IMPACT OF INSTITUTIONAL OWNERSHIP ON THE PERFORMANCE OF INDIAN CORPORATE SECTOR: AN EMPIRICAL STUDY

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ABSTRACT

Institutional investors with large ownership stakes have strong incentives to maximize their firms' value as their ultimate objective is to earn maximum return for their own shareholders. By virtue of their large stockholdings, they have the opportunity, resources, and ability to monitor, discipline and influence managers, which can force them to focus more on corporate performance. Their active involvement in the corporate affairs can help overcome one of the principal-agent problems in the modern corporation as they have both the general interest in profit maximization and enough control over the assets of the firm to have their interest respected. Present study intends to establish the relationship between institutional holdings and firm performance measured in terms of balance sheet data viz., return on capital employed and earnings per share as well as market data in terms of Tobin's q and risk-adjusted excess return. The study documented that large size of institutional holdings collectively in India do significantly influence the firm performance reported in terms of higher returns on capital employed, higher earnings and market capitalization.

keywords: *Institutional Holdings, Firm Performance, Balance Sheet Data, Market Data.*

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1. **Introduction**

Institutional investors with large ownership stakes have strong incentives to maximize their firms' value as their ultimate objective is to earn maximum return for their own shareholders. By virtue of their large stockholdings, they have the opportunity, resources, and ability to monitor, discipline and influence managers, which can force them to focus more on corporate performance and less on opportunistic or self-serving behaviour. Their active involvement can help overcome one of the principal-agent problems in the modern corporations as they have both the general interest in profit maximization and enough control over the assets of the firm to have their interest respected. There has been an increased focus by regulators and researchers alike on their role in enhancing the firm's value.

Before we proceed further it would be essential to examine the literature on the subject so as to sharpen our understanding of the same and identify the research gaps.

2. Literature Review

Many researchers have studied the relationship between the institutional holdings and firm performance. Some of the most relevant ones are reviewed here as a part of our research attempt.

Holderness and Sheehan (1988) found that Tobin's q and accounting profits are significantly lower for firms with individual majority owners than for the firms with corporate majority owners. McConnell and Servaes (1990) found a strong positive relationship between the value of the firm and the fraction of shares held by institutional investors. Han and Suk (1998) found (for a sample of US firms) that stock returns are positively related to ownership by institutional investors. Majumdar and Nagarajan (1994) found that levels of institutional investment are positively related to the current performance levels of firms. Douma, Rejie and Kabir (2006) found that there is positive effect of foreign ownership on firm performance. Wiwattanakantang (2001) enquired into the effects of controlling shareholders on corporate performance and found that presence of controlling shareholders in the firm is associated with higher financial performance. The evidence also revealed that firms controlled by foreign investors as well as more than one domestic shareholder also have higher return on assets, relative to firms with no controlling shareholder. Abdul Wahab et al. (2007) found that institutional investors do not have positive impact on the firm performance. Qiet et al. (2000) found little evidence in support of positive association between corporate performance and the proportions of tradable shares owned by domestic as well as foreign investors. Wahal (1996) observed that although institutional investors, particularly, activist institutions, have been successful in their efforts to affect the governance of targeted firms, these same firms have not demonstrated performance improvements. Chaganti and Damanpour (1991) and Lowenstein (1991) find little evidence that institutional ownership is correlated with Firm Performance. However, Shleifer and Vishny's (1997) as well as Pound's (1988) theorizations and later empirical examinations by McConnell and Servaes (1990) suggest that shareholders are differentiable and pursue different agendas. Jensen and Merkling (1976) also show that equity ownerships by different groups have different effects on the Firm Performance. Agrawal and Knoeber (1996), Duggal and Miller (1999) find no such significant relation between Institutional Holdings and Firm Performance. Kaur and Gill (2007) established significant positive effect of institutional ownership on company profitability. Chhibber and Majumdar (1999) examined the relation between foreign ownership and performance in India post liberalization era and found that only when foreign owner's control exceeds 51 percent, do firms display superior accounting performance. Douma, George, and Kabir (2002) found the positive effect of foreign ownership on Firm Performance was substantially attributable to foreign corporations and not to foreign institutional investors. Kumar (2004) provided evidence that equity shareholdings by institutional investors and managers do not affect Firm Performance linearly even after controlling for observed firm characteristics and unobserved firm heterogeneity. The study also found that equity shareholdings by foreign investors and corporate shareholders do not influence Firm Performance. Patibandla (2002) did not find any evidence that foreign investments have any direct positive impact over firm-level productivity.

In summary, the literature review indicates mixed response as to the relationship between institutional holdings and firm performance. Some of the observations contend that institutional investors are more expert in monitoring the affairs of companies as compared to individual investors; their holdings improve the financial performance of target companies. But the results of other observations state otherwise.

3. Objectives

The present study intends to examine the impact of institutional holdings over firm performance for empiricism in the Indian corporate sector. More precisely, it is focused on the following objectives:

i) To study the relationship between institutional holdings and firm performance in terms of accounting returns and;

ii) To study the relationship between institutional holdings and firm performance in terms of market return.

4. Hypotheses

H_0: Institutional Holdings and firm performance are very closely related to depict positive relationship between the two;

H_1: Institutional Holdings and firm performance are not related to depict positive relationship between the two.

5. Data and Methodology

The present study follows a descriptive research design given the objectives as the findings describe the status of relationship between the institutional holdings and identified measures of firm performance. The sample comprised 200 (group A) firms listed on the NSE. Data regarding institutional holdings have been collected from the official website of national stock exchange of India. While the same pertaining to the identified parameters of firm performance was compiled from the official website of national stock exchange, annual reports of sample companies and Prowess database compiled and maintained by the Centre for Monitoring Indian Economy (CMIE), Bombay under a licensing agreement for a period of five years from 2004 to 2008.

The present study identified four parameters of firm performance such as return on capital employed, earnings per share, Tobin's q and risk-adjusted excess return. The former two were essentially based on balance sheet data while the latter two on the market data set. These were obtained as:

i) Return on capital employed:

(Profit after Tax/Average capital employed)/100

Capital employed represents the share capital plus reserves and long- term debt of a company. It is arrived as Equity Capital+ Preference Capital+Reserves and Surplus-

Revaluation Reserve-Miscellaneous expenses not written off+Total borrowings- (Bank Borrowings+Short- term commercial paper).

ii) Earnings Per Share:

(Net Profit after tax/number of outstanding shares as on date)

iii) Tobin's q:

{(Market Capitalization+Book value of Debt)/Book value of assets} x100.

Market Capitalization is obtained multiplying closing stock price and the number of outstanding shares as on date.

iv) Risk- Adjusted Excess Return:

$\{(R_i - R_m)/\beta_i\}$ x100, is a market return based measure of firm.

Where in, R_i is the average annual return on the ith stock R_m is that on the market, NSE (Nifty 50), β_i is the measure of the systematic risk of the ith stock.

Statistical Tools

Institutional Holdings and Firm Performance parameters obtained above were regressed in the Software Package for Social Sciences (SPSS) for analytical parameters in terms of constant (α), β (regression co-efficient), R^2 and t-values.

6. Results and Discussion

As hypothesized (H_0), substantial holdings by institutional investors are expected to result in better firm performance. The improved firm performance is expected to be reflected in the terms of accounting returns (return on capital employed and earnings per share) and market-based returns (Tobin's q and risk-adjusted excess return). To witness the same, the regression results obtained for the study period (2004-2008) are reported in the following table.

Institutional Holdings and Firm Performance

A) Return on Capital Employed

Regression Parameters					
Constant, α	7.61	9.75	8.98	9.19	9.58
Coefficient, β	0.13	0.14	0.16	0.25	0.18

R^2	0.02	0.02	0.02	0.06	0.03
t-value	1.81	2.04*	2.27*	3.59*	2.62*

B) Earnings Per Share

Regression Parameters					
Constant, α	6.51	9.81	12.45	10.96	12.59
Coefficient, β	0.27	0.22	0.10	0.19	0.16
R^2	0.07	0.05	0.01	0.03	0.02
t-value	3.98*	3.21*	1.48	2.67*	2.23*

C) Tobin's q

Regression Parameters					
Constant, α	2.26	1.55	1.85	1.73	1.76
Coefficient, β	-0.00	0.16	0.22	0.26	0.29
R^2	0.00	0.03	0.05	0.07	0.09
t-value	-0.07	2.33*	3.25*	3.78*	4.33*

D) Risk Adjusted Excess Return

Regression Parameters					
Constant, α	111.74	94.01	-2.56	3.43	-18.65
Coefficient, β	-0.02	-0.12	0.16	-0.06	0.13
R^2	0.00	0.01	0.03	0.00	0.02
t-value	-0.31	-1.66	2.31*	-0.79	1.78*

Note: i) Predictor: Institutional Holdings for return on capital employed, earnings per share, Tobin's q and risk adjusted excess return respectively.
ii)*significant $t_{0.05}$ values at requisite degrees of freedom.

The t-values have been highlighted with stars which show the significant relationship between Institutional holdings and respective parameters of financial performance. The study found a significant and strong relationship between the the institutional holdings and parameters of firm performance for return on capital employed, earning per share and Tobin's q during the study period as in four out of five years covering the study period shows t-values significant. However, weak relationship is observed between the institutional holdings and risk adjusted excess return. The institutional investors are able to improve return on capital employed. The assets have been utilized efficiently, thereby, earning good return on shareholders' funds and debt funds as well. Similarly, the impact is positive on earning per share as well due to good return on assets and possibly low financing costs. Hence, the institutional holdings have significant impact over the firm performance in terms of accounting returns. Likewise, institutional holdings have been successful in putting great positive impact over Tobin's q as well. Market Capitalization, book value of debt and book value of assets are the three constituents of Tobin's q measure, of these, book value of assets and book value of debt are key constituents which are also reported as balance sheet data. As outlined earlier, substantial institutional stake have strong positive impact over tangible corporate performance reported as balance sheet data. Therefore, institutional holdings do affect firm performance in terms of market returns as well with the exception of risk-adjusted excess return.

7. Conclusion

It is concluded that large size of institutional holdings in India do significantly influence the firm performance reported in terms of higher returns on capital employed, higher earnings and market capitalization.

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