Ownership Structure and Firm Performance- Evidence from Indian Firms

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Abstract

The purpose of present study is to empirically investigate the effect of ownership structure, and ownership concentration on financial performance of companies in India. The study examines the cross-sectional variation in Tobin's Q with respect to changes in ownership structure and its concentration for top 100 companies listed on NSE as on 31st March 2016. Durbin Wu Hausman test is applied to test whether ownership variables are endogenously determined or not. The results of DWH test did not document any evidence of endogeneity of ownership. Ordinary least square regression technique is employed to analyze the data. The study finds no significant relationship between ownership structure (promoters' shareholding and non-promoters' shareholding) and Tobin's Q. there is also no significant relationship between ownership concentration and TOBIN'S Q. The findings of the study are in line with the arguments of Demsetz (1983).

Keywords: Ownership Structure, Ownership Concentration, Promoters' Shareholding, Non-Promoters' Shareholding, Firm Performance

Introduction

The relationship between ownership structure and corporate financial performance has been an important and debated subject in the finance literature. It has received considerable attention within the corporate governance framework. The ongoing discussion starts with the pioneering study of Berle & Means (1932) who argue that the separation of ownership and management would adversely affect firm's performance. To say it differently, there exists an inverse relationship between the ownership diffusion and performance of the firm. The idea behind the notion is that the professional managers do not act in the best interest of the shareholders that is maximizing shareholders' wealth. When the ownership is widely spread, small shareholders (diffused owners) have little chance to influence the actions and corporate decisions of the managers. Managers, who have control over the company's decision making, have an opportunity to misuse their position. This gives birth to conflict of interests among the managers and shareholders due to separation of ownership and management. This is referred to as conflict of interest hypothesis. Corporate actions that reduce this conflict of interest involve certain costs, known as agency costs. The debate got a gear with the agency theory by Jensen & Meckling (1976) which postulates that with increase in the level of managerial ownership, the interest of the

managers coincides with that of the shareholders, which in turn increases firm performance. This is referred to as alignment of interest hypothesis. Moreover, managerial ownership after reaching a threshold limit is found to have a negative effect on firm performance for the reason that managers then entrench themselves and engage in activities of extracting private benefits such as consumption of goods produced by the firm, extraction of assets or takeover defense for insiders (Barclay and Holderness, 1989; Bebchuk, 1999). This is called entrenchment hypothesis/ private benefits of control. Shleifer & Vishney (1986) in turn suggested that block ownership by large outside shareholders might have a role to play as monitors of the management and thus increase firm performance. This is known as efficient monitoring hypothesis. However, literature on private benefits suggests that concentration of ownership by large block-holders may lead to extraction of firm's resources by dominant owners at the expense of other shareholders. This is known as entrenchment hypothesis (Barclay & Holderness, 1989 and Bebchuk, 1999). Pound (1988) also suggested that large outside block holders may collude with insiders and act as passive voters which might negatively affect performance of the firm. This is also called passive voters' hypothesis or strategic alignment hypothesis.

On the other hand, Demsetz (1983) argues that 'ownership structure of a firm emerges as an endogenous outcome of competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organization of the firm'. According to him, there is no relation between ownership structure and firm profitability. Demsetz & Lehn (1985) empirically support conclusions by Demsetz (1983). They found no significant relation between measures of ownership concentration and firm's accounting profit after regressing 511 US companies in 1980.

Based on the above studies and their arguments, a number of studies have been done, but no consensus has been arrived yet. The literature review incorporates some of the significant studies and their findings.

Literature Review

Morck et al (1988) using a piece wise linear regression in which the ownership concentration was measured by percentage of shares held by the board of directors of the company and firm's performance was measured by Tobin's Q and accounting profit for 371 Fortune 500 firms found a non-monotonic relation between Q and the stock owned by the board of directors. They found that Q first rises as insider ownership increases up to 5%, then falls as ownership increases to 15%, then rises slightly again as the ownership level increases above 25%.

Hermalin & Weisbach (1987) also found a non-monotonic relationship for134 NYSE firms for 1971, 1974, 1977, 1980 and 1983. They found that Q increases for stock ownership by CEOs between (0-1) %, decreases between (1-5) %, increases between (5-20) % and decreases thereafter.

Loderer & Martin (1997) took directors' ownership as measure of insider ownership and Tobin's Q as measure of performance. Using simultaneous equation model, their study found that ownership does not affect performance but there is a negative effect of performance on ownership. Similarly, Cho (1988) found that ownership (percentage of shares held by directors) does not affect firm performance but if effected by the firm performance.

Demsetz & Villalonga (2001) examined the relationship between ownership structure and performance (Tobin's Q) for a period of five years from 1976-1980. Making ownership multidimensional and treating it as an endogenous variable, they found no statistically significant relationship between ownership structure and firm performance. The findings are consistent with the arguments of Demsetz (1983).

Himmelberg, Hubbard & Palia (1999) after taking into account the endogeneity of ownership, estimated panel data using fixed effects model for insider ownership and firm performance and did not find any significant relationship.

Kumar (2004) empirically examined the effect of ownership structure on firm performance from an agency perspective. Using form level panel data for more than 2000 firms over a period of 1994-2000 and controlling for unobserved firm heterogeneity, they found that's shareholding by managers and institutional investors affect firm performance non-linearly. They however, did not find any evidence of endogeneity of ownership.

Selarka (2005) investigated the impact of ownership concentration (insider & outsider) on the firm value for a cross-sectional sample of 1397 manufacturing firms listed in BSE for the year 2011. They found a strong U-shaped relationship between insider ownership and market value of the firms.

Li et al (2006) studied the effect of institutional ownership on corporate governance and firm performance for 433 public companies listed on Hong Kong Stock Exchange over a period of 1996-1998. Using partial least square, they found no effect of institutional ownership, CEO duality and board composition on firm performance. They found that ownership concentration has no significant effect on firm performance.

Objectives of The Study

Grounded upon the theoretical background and differing results of previous literature on the relationship between ownership and firm performance, the present study attempts to empirically examine the effect of ownership structure and concentration on firm performance for companies listed in India.

Hypothesis

Null hypothesis for studying the relationship between ownership structure and firm performance

H_0 1: There is no significant effect of ownership by promoters on Tobin's Q.

H_0 2: There is no significant effect of ownership by non-promoters on Tobin's Q.

Ho3: There is no significant effect of Herfindahl index on Tobin's Q.

Methodology

For the purpose of above study 100 companies were taken from NSE CNX 100 list for the year 2016. Nifty CNX 100 index is a diversified 100 stock index accounting for 28 sectors of the economy. Nifty 100 represents top 100 companies based on full market capitalization from Nifty 500. Nifty 100 index represents about 77% of the free float market capitalization of all the stocks as in 31st March 2016. The sample excludes all the financial and government companies subject to different legislative system and ownership patterns. The final criterion is that the companies with missing data for any variable are excluded from the sample. The final sample consists of 63 firms for the year 2016. The study uses ordinary least squares (OLS) to examine the impact of ownership structure on firm performance. The study also tests for the possibility of endogeneity of ownership structure and concentration. It applies DWH specification error to test for endogeneity of ownership and its concentration.

Variables

A lot of variation is witnessed for choosing measures of ownership structure, ownership concentration and firm performance.

Dependent variable

Studies have been measuring firm performance either by accounting rate of return or Tobin's Q. both measures suffer from their specific disadvantages. However, the main advantage of Tobin's Q is that it is forward looking and market based in contrast to the accounting based backward looking measure. Moreover, the value of equity is also usually more interesting from shareholder's perspective than pure cash flows. The present study also uses Tobin's Q as a proxy for firm performance. Tobin's Q is defined as sum of market capitalization of the firm and the value of its debt divided by the book value of its total assets. The larger the Q a firm has, the greater is its value in the market.

Independent variables

Shareholding of firms in India is categorized by two major and distinct groups having diverse interests i.e. promoters and non-promoters. For the purpose of present study, promoters' shareholding (fraction of shares held by promoters, abbreviated as PSH) and non-promoters shareholding (fraction of shares held by non-promoters, abbreviated as NPSH) are considered as the two major groups of ownership. Ownership concentration is measured through Herfindahl Index which is the sum of squared percentage of shares held by each largest shareholder (H1).

Control variables

Debt–Ratio: As per capital structure theories, debt financing is associated with tax advantage and hence is favorable to the firm. As a result, increase in debt level should increase the value of the firm. However, debt financing is also associated with cost of bankruptcy which is likely to arise when a firm includes more debt in its capital structure (Bringham & Houstan, 2004). Hence the relationship between capital structure and firm performance of a firm could be both positive and negative. The book value of total debt to the book value of equity is used as a proxy for debt ratio.

Size: Welch (2003) stated that is was necessary to control for firm size while studying the association between ownership structure and firm performance to account for the possibility that both were related. Another view in support is that larger, older and better known firms are less likely to go bankrupt. Firm size was expected to be inversely related with firm performance since larger firms had more bureaucracy, bigger agency cost and more trouble adapting to frequent changes in political and economic environment (Ivg et al, 2008). Farooque et al (2007) found that firm size had significantly negative association with firm performance. Klen et al (2005) also found a negative relation between size and firm performance. Kapopoulos & Lazaretan (2007) also found an inverse relationship between size (measured by book value of total assets) and firm performance. The present study uses log of total assets as a proxy for firm size.

Age: Age can be one of the important determinants of firm performance. Older firms enjoy economies of scale. Older firms have lower cost of production causing an increase in their revenue and profits. However, older firms need to adapt to the changes in the system and cope up with the new environmental conditions, failing which they can deteriorate their performance. Kuntluru et al. (2008) found a statistically significant positive relationship between age of the firm and ROA. On the other hand, Chibber & Majumdar (1999) found a negative relationship between firms' age and profitability. For the purpose of present study age of the firm has been measured as the number of years since incorporation of the firm to the date of observation.

Research and Development intensity: The present study uses ratio of research and development expenditure to sales for the financial year 2016. It focuses on the intangible assets related to sales and controls for asset specificity. It is

expected to have a positive influence of R&D on firm's performance (Kotabe, 1990). However, higher research & development expenditure by firms may be costly to be monitored by investors which may negatively influence firm performance (Chen & Steiner, 1999).

Advertisement intensity: ADV is measured through ratio of advertisement and distribution expenditure to sales for the financial year 2016. ADV is expected to have a positive influence on the performance of firms for the reason that investors react positively to the announcements of changes in advertisements leading to higher market value of firms. Graham & Frankenberger (2000) found a positive relationship between firm's market value and advertising asset value.

Cash Outflow: CASH measured through ratio of cash outflow to sales. It evaluates financial strength and profitability of the company, helps in planning capital budgets and investment plans over a longer span of time. It is expected to have a negative relationship between cash outflow to sales ratio and profitability.

ID: Ownership concentration may vary among different industries. Therefore, industry is also one among the different significant factors for studying the association between ownership concentration and firm's performance. For the purpose of present study, industry is controlled by introducing a dummy variable ID where 1 represents manufacturing company, 2 denotes service industry and 3 stands for industries other than manufacturing and service.

Model

In order to test the above three hypothesis, three regression equation are framed. Equation 1 tests the first hypothesis i.e. there is no significant effect of ownership by promoters' group on TOBIN'S Q. Equation 2 tests the second hypothesis i.e. there is no significant effect of ownership by non-promoters' group on TOBIN'S Q and Equation 3 tests the third hypothesis i.e. there is no significant effect of ownership concentration on TOBIN'S Q.

$$TQ_i = \propto_0 + \propto_1 PSH_i + \propto_2 DR_i + +\propto_3 SIZE_i + \propto_4 AGE_i + \propto_5 RD_i + \propto_6 ADV_i + \propto_7 CASH_i + \propto_8 ID_i + \varepsilon_{1i}$$

.....Equation (1)

$$TQ_i = \propto_0 + \propto_1 NPSH_i + \propto_2 DR_i + +\propto_3 SIZE_i + \propto_4 AGE_i + \propto_5 RD_i + \propto_6 ADV_i + \propto_7 CASH_i + \propto_8 ID_i + \varepsilon_{2i}$$

.....Equation (2)

$$TQ_i = \propto_0 + \propto_1 H1_i + \propto_2 DR_i + +\propto_3 SIZE_i + \propto_4 AGE_i + \propto_5 RD_i + \propto_6 ADV_i + \propto_7 CASH_i + \propto_8 ID_i + \varepsilon_{3i}$$

.....Equation (3)

Where,

I	Cross section firms
$\propto$, β and σ	Are parameters
TQ	Tobin's Q
PSH	Promoters' Shareholding
NPSH	Non-promoters' Shareholding
H1	Herfindahl Index (Ownership concentration by largest shareholder)
DR	Debt Ratio
SIZE	Size of the Firm
AGE	Age of the Firm
RD	Ratio of Research and Development Expenditure to Sales
ADV	Ratio of Advertisement and Distribution Expenses to Sales
CASH	Ratio of Cash Outflow to Sales
ID	Industry Dummy
$\varepsilon_1, \varepsilon_2$ and ε_3	Residual Error Terms

Data Analysis

Test of Multicollinearity

When the explanatory variables correlate with each other, there is possibility of problem of multicollinearity. As a result, the result of each specific variable on the dependent variable becomes difficult to specify. Tolerance Value and Variance Inflation Factor (VIF), for each variable were used to test multicollinearity. Generally a set of explanatory variables is said to be highly correlated if tolerance is low and VIF exceeds 10. No problem of multicollinearity was found in each of the regression equations.

Testing for Endogeneity

An explanatory variable is said to be endogenous when it is simultaneously determined by the dependent variable. That endogenous is therefore likely to be correlated with the error term or the disturbance. It is also referred to as simultaneity problem where a regressor is simultaneously determined by the regressand. In the absence of simultaneity problem OLS estimates produce consistent and efficient estimators. On the other hand, if there is simultaneity, OLS estimators are not even consistent. In such case, the method of two stage least square (2SLS) and instrumental variables will give estimators that are consistent and efficient. However, if these methods are applied when there is in fact no simultaneity issue, the results of these methods are consistent rather inefficient. Therefore, it is always suggested to test and check for simultaneity issue before choosing among the alternative methods. For the purpose of checking the possibility of endogeneity of ownership and concentration DWH (Durbin Wu Hausman Specification) Test was applied. The results of DWH test did not document endogeneity for any of the ownership variables. In the absence of endogeneity or simultaneity, OLS regression technique is applied to get the estimated results.

Empirical Results

While Table 1 presents the descriptive statistics, Table 2 shows the correlation matrix among the variables.

Table 1: Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.
TQ	2.340476	1.79	9.15	0.4	1.765004
PSH	49.73794	51	75	0	18.24699
NPSH	48.42111	47.92	99.75	24.65	16.96967
H1	2613.844	2355.161	5625	250.7129	1515.654
DR	0.280476	0.08	2.64	0	0.440276
SIZE	4.192602	4.1028	5.5996	3.2309	0.505465
AGE	55.44444	53	189	8	34.77614
RD	0.01454	0.0038	0.1191	0	0.027672
ADV	0.028349	0.0087	0.1794	0	0.046353
CASH	0.068109	0.0526	0.3424	0.004	0.055915
ID	1.428571	1	3	1	0.688952

Table 2: Correlation Matrix

	TQ	PSH	NPSH	H1	DR	SIZE	AGE	RD	ADV	CASH	ID
TQ	**1.00**										
PSH	**-0.03**	**1.00**									
NPSH	**0.07**	**-0.97**	**1.00**								
H1	**0.05**	**0.78**	**-0.76**	**1.00**							
DR	**-0.27**	**0.06**	**-0.12**	**-0.18**	**1.00**						
SIZE	**-0.50**	**-0.22**	**0.16**	**-0.19**	**0.31**	**1.00**					
AGE	**0.33**	**-0.12**	**0.14**	**-0.18**	**0.26**	**-0.19**	**1.00**				
RD	**0.11**	**-0.15**	**0.08**	**-0.12**	**-0.05**	**0.02**	**-0.08**	**1.00**			
ADV	**0.35**	**0.27**	**-0.24**	**0.16**	**-0.04**	**-0.48**	**0.27**	**-0.08**	**1.00**		
CASH	**-0.24**	**0.04**	**-0.04**	**-0.08**	**0.08**	**0.29**	**-0.40**	**0.01**	**-0.28**	**1.00**	
ID	**-0.36**	**0.01**	**-0.02**	**0.06**	**0.14**	**0.54**	**-0.30**	**-0.27**	**-0.29**	**0.40**	**1.00**

Table 3 presents the OLS regression results between ownership structure (promoters' shareholding and non-promoters' shareholding) and firm performance (Tobin's Q).

Table 3: Results of Ordinary Least Square Technique to study the effect of ownership structure (PSH and NPSH) and ownership concentration (H1) on firm performance (TOBIN'S Q).

Independent Variables	Tobin's Q as Dependent Variable		
	PSH	NPSH	H1
Constant	6.494660*** [2.807686]	5.768353*** [2.767162]	5.843573** [2.648258]
PSH	-0.006399 [-0.557961]	–	–
NPSH	–	0.008137 [0.668224]	–
H1	–	–	1.46E-05 [0.108281]
DR	-0.938189* [-1.899724]	-0.911661* [-1.828952]	-0.988583** [-2.031239]
SIZE	-1.147383** [-2.183370]	-1.143281** [-2.196106]	-1.079052** [-2.064767]
AGE	0.015758** [2.344295]	0.015485** [2.294299]	0.016807** [2.509182]
RD	8.167142 [1.099525]	8.418211 [1.141847]	8.737457 [1.178708]
ADV	5.368795 [1.090469]	5.503005 [1.118057]	4.694541 [0.969020]
CASH	1.330678 [0.335811]	1277419 [0.322900]	1.325555 [0.330762]
ID	0.001750 [0.004724]	0.002194 [0.005933]	-0.015568 [-0.041531]
R SQUARE	0.383227	0.384759	0.379806
ADJUSTED R SQUARE	0.291854	0.0293612	0.287926
F-STATISTICS	4.194065***	4.221309***	4.133694***

t- Statistics is in parenthesis, *** denotes significance at 1% level, ** denotes significance at 5% level, *denotes significance at 10% level.

Discussion of results

The results of the OLS regression analysis show that ownership by promoters and non-promoters group have negative and positive effect on TOBIN'S Q respectively. The result is however insignificant in both the cases. The study also do not witness any significant relationship between ownership concentration by largest shareholder measured through Herfindahl index and firm performance measured through TOBIN'S Q. Debt ratio of the firm is found to have a significant negative impact on Tobin's Q for all the three cases. This means that as the as the debt employed by the firm increases, TOBIN'S Q decreases. This

could be because higher use of debt is associated with bankruptcy cost which ultimately causes financial risk for the firm (Bringham & Houstan, 2004) and as a result higher debt employment deteriorates firm performance. Moreover, size of the firm is found to exert significant negative impact on firm performance (Tobin's Q), for both categories of ownership as well as ownership concentration measured through Herfindahl index. This result is in line with the outcomes of Farooque et al (2007), Klen et al (2005) and Kapopoulos & Lazaretan (2007). Firm size was expected to be inversely related with firm performance since larger firms had more bureaucracy, bigger agency cost and more trouble adapting to frequent changes in political and economic environment. The results also document that age of the firm has significant positive impact on TOBIN'S Q in case of ownership by promoters, non-promoters as well as Herfindahl index. This is consistent with the result of Kuntluru et al. (2008) who found a positive relationship between age of the firm and firm performance with ROA. The regression results, however, did not find any significant effect of Research and development intensity, advertisement intensity and cash outflow to sales on Tobin's Q. The hypothesis Ho1, Ho2 and Ho3 are accepted.

Conclusion

The present study analyses the relationship between ownership structure and firm performance and also investigates the effect of ownership concentration on firm performance for top 100 companies of India taken from NSE-CNX100 as on 31st March 2016. Percentage shareholding by promoters and non-promoters is used to measure the two groups of ownership. Ownership concentration is measured through Herfindahl Index which is the sum of squared percentage of shares held by each largest shareholder (H1). Other control variables include debt ratio, size, age, research and development intensity, advertisement intensity and cash intensity. The study uses DWH method to test the possibility of endogeneity of ownership i.e. whether ownership variables are simultaneously determined by firm performance. There is, however, no evidence of presence of endogeneity. Applying OLS (ordinary least square) regression technique, the study found no significant effect of ownership by promoters, non-promoters as well as Herfindahl index on firm performance measured through TOBIN'S Q. The findings of the study confirm the findings of Demsetz and Villalonga (2001) who concluded that there is no statistically significant relationship between ownership structure and firm performance. The null hypotheses Ho1, Ho2 and Ho3 are accepted. Among the control variables the study finds that debt ratio and size of the firm are significantly negatively related to TOBIN'S Q. The study also discovers a statistically significant positive relation between age of the firm and firm's performance (Tobin's Q). Other variables do not show any significant effect on performance of the firm.

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