

OWNERSHIP STRUCTURE AND FIRM PERFORMANCE
IN INDIAN COMPANIES: EVIDENCE FROM 30 BSE
SENSEX COMPANIES

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Abstract:

There are varied assertions with regard to the relationship between ownership structure and firm performance. Studies show positive, negative as well as both positive and negative relationship at differing levels of equity holdings by managers. Majority findings argued about owner controlled firm's performance being better than manager controlled ones, yet lacking statistical assertion for the same. This research work is empirically investigating the impact of ownership structure on corporate performance by analysing firms traded on Bombay Stock Exchange (BSE). Using data spanning the 2008-2013 fiscal years of 30 of India's largest manufacturers (30 companies listed on BSE SENSEX index), this research paper empirically evaluates the extent to which a firm's financial performance is influenced by its ownership structure. To do so, I have examined distinct categories of Indian shareholders: Market investors, Stable investors and inside investors. The findings of this study strongly indicate that the relationship between the equity stakes of a particular category of investor and a firm's financial performance are highly idiosyncratic. Such a result emphasizes the importance of making finely grained and contextually relevant distinctions when modeling and evaluating corporate governance relations.

Keywords: Ownership Structure, Investment Behaviour, Financial Performance, Determinants and Measures of Financial Performance.

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Introduction:

The relationship between ownership structure and firm performance has received substantial notice in the finance literature. Berle and Means (1932) are among the first breed of researchers to draw attention to the fact that firm performance is inversely affected as diffuseness of the ownership structure enhances. Succeeding studies by scholars have either supported or rejected this argument. Studies throughout the world have focused on different aspects of ownership and their effects on firm performance.

Differing viewpoints on the ownership debate by varied researchers has created a dilemma as to which ownership group maximizes firm performance. While Jensen (1993), Chew (1997) have tried to empirically prove that large investors with long term interest in firms help in improving performance in a market based economy. Others like Rajan and Zingales (1999) have criticized the relationship model of ownership structure as the main cause of East Asian Debacle. Thus arguments vary as per the prevailing market system. Highly efficient markets attract agency cost whereas weak markets have the possibility of principals expropriating shareholder's value. Literature on the latter is evidently missing in the finance literature since majority studies are conducted with regards to developed market model economies or relationship-centered, multi-tiered ownership economies. Our study with regards to the developing country, India sheds some light on the governance practices in transition economies. India is a typical example where majority ownership is closely held. The primary problem in such closely held firms would be the controlling shareholder's abuse of the minority shareholders Shleifer and Vishny (1997).

This paper has two primary objectives. The first objective is to investigate the extent to which the strategic behavior and financial performance of Indian companies are sensitive to the investment objectives of different types of shareholders. Our related second objective is to empirically evaluate the widely held belief that Indian shareholders have more diverse investment objectives than is captured in the standard agency theory treatment of ownership and control. To examine these issues, this paper proceeds as follows. First, past studies dealing with the effects of ownership structure are reviewed and then the issues related to the characteristics and objectives of different types of Indian shareholders are elaborated upon. Research hypotheses are developed based on these differences. Subsequent sections describe the data analysis and the results. After this the conclusions regarding the findings have been made.

Literature Review:

Most research on the relationship between ownership and financial performance is rooted in an agency framework. 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; Shleifer and Vishny, 1997).

In the literature, there are alternative views on the relationship between ownership and performance. One approach assumes an exogenous optimal ownership structure that combines with other governance mechanisms to collectively maximize firm value. The other approach assumes that firms choose a combination of ownership structure and other governance mechanisms to maximize performance while recognizing that ownership is itself affected by performance, that is, it is endogenous. Accordingly, empirical studies addressing the relationship between ownership structure and performance provide two opposite and contradictory views on the role of ownership. Assuming ownership is exogenous and applying ordinary least squares, one group of studies provides evidence of either a linear or a non-linear relationship between ownership and performance. The other group assumes ownership and performance to be endogenous and applies two-stage least squares (2-SLS) or three-stage least-squares (3-SLS) to a set of simultaneous equations and finds either no evidence of a systematic relationship between the variables or a reverse causality between them. A reverse causality finding implies that performance determines ownership structure, and not the other way around. The former group of studies supports either the interest alignment hypothesis (Berle and Means, 1932; Jensen and Meckling, 1976; Hart and Holmstrom, 1987; Morck et al., 1988) or the entrenchment hypothesis (Fama and Jensen, 1983 a & b; Morck et al., 1988) or both. The latter group supports the natural selection hypothesis (Demsetz, 1983; Demsetz and Lehn, 1985; Kole and Lehn, 1997) or the mutual neutralization hypothesis (Jensen, 1986). Some of the studies that identify reverse causality argue in favor of the reward hypothesis (Kole, 1996), the insider-reward hypothesis (Cho, 1998) and the insider-investment hypothesis (Loderer and Martin, 1997).

Like the vast majority of shareholders in arm's length governance systems such as the U.S., the sole tie that these shareholders have to the firm in which they hold shares is their equity stake (Rajan&Zingales, 1998). Consequently, such market investors have equity returns as their primary investment objective. Inside investors which include corporate managers as well as corporate founders and their immediate families constitute a third class of shareholder found in

Japan. The investment objectives of insider investors are relatively ambiguous insofar as their shareholdings provide them with an incentive to adopt policies consistent with shareholder wealth maximization (Hill & Snell, 1989). However, the analysis of Fama & Jensen (1983) indicates that insiders are likely to favor more risk averse strategies than other shareholders owing to the fact that the vast majority of their wealth and income streams are tied to the fortunes of the firm they manage (Amihud & Lev, 1981; May, 1995).

Objectives of the paper:

The main objective of this project is to study and analyze the nature of ownership structure, investment behavior and firm performance in Indian companies.

Sub Objectives:

- To study the relationship between ownership structure and investment behaviour.
- To study the relationship between ownership structure and corporate profitability.

Data description, sources and methodology:

The research was conducted to understand the relationship between ownership structure, investment behaviour and firm performance in Indian companies (those listed on “Bombay Stock Exchange”). For the completion of this project and collection of relevant data only “secondary data” has been used. For this project the base sample consisted of 30 Indian companies listed on “Bombay Stock Exchange (BSE)”. Data was collected from multiple sources such as: website of Bombay Stock Exchange, internet, reports, journals and ProWess. Five years data (2008 – 2013) are considered for each of these companies resulting in a sample size of 150 (30 X 5) company years.

The companies in the sample represent a broad cross – section of Indian concerns. In terms of industrial composition, the sample is comprised of companies from the consumer finance (3.33%), automotive (16.67%), banking (10%), consumer goods (3.33%), information technology (10%), oil and gas (10%), telecommunications (3.33%), power (6.67%), metal and mining (10%), electronics (3.33%), pharmaceutical (6.67%), steel (6.67%), real estate (3.33%) and conglomerate (6.67%), thus representing the coverage of wide array of industries.

Table 1: List of companies listed in BSE SENSEX

Axis Bank Ltd	ITC Ltd
Bajaj Auto Ltd	Larsen & Toubro Ltd
Bharat Heavy Electricals Ltd	Mahindra and Mahindra Ltd
Bharti Airtel Ltd	Maruti Suzuki India Ltd
Cipla Ltd	NTPC Ltd
Coal India Ltd	Oil and Natural Gas Corporation Ltd
Dr.Reddy's Laboratories Ltd	Reliance Industries Ltd
GAIL (India) Ltd	Sesa Goa Ltd
HDFC Bank Ltd	State Bank of India
Hero MotoCorp Ltd	Sun Pharmaceutical Industries Ltd
Hindalco Industries Ltd	Tata Consultancy Services Ltd
Hindustan Unilever Ltd	Tata Motors Ltd
Housing Development Finance Corporation Ltd	Tata Power Company Ltd
ICICI Bank Ltd	Tata Steel Ltd
Infosys Ltd	Wipro Ltd

Variables Used In the Study:

Independent variables:

Ownership Structure: The ownership structure broadly consists of three classes of shareholders: Market investors, Stable investors and Inside investors

Market Investors: Foreign and outside the company shareholders such as general public, Nbanks Mfs, GDR are considered market investors who have no ongoing business ties with the Indian companies in which they own shares.

Stable Investors: Stable investors include the financial institutions and the affiliated firms as they have both significant and enduring business ties with companies in which they hold shares.

Inside Investors: This category includes only the shares held by the managers, founders, directors and their family members. Thus these shareholders are internal to the company and thus have a direct control on its working.

Dependent variables:

Dividend Payout Ratio (DPR): The dividend payout ratio is the amount of dividends paid to stockholders relative to the amount of total net income of a company.

$$\text{Payout Ratio} = (\text{Dividends} - \text{Preferred Stock Dividends}) / \text{Net Income}$$

Profit after Tax Ratio (PAT): The *after tax profit margin ratio* tells us the profit *per sales dollar* after all expenses are deducted from sales. In other words, the after tax profit margin ratio shows you the percentage of net sales that remains after deducting the cost of goods sold and all other expenses including income tax expense. The calculation is:

$$= \text{Net Income after Tax} / \text{Net Sales}$$

Hypotheses Formulation:

I developed hypotheses which examine how the investment objectives of stable, market and inside investors influence strategic behavior and the generation and use of financial resources. More specifically, I developed hypotheses which relate the investment objectives of the three investor types to corporate dividend policy, accounting profit and return on net worth.

Hypothesis 1a: *The size of the ownership stake of stable investors is negatively related to a firm's dividend payout levels.*

Hypothesis 1b: *The size of the ownership stake of market investors is positively related to a firm's dividend payout levels.*

Hypothesis 1c: *The size of the ownership stake of inside investors is positively related to a firm's dividend payout levels.*

Hypothesis 2a: The size of the ownership stake held by stable investors is negatively related to corporate profitability.

Hypothesis 2b: The size of the ownership stake held by market investors is positively related to corporate profitability.

Hypothesis 2c: The size of the ownership stake held by inside investors is positively related to corporate profitability.

Data Interpretation:

Table 2: Summary of Hypotheses and Expected Results

Hypotheses	Dependent Variable	Stable Investors	Market Investors	Insider Investors
1a-1c	Dividend Payout	(-)	(+)	(+)
2a-2c	Profit After Tax	(-)	(+)	(+)

The above table summarizes the hypotheses of this study. As this table shows, different types of investors are associated with different investment objectives.

**Table 3: Pooled Means, Median and Standard Deviations
(2008-2013)**

	Stable Investors	Market Investors	Insider Investors	DP Ratio	PAT Ratio
Mean	13.92933	754.4214	36.99094	33.18732	17.26007
Median	12.67000	54.99000	33.88000	26.52000	13.85000
Maximum	28.26000	21063.00	90.00000	212.7300	84.75000
Minimum	2.700000	4.480000	0.000000	4.030000	0.59000
Std. Deviation	6.993341	3797.127	26.06833	26.18013	14.15138
Skewness	0.382674	5.179856	0.136281	3.026574	3.118235
Kurtosis	2.113267	27.83227	2.034571	17.56725	14.37213
Jarque -Bera	8.518166	4494.619	6.247708	1544.915	1044.359
Probability	0.014135	0.000000	0.043987	0.000000	0.000000
Sum	2075.470	112408.8	5511.650	4944.910	2571.750
Sum Sq. Deviation	7238.210	2.133.09	100574.5	101439.1	29638.71
Observations	150	150	150	150	150

Table 3 presents the pooled (2008-2013) means, median, standard deviations, skewness, probability and kurtosis of the continuous measures used in this study. Notable among the descriptive statistics are the averages of stock ownership by category of investors.

- These statistics suggest that at the sample level, shareholdings by market investors such as general public, foreign institutions, NB mutual funds (49.4817%) are considerably larger than the holdings of either stable investors such as financial institutions and affiliated firms foreigners (13.91333%) or the holdings of inside investors (37.24433%).
- On the other hand, the standard deviation for these variables indicates that there is still significant company-level variation in terms of the ownership structures of Indian companies. The maximum proportion of shares being held by stable investors is 28.26% whereas the minimum for same is 2.7%. The maximum proportion of shares being held by market investors is 21.063% whereas the minimum for same is 4.48% and the maximum proportion of shares being held by insider investors is 90% whereas the minimum for same is 0%.
- Probability is highest for insider investors.
- Average PAT Ratio, DP Ratio is 33.18% and 17.265 respectively.

Table 4: Correlation between Different Variables

Stable Investors	Market Investors	Insider Investors	DP Investors	PAT Ratio
Stable Investors	1			
Market Investors	-0.2526	1		
Insider Investors	-0.3690	0.2589	1	

DP

Ratio -0.2615 0.0678 0.0462 1

PAT

Ratio -0.2490 0.0915 0.4180 0.1388 1

The most pronounced correlation presented in table 4 is between PAT and insider investors (0.4180, positive correlation). This indicates the existence of much evident relation between different dependent variables.

Table 5: Random-Effects Estimates of Dividend Payout

Independent Variables	Coefficient	Standard Error	Probability	
Stable				
Investors	-1.050592	0.583569	0.0739	
Market				
Investors		8.38e-05	0.001033	0.9355
Insider				
Investors		-0.059655	0.155639	0.7021
Adjusted R-Squared :	0.003429			

The dividend payout results are interpreted as follows:

- Since p is not less than 0.05 (at 95% confidence level) the relation is not significant. However, the dividend payout results reported in table 4 support the hypotheses 1a as the coefficient is negative showing negative association between the percentage of shares held by stable investors and dividend payout levels.
- Also the results evidently support hypotheses 1b according to which the percentage of shares held by market investors is positively related to dividend payouts, though p not less than 0.05 hence not significant.

- When checked for insider investors since the value of p is not less than 0.05, the relation is not significant. Also there do not exist any positive relation (as expected) between the percentage of shares held by insider investors and dividend payout levels as the coefficient is negative proving our assumptions wrong.

Table 6: Random-Effects Estimates of Profit after Tax

Independent Variables	Coefficient	Standard Error	Probability
Stable			
Investors	-0.345664	0.372902	0.3555
Market			
Investors	-0.000165	0.000660	0.8032
Insider			
Investors	0.195769	0.099454	0.0509
Adjusted R-Squared :	0.025667		

The profit after tax results presented in table 5 are interpreted as follows:

- For stable investors since p is not less than 0.05, the relation is not significant. However, the negative value of coefficient shows the existence of negative association between the percentage of shares held by stable investors and profitability levels supporting hypotheses 2a.
- For market investors since the value of p is not less than 0.05 the relation is not significant and because the value of coefficient comes to be negative results do not show any support for hypotheses 2b.
- For insider investors since the value of p is less than 0.05 the relation is significant and positive value of coefficient shows some support for hypotheses 2c as a positive association is found between insider investors and profit after tax.

Conclusion:

The results of study reported here offer evidence that Indian corporations are sensitive to the investment objectives of their shareholders. These results also provide a strong indication that this effect varies significantly across class of shareholder and criterion variable. In terms of dividend policy, we find that stock ownership by stable investors has a negative association with dividend payouts, while stock ownership by market investors has a positive association with dividend payouts. Insider investors seem to have a negative relation with dividend payout, contrary to what expected.

Similarly while share ownership by stable investors is associated with lower levels of profitability, share of insider investors is related to higher levels of profitability.

From the results obtained we can conclude that promoters' holding is a major contributor in the firm performance. There is a significant and positive relation between firm performance and promoters holding. Thus, non-promoters holding do not contribute much to the firm performance.

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