a topic investigated by researchers for decades; however, most of the studies in this context are conducted outside of India. The study failed to document any relevant study on the topic in Indian context. Fama and Jensen (1983 a & b) addresses the agency problems and they explained that a major source of cost to shareholders is the separation of ownership and control in the modern corporation. Even in developed countries, these agency problems continue to be sources of large costs to shareholders1.Demstez and Lehn (1985) argued both that the optimal corporate ownership structure was firm specific, and that market competition would derive firms toward that optimum.

Because ownership was endogenous to expected performance, they cautioned, any regression of profitability on ownership patterns should yield insignificant results. Morck. (1988) by taking percentage of shares held by the board of directors of the company as a measure of ownership concentration and holding both Tobin's Q and accounting profit as performance measure of 500 Fortune companies and using piece-wise linear regression, found a positive relation between Tobin's Q and board ownership ranging from 0% to 5%, a negative relation for board ownership ranging from 5% to 25%, and again a positive relation for the said ownership above 25%. It is argued that the separation of ownership from control for a corporate firm creates an agency problem that results in conflicts between shareholders and managers (Jensen and Meckling, 1976).

The interests of other investors can generally be protected through contractual arrangements between the company and concerned stakeholders, leaving shareholders as the residual claimants whose interests can adequately be protected only through the institutions of corporate governance (Shleifer and Vishny, 1997). Loderer and Martin (1997) took shareholding by the insiders (i.e., director's ownership) as a measure of ownership. Taking the said measure as endogenous variable and Tobin's Q as performance measure, they found (through simultaneous equation model) that ownership does not predict performance, but performance is a negative predictor of ownership. Steen Thomsen and Torben Pedersen (1997) examine the impact of ownership structure on company economic performance in the largest companies from 12 European nations.

According to their findings the positive marginal effect of ownership ties to financial institutions is stronger in the market-based British system than in continental Europe. Cho (1998) found that firm performance affects ownership structure (signifying percentage of shares held by directors), but not vice versa. Jürgen Weigand (2000) documented that (1) the presence of large shareholders does not necessarily enhance profitability, and (2) the high degree of ownership concentration seems to be a sub-optimal choice for many of the tightly held German corporations. Their results also imply ownership concentration to affect profitability significantly negatively.

Their empirical evidence suggests that representation of owners on the board of executive directors does not make a difference. Yoshiro Miwa and Mark Ramseyer (2001) stated with a sample of 637 Japanese firms and confirmed the equilibrium mechanism behind Demstez-Lehn. Demsetz and Villalonga (2001) investigated the relation between the ownership structure and the performance (average Tobin's Q for five years—1976-80) of the corporations if ownership is made multidimensional and also treated it as an endogenous variable. By using Ordinary Least Squares (OLS) and Two-stage Least Squares (2 SLS) regression model, they found no significant systematic relation between the ownership structure and firm performance.

Demsetz and Villalonga (2001), examined the relationship between ownership structure and firm performance of Australian listed companies. Her OLS results suggest that ownership of shares by the top management is significant in explaining the performance measured by accounting rate of return, but not significant if performance is measured by Tobin's Q. However, when ownership is treated as endogenous, the same is not dependent upon any of the performance measures. Lins (2002) investigates whether management ownership structures and large non-management block holders are related to firm value across a sample of 1433 firms from 18 emerging markets.He finds that large non-management control rights block holdings (having more control rights) are positively related to firm value measured by Tobin's Q. Michael L Lemmon and Karl V Lins (2003) use a sample of 800 firms in eight East Asian countries to study the effect of ownership structure on value during the region's financial crisis.

The crisis negatively impacted firm's investment opportunities, raising the incentives of controlling shareholders to expropriate minority investors. The evidence is consistent with the view that ownership structure plays an important role in determining whether insiders expropriate minority shareholders. Using a sample of 144 Israeli firms, Beni Lauterbach and Efrat Tolkowsky (2004) find that Tobin's Q is maximized when control group vote reaches 67%. This evidence is strong when ownership structure is treated as exogenous and weak when it is considered endogenous. Christoph Kaserer and Benjamin Moldenhauer (2005) address the question whether there is any empirical relationship between corporate performance and insider ownership. Using a data set of 245 Germen firms for the year 2003 they find evidence for a positive and significant relationship between corporate performance, as measured by stock price performance as well as by Tobin's Q, and insider ownership. Kapopoulos and Lazaretou (2007) tried the model of Demsetz and Villalonga (2001) for 175 Greek firms for the year 2000 and found that higher firm profitability requires less diffused ownership structure He also provides evidence that large non management block holders can mitigate the valuation discounts associated with the expected agency problem.

3. Data and Methodology

The study aims to explore the disciplinary effect of the market in a context with concentrated ownership structure and weak investor protection. The paper aims to explore if there are dominant certain types of owners of actively listed and traded companies on Indian Stock Exchanges. Further, it investigates whether the ownership type affects some key accounting and market performance indicators of listed firms. It shows that there might be other reasons that have affected the performance of the listed companies of BSE 100, other than ownership structure.

The data set consists of detailed trading and financial information and indicators about the 98 most actively traded BSE 100 listed companies on the Bombay Stock Exchange of India (BSE) during 2009-2010. The ninety eight companies cover a broad spectrum of sectors or industries totaling 18, which are: Finance, Oil & Gas, Information Technology, Metal, Metal Products & Mining, Capital Goods, FMCG, Transport Equipments, Power, Housing Related, Healthcare, Telecom, Diversified, Chemical & Petrochemical, Miscellaneous, Media & Publishing, Transport Services, Tourism and Agriculture. The details and proportion of these sectors in BSE 100 is given in table 1.

Insert table (1) about here

The main financial indicators obtained from the companies financial statements included Total Revenues or Turnover, Gross Profit, Net Income or Earnings After Taxes, Current Assets, Fixed Assets, Long Term Debt and Shareholders Equity. Finally, the third subset consists of companies' stock performance indicators obtained from CMIE PROWESS database including value traded, volume traded, number of transactions, market capitalization, market price as well as some calculated ratios using both CMIE PROWESS database as well as items reported in financial statements of sample companies such as debt to equity ratio, return on equity, return on assets, price earnings ratio and price to book value.

The empirical investigation is conducted using known Ordinary Least Square Estimation methodology using both Return on Equity (ROE) and Return on Investment (ROI) variables - representing accounting performance measures, and Price-Earning Ratio (P/E) and Price to Book Value (P/BV) – representing stock market performance measures; separately as dependent variables. The following formula was used for modeling:

$$\mathbf{Y_{ij} = \alpha + x_{ff,\,j} + x_{de,j} + x_{dph,j} + x_{fp,j} + x_{npi,j} + x_{npni,j} + \varepsilon} \ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\mathbf{(i)}$$

Where $\varepsilon \sim ND\,(0, \sigma^2)$

$\mathbf{Y_{ij}}$: i corresponds to ROE, ROI, P/E or P/B for company j (j=1…98)

$\mathbf{x_{ff,\,j}}$: represents the percentage of free float in company *j* capital structure,

$\mathbf{x_{de,j}}$: represents the debt to equity ratio for company *j,*

$\mathbf{x_{dph,j}\ and\ x_{fp,j}}$: represents the domestic promoter and foreign promoter holding in the company

$\mathbf{x_{npi,j}\ and\ x_{npni,j}}$: represents non promoter institutional and non promoter non institutional holding of the company.

The independent variables are represented by the percentage of Free Floated shares (FF), Debt to Equity ratio (D/E) and four variables representing promoters and non promoters stake representing the ownership structure in sampled companies, namely; Tables (2) and (3), (4) and (5) in the appendix summarize the regression analysis.

4. Results and analysis

The sampled companies of BSE 100 were analyzed on the basis of their free floats and the findings are given below in table 2. Table 2 clearly depict that majority of the sampled companies have less than 75% of the free float. Even 13% companies have a free float of less than 25%. Only 13% of the companies have a free float of greater than 75%.

Insert table (2) about here
Insert table (3) about here

Table three gives the details about the ownership structure of the sampled firms. Data clearly depicts that the stake of Indian promoters I the sampled company varies from 0% to 99% with a average holding of 41%. That means on an average the sampled companies are dominated by Indian promoter's holdings. While the average foreign promoters holding is just 7.51%. That clearly confirms the belief that the Indian companies are dominated by families and promoter's stakes. Data related with debt equity profile of sampled companies is given in table 4.

The results clearly indicates that majority of the sampled companies are in first category of 0-2 which clearly depicts that the majority of the sampled companies are not highly levered.

Insert table (4) about here

Performance measures in the paper are represented by two sets of variables accounting measures are ROA and ROE while the market measures are P/E and P/BV ratio. Table five depicts that average ROE, ROA, P/E and P/BV values are 17.36%, 12.77%, 34.8 and 3.8 respectively.

Insert table (5) about here

The results of OLS regression analysis are given in table 6 below. The empirical results reflect at 5% level of significance the ownership characteristic does not reflect any relationship with either accounting performance measures ROA and ROE or show any significant relationship between ownership structure and stock market indicators P/E and P/BV ratios, as shown in Table (6) below. But at 10% level of significance all sampled variables shows significant relationship with ROA, ROE, P/E and P/BV for performance of any company.

Insert table (6) about here

5. Findings and Conclusion

The significance of ownership characteristics and accounting performance measures i.e. ROA and ROE could be explained by the fact that the fundamental evaluation of companies, measured by, its financial indicators such as (ROA and ROE) are the most important factors used by investors in India to assess company's performance. In India, although earlier investors have culturally placed more emphasis on accounting performance measures, not stock market indicators, due to the inactivity and stagnation of the stock market for a long period (till early 1990's). Furthermore, Indian investors always favored payment of dividends rather than stock price appreciation, due to inactivity of market.

Accordingly, the dividends yield paid by Indian companies are always very high (10%-13%) compared to other emerging and developed markets (3%-5%). Thus the author did not consider dividend yield in the stock market indicators since it will be a distorted measure since issuers in India always pay a high dividends yield, sometimes, irrespective of earnings, since they are valued by investors according to dividends not price appreciation. Furthermore, the type of ownership had an insignificant impact on stock market performance measures, which might imply that the stock performance was mainly affected by economic and market conditions rather than ownership concentration. Furthermore, the results could be related to the market inefficiency of the Indian stock market, given its small and thin characteristics, as well as the lack of prompt disclosure by listed companies, even the active ones, at the Indian stock market. Stock prices therefore may not appropriately reflect the costs and benefits of diversification as shown.

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Table 1: Sectorwise Breakup of BSE 100 Companies

S.No.	Sectors	%
	BSE100	100
1	Finance	22.14
2	Oil & Gas	15.26
3	Information Technology	11.71
4	Metal,Metal Products & Mining	9.58
5	Capital Goods	8.83
6	FMCG	6.36
7	Transport Equipments	5.49
8	Power	5.13
9	Housing Related	4.03
10	Healthcare	3.78
11	Telecom	3.34
12	Diversified	2.13
13	Chemical & Petrochemical	0.55
14	Miscellaneous	0.43
15	Media & Publishing	0.36
16	Transport Services	0.31
17	Tourism	0.29
18	Agriculture	0.27

Source: Bombay Stock Exchange (Adjustment factors are converted into % FF)

Table 2: Free Float of Companies in BSE 100

S.No	Free Float	Number of Companies	Cumulative
1	0-25%	13	13
2	25-50%	27	40
3	50-75%	46	86
4	75%-100%	13	99
5	100%	1	100

Source: Bombay Stock Exchange (Adjustment factors are converted into % FF)

Table 3: Ownership Structure in Sampled Firms

	N	Minimum	Maximum	Mean	Std. Deviation
Indian Promoters (%)	98	0	99.33	41.31	25.93
Foreign Promoters (%)	98	0	63.92	7.51	16.84
Institutions (%) - Non-Promoters	98	0.64	88.07	32.01	16.39
Non-institutions (%) - Non-Promoters	98	0.03	48.97	16.26	8.94
Valid N (listwise)	98				

Source: CMIE PROWESS

Table 4: Debt Equity Ratio of Sampled Firms

S.No	Debt Equity Ratio	Number of Companies	Cumulative
1	0-2.00	72	72
2	2.00-4.00	20	92
3	4.00-6.00	2	96
4	6.00-8.00	3	99
5	8.00-10.00	1	100

Source: CMIE PROWESS

Table 5: Performance Measures of sampled firms

	N	Minimum	Maximum	Mean	Std. Deviation
ROE	98	-34.19	129.32	17.36	19.40
ROA	98	-16.28	129.32	12.77	17.25
P/E	98	-26.42	575.37	34.86	65.34
P/BV	98	0.41	16.95	3.83	2.95

Source: PROWESS

Table 6: Results of OLS Regression Analysis

	ROE	ROA	P/E	P/BV
Constant	-20.883	-3.032	-107.730	2.721
Free float	-0.022	0.039	0.386	-0.040
Debt Equity ratio	-0.210	-0.338	0.031	0.113
Domestic Promoter Holding	0.539	0.287	0.213	0.213
Foreign Promoter Holding	0.517	0.453	-0.205	0.122
Non Promoter Institution Holding	0.424	0.168	-0.176	-0.050
Non Promoter Non Institution Holding	0.162	0.067	-0.215	-0.065
R^2	0.128	0.235	0.165	0.094
F value	2.034	4.253	2.727	1.441
Significance of F value	0.070	0.001	0.018	0.209
DW statistics	2.167	2.174	2.092	1.926