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DOES FAMILIAL OR INDIVIDUAL LARGEST SHAREHOLDER DETERIORATE FIRM VALUE?

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ABSTRACT

The main purpose of this study is to examine the expropriating behavior of large shareholders at the cost of minority shareholders. Particularly, the companies that are in early stages of their life cycle may characterize concentrated ownership where owner-managers may make all efforts to increase firm value. Therefore, the paper intends to study the impact of ownership concentration on families or individuals on the corporate performance of listed companies in Sri Lanka. Such block owners can exert control towards corporate management to safeguard their interest. Thus, it is important to determine how such dominating power of large shareholders expropriate corporate resources. Data is collected from companies' annual reports as longitudinal data for seven years from the year 2013. Firm value is proxied by Tobin's Q and ROA. Panel regressions on firm and industry fixed-effects reveal that the presence of the largest familial or individual shareholder deteriorates market-based performance, but not accounting-based performance. Inferior market performance could be due to the fact that concentrated ownership to families or individual could worsen market liquidity. Our results propose that firms with concentrated ownership to families and individuals would not be attractive for growth investors as they expect to earn a higher return through more liquid stocks. However, the negative market outcomes of such large shareholders seem to be mitigated by the presence of one of the big-4 auditors and of an independent board. These findings offer some important policy implications particularly for market regulators such that reconsidering the minimum public holding of firms and strengthening rules and regulations in order to protect the rights of minority shareholders.

Keywords: ***Agency Theory, Corporate Performance, Familial or Individual Largest Shareholder, Sri Lanka***

1. INTRODUCTION

The term corporate governance was first introduced in the 1980s. Owing to major corporate scandals that took place all over the world, good practices of corporate governance were formed in the form of codes. Following corporate scandals, the United Kingdom drafted pioneering codes of best practices in corporate governance. During the late 1980s and early 1990s, a number of major British corporations, including Maxwell Communication Corporation, Pollypeck International, and the Bank of Credit and Commerce International, filed for bankruptcy. Further, bad governance practices directed some other scandals world-wide such as Enron, WorldCom, and Tyco International. Cadbury and Greenbury committees in the UK were the driving forces of the evolution of such corporate governance practices. The reports of respective committees gave recommendations to listed companies on how management is responsible to implement internal governance structure. From time to time, scholars pay attention towards the conflicts of interest between different stakeholder groups. Several corporate governance mechanisms are implemented to solve such conflicts of interest and ultimately, to reduce the associated costs.

Ownership structure plays a vital role in reducing agency conflicts to the extent that corporate monitoring is attached to the ownership. Recent empirical research shows that founding-family ownership is connected with higher corporate performance in terms of both accounting performance and market valuation, when compared to widely-held companies (Anderson and Reeb, 2003; Villalonga and Amit, 2006; Barontini and Caprio, 2006). Berle and Means (1932) discuss that corporate governance is a mechanism of diffusion in the share capital possession of current organizations and has a separate ownership from control, and it is the method by which firms are overseen and regulated.

The arguments of agency theory lie at the heart of mainstream corporate governance frameworks (Berle and Means, 1932; Jensen and Meckling, 1976; Fama and Jensen, 1983). It explains the conflict between inside owners and outside parties of the firm. As per Jensen and Meckling (1976), the model on agency costs and ownership structure plays a key role. And also, even if there is no evident principal-agent relationship, agency costs emerge in any situation that involves a joint effort by two or more persons. The arguments of the agency theory were developed by Demsetz (1983) who concludes that a firm’s ownership structure should be viewed as an endogenous result of actions that reflect shareholder involvement. Accordingly, there should not be a systematic relationship between changes in ownership structure and changes in corporate performance. Large shareholders in concentrated ownership firms hold a significant number of shares in order to increase the value of their holdings (Li, Wang, and Deng, 2008). Alternatively, if large owners utilize their control rights to gain personal gain, performance may decrease (Shleifer and Vishny, 1986). Owners of legal entities are more driven to make profits and have access to information, and also, they may perform better (La Porta, Florencio, and Shleifer, 1999).

Asian economies encounter the typical agency problem between large shareholders and minority shareholders (Claessens and Fan, 2002). Similarly, the ownership structure of Sri Lankan firms is highly concentrated in the hands of a few individuals, families, or corporate groupings who usually enjoy control rights exceeding cash flow rights. Usually, control is exercised in business groups through control pyramids or intermediate private firms (Mapitiya et al., 2015). Nazliben, Renneboog, and Uduwalage (2023) report that large shareholders (share blocks 3% or more) account for 78.80% of equity stake in Sri Lankan firms. Out of which, cumulative equity stake of large block owners (10% or more) stands at 69.08%. Therefore, it can be believed that large shareholders may expropriate corporate resources to maximize their own benefits at the cost of minority shareholders. This can particularly be applicable when large shareholders unnecessarily interfere with managerial actions. This can be more severe when the ownership is concentrated to individuals or families. Particularly, such firms may practice nepotism where relatives or friends are taken into key positions of the firm. In family firms, decision making dominance of family members in the board as well as management team could be characterized. According to Nazliben, Renneboog, and Uduwalage (2023), families and individuals claim 15.09% of total equity of Sri Lankan firms, and a family or an individual is observed as the largest shareholder in approximately 12% of firms.

In Sri Lanka, the empirical literature often focuses on the classical agency problem between managers and shareholders and how it deteriorates corporate performance (e.g. Manawaduge and Zoysa, 2013). This may not be the severe agency problem in the corporate sector as the ownership is highly concentrated. In this research, we strive to implement a novel approach to examine the expropriating behavior of familial and individual large shareholders at the cost of minority shareholders. Therefore, the objective of this study is to examine the impact of ownership concentration on families or individuals on corporate performance. We further examine how this relationship is mediated by big-4 auditors, board independence and board size.

2. LITERATURE REVIEW

Corporate Governance is a global phenomenon that attracts a lot of interest from academics and practitioners alike. A rising amount of research in this area indicates that this new field is gaining relevance, and its development has an impact on various disciplines. Experiencing many corporate failures across the world, "Corporate Governance" came into practice to manage the best interest of all stakeholders, to increase investor confidence, and to strengthen existing internal control mechanisms. Thus, corporate governance and control systems must be effective and efficient in order to mitigate possible expropriations. According to Williamson (1985), the firm's managers should be considered as a control mechanism to ensure that the firm's assets are handled in the best interests of shareholders. Long term value of the firm is, therefore, influenced by the distribution of ownership among different shareholder groups. Nevertheless, separation of ownership and control in the corporate setting often leads to agency problems between managers and shareholders.

Agency Theory

The notions of separation of ownership from control and the agency theory have been the key considerations in investigating the association between ownership composition and firm performance. Berle and Means (1932) first noted an agency conflict between principal and the agent due to the separation of ownership and control. As the agents may strive to maximize their own benefits, rights of the principal may not be protected. Jensen and Meckling (1976) propose agency theory which states that a divergence of interest between managers and shareholders creates an agency cost in modern corporations where managers will tend to act in their own interest, but not always in the interest of shareholders. Shleifer & Vishny (1997) also emphasize that separation of ownership and control is the key to agency conflicts between the providers of capital and those who run the business.

Agency cost comprises three components such as monitoring cost, bonding cost, and residual loss (see Jensen & Meckling, 1976). Monitoring costs are the control costs incurred when limiting the harmful activities of the agent. Bonding cost arises in relation to agent's actions which are beneficial to the principal. When both monitoring costs and bonding costs fail to control the harmful activities of the agent, residual loss incurs. These costs reduce corporate performance (Bozec & Bozec, 2007; Clark & Wójcik, 2005). Jensen & Meckling (1976) argue that the principal can mitigate the divergence of interest between agent and principal by introducing incentive instruments for managers and implementing monitoring procedures towards managerial actions. The approach of Jensen and Meckling has a number of advantages, the most important of which is its generality; agency interactions are all around us. When the firm is a having weaker governance structure, managers act rationally to maximize their own benefits.

To mitigate the self-interested behavior of management, corporate governance practices can be implemented as a governing mechanism that requires delegating the board of directors the monitoring power over management. While corporate managers and shareholders are denoted as agent and principal respectively, board of directors is established as the monitoring body (Mallin, 2004). From time to time, agency theorists contribute to various governance mechanisms by ways of protecting shareholders' interests, minimizing organizational costs, and guaranteeing the companies' capacity to oversee and control their managers.

Ownership Concentration

Empirical evidence on the relation between ownership composition and corporate performance are mixed. If the ownership is concentrated, it reduces the agency cost and provides monitoring incentives. Accordingly, based on such ownership structure, insider owners may have incentives to maximize own benefits, which may ultimately align with increased firm value.

As per Porta et al. (2002), countries with lesser shareholder protection are characterized by concentrated ownership structures, resulting in conflicts between majority shareholders and minorities. Large shareholders in small businesses are willing to integrate personal success and work mission with the success and mission of the corporation (Ciampi, 2015). Berle & Means (1932) state that there is a negative relationship between publicly-held firm's ownership structure and performance. Morck et al. (1988) ignore the endogenous issue and find a non-linear relationship between ownership structure and corporate performance proxied by Tobin's Q.

Results are inconsistent in the literature on the relations between ownership structure and corporate performance due to contextual differences among countries. For example, in emerging economies, corporate ownership is highly concentrated among families or individuals, which has a major positive effect on corporate performance

(Zeitun & Tian, 2007). Loderer & Martin (1997) and Demsetz & Villalonga (2001) find that there is no relationship between ownership structure and corporate performance in U.S. companies.

Individual or Family Ownership

At first glance, founding families appear to be just one of several categories of blockholders. Similar to other large shareholders such as institutional shareholders, financial institutions and other corporate shareholders, families or individual blockholders may have a key interest in mitigating agency conflicts and consequently, boosting corporate performance. Family ownership should particularly be a powerful incentive because many families invest the majority of their own money in the business without diversifying their investment portfolio.

Family businesses may be more successful in terms of creating a work climate assuring trust and loyalty in employees' minds, which can ultimately result in lesser attrition and staffing costs (Ward, 1988). The long-term nature of family shareholdings also suggests that family businesses develop a reputation that influences their relationships with customers and capital providers. Anderson & Reeb (2003) find that family ownership is an effective organizational structure in the USA. In terms of market-based and accounting-based measures, family firms perform better than non-family firms.

On the other hand, family ownership may come with additional expenses and drawbacks. Family shareholders may largely expropriate minority shareholders' rights in order to maximize their own gains rather than the worth of the firm (Faccio et al., 2001). In addition, La Porta et al. (1999) establishes that many nations, including industrialized ones, lack appropriate laws and regulations to control major shareholders' expropriating behavior towards the rights of minority shareholders. In the empirical literature, many studies on founding-family ownership establish that family-owned businesses outperform. Accordingly, familial businesses can perform better than widely-held firms and those with other types of block holders.

3.METHODOLOGY

The sample consists of 130 non-financial firms listed on the Colombo Stock Exchange excluding the financial sector firms due to their different reporting practices and extensive regulatory requirements. Data is collected as longitudinal data for seven years from the year 2013. The panel data window ultimately creates 910 firm-year observations. We consider the largest shareholder as the independent variable of the study, a binary variable that takes the value 1 if the largest shareholder is an individual or family, and 0 otherwise (see table 1). Corporate performance is the dependent variable which is proxied by Tobin's Q and return on assets (Demsetz & Villalonga, 2001; Morck et al., 1988). Tobin's Q has recently garnered a lot of interest as a performance indicator for the future. In order to compute return on assets, we use earnings before interest and taxes (EBIT) scaled by total assets. According to King & Santor (2008), Tobin's Q is a measurement that looks ahead and seeks to reflect how the market values the firm's assets about its book value and the company's potential for future growth.

The ownership structure of the company might interact with other corporate governance mechanisms. Besides, the study uses corporate governance mechanisms such as auditor of the company (dummy variable equals 1 if the auditor belongs to a big-4 audit firm), board size, and board independence (proportion of independent non-executive directors) as interaction terms on the relationship between largest shareholder and corporate performance.

Firm size (natural logarithm of total assets), financial leverage (ratio of the book value of total liabilities to total assets), CEO duality, and firm age can influence corporate performance and they are used as control variables. Table 1 illustrates detailed descriptions of these variables. Results are generated through correlation analysis, and panel regression analysis with interaction terms.

Table 1. Variable Definitions

Variable	Acronym	Measurement
Dependent variables		
Tobin's Q	Tob. Q	(Book value of liability + market value of equity) / Book value of assets
Return on Assets	ROA	Earnings before interest and taxes to total assets
Independent Variables		
Largest Shareholder	Larg. Sha.	Dummy variable equals to 1 if the largest shareholder is a family or an individual, and 0 otherwise
Interaction Variables		
Auditor	Auditor	Dummy variable equals to 1 if the auditor belongs to big-4 audit firm, and 0 otherwise
Board Size	Boar. Siz.	Number of directors on the board
Board Independence	Boar. Ind.	Proportion of independent non-executive directors
Control Variables		
Firm Size	Firm Size	Natural logarithm of total assets
Financial Leverage	Fin. Leve.	Book value of total liabilities to total assets
CEO Duality	CEO Dual.	A dummy variable equals to 1 if the CEO holds board chair position, and 0 otherwise
Firm Age	Firm Age	Natural logarithm of firm age

4. FINDINGS AND DISCUSSION

Table 2 shows that the large shareholder (familial or individual largest shareholder) is present at 8% of occasions in the sample. The audit of more than 90% of firms is carried out by one of the big-4 auditors. Though an average board consists of eight directors, it comprises nearly 40% of independent non-executive directors. Around in one-fourth of firms, the CEO also holds the board chair position. The sample firms are less likely to be financially leveraged (about 35%). Return on assets and Tobin's Q of an average firm amount to 9% and 1.35, respectively.

Table 2. Descriptive Statistics

Variable	Obs.	Mean	S.D.	Min.	Max.
Largest shareholder (dummy)	910	0.081	0.274	0.000	1.000
Big-4 auditor (dummy)	910	0.904	0.294	0.000	1.000
Board size (number)	910	8.047	2.039	3.000	14.000
Board independence (ratio)	910	0.389	0.113	0.111	0.875
Firm size (number)	910	3.089	0.055	2.917	3.217
Financial leverage (ratio)	910	0.355	0.274	0.000	1.774
CEO duality (dummy)	910	0.236	0.236	0.000	1.000
Firm age (number)	910	3.117	0.716	0.000	4.511
Tobin's Q (ratio)	910	1.347	1.598	0.141	19.272
Return on assets (ratio)	910	0.094	0.272	-1.618	4.162

Source: Authors' Own, 2022

Table 3. Correlation Matrix

	1	2	3	4	5	6	7	8	9	10
Larg. Sha.	1.00									
Auditor	0.02	1.00								
Boar. Siz.	0.08	-0.02	1.00							
Boar. Ind.	0.06	-0.07	-0.12	1.00						
Firm Size	0.01	-0.04	0.22	-0.07	1.00					
Fin. Leve.	-0.11	0.20	0.13	-0.14	0.25	1.00				
CEO Dual.	0.07	0.01	-0.01	0.01	0.06	0.15	1.00			
Firm Age	-0.05	-0.10	0.02	-0.03	-0.01	-0.05	-0.15	1.00		
Tobin's Q	-0.06	0.03	-0.06	-0.06	-0.02	0.00	-0.07	0.15	1.00	
ROA	0.08	-0.04	-0.06	0.03	-0.04	-0.03	-0.07	0.06	0.31	1.00

Source: Authors' Own, 2022

In Table 3, we show how familial or individual largest shareholder, and other corporate governance and firm-specific characteristics correlate with corporate performance. While the familial or individual largest shareholder positively relates to accounting performance (ROA), it is negatively related to market-based performance measure (Tobin's Q). It indicates that firms having familial or individual shareholder as the largest shareholder tend to generate higher accounting return but worsen market performance. In terms of accounting performance, an opposite relation is observed on the presence of big-4 auditors. Large boards, boards dominated by a unitary leader as well as large firms seem to deteriorate corporate performance. Mature firms, however, show higher performance than younger ones.

The study uses fixed-effect model to test the impact of concentrated ownership to a family or an individual on corporate performance. The results of Hausman test were used to select the fixed-effect model (χ^2 (5) = 22.68, $p < 0.05$) which was compared with random-effect model. Table 4 exhibits panel regression results against Tobin's Q and return on assets. In models (1) and (2), familial or individual largest shareholder negatively impacts on Tobin's Q, but ROA carries positive insignificant coefficients. In relation to East Asia, Claessens et al. (1999) observe a negative relationship between concentrated control rights and share price valuation. Over all models, large firms generate lower corporate performance while mature firms earn higher market returns (model (2)). Unitary leadership structure deteriorates both market performance (model (2)) as well as accounting return (4)). According to the panel industry and time-fixed effects regression model (model 2), R^2 stands at 11.81%. It indicates that regressors of the model explain 11.81% variation of the response variable; Tobin's Q.

Table 4. Panel Regressions

	Dependent variable			
	Tobin's Q		Return on Assets	
	(1)	(2)	(3)	(4)
Largest shareholder	-0.131	-0.368***	0.023	0.087
	(0.126)	(0.099)	(0.079)	(0.070)
Firm size	-2.902	-3.195*	-0.669	-0.177
	(4.119)	(1.662)	(2.221)	(0.271)
Firm age	-0.574	0.5144***	-0.025	0.017
	(0.478)	(0.119)	(0.050)	(0. 012)
Financial leverage	0.229	0.079	-0.045	-0.033
	(0.283)	(0.211)	(0.084)	(0.027)
CEO duality	-0.024	-0.135*	-0.190	-0.059***
	(0.094)	(0.080)	(0.150)	(0.017)
Constant	11.979	10.607**	2.264	0.645
	(12.563)	(5.280)	(6.798)	(0.844)
Year dummy	yes	yes	yes	yes
Industry dummy	no	yes	no	yes
R^2	0.0113	0.1181	0.0181	0.0627
Prob> F	0.0000	0.0000	0.0000	0.0000
Groups	130	130	130	130
Obs.	960	960	960	960

Source: Authors' Own, 2022

*Notes: ***, **, and * denote statistical significance at 1%, 5%, and 10 levels, respectively.*

Models (1) and (3) report firm and time-fixed effect regressions and Models (2) and (4) belong to industry and time-fixed effects regressions.

In Table 5, we implement a robustness analysis where familial or individual largest shareholder is allowed to interact with some firm and board characteristics. Accordingly, the negative impact of familial or individual largest shareholder on corporate performance disappears in the presence of one of the big-4 auditors (model (1)) and of independent boards (model (4)).

Table 5. Panel Regressions (Interactions)

	Dependent Variable					
	Tob. Q (1)	ROA (2)	Tob. Q (3)	ROA (4)	Tob. Q (5)	ROA (6)
Larg. Sha.	-0.791***	0.006	-0.772**	-0.330*	-0.172	0.319
Auditor	-0.149	-0.057				
Aud. Com.						
Boar. Ind.			-0.550	-0.058		
Boar. Siz.					-0.069**	-0.007**
Larg.Sha. *Auditor	0.353*	0.083				
Larg.Sha.* Boar.Ind.			0.764	0.979*		
Larg. Sha.*Boar.Siz.					0.030	-0.027
Firm Size	-0.164**	-0.007	-0.166**	-0.004	-0.152**	-0.006
Firm Age	0.038***	0.002**	0.037***	0.002**	0.038***	0.002**
Fin. Leve.	0.113	-0.039	0.097	-0.038	0.188	-0.023
CEO Dua.	-0.184	-0.062***	-0.183**	-0.063***	-0.175**	-0.058***
Intercept	5.246	0.330	10.657	0.221	5.262***	0.282
Industry dummy	yes	yes	yes	yes	yes	yes
R^2	0.1650	0.070	0.1654	0.0845	0.1712	0.0734
Prob> F	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
Obs.	910	910	910	910	910	910

Source: Authors' Own, 2022

5. CONCLUSION

This study investigated the impact of ownership concentration on the family or individuals on the corporate performance of a sample of listed firms in Sri Lanka. We conclude that the presence of the largest familial or individual shareholder deteriorates market-based performance, but not accounting-based performance. These results are more valid when we capture industry-wide differences. Inferior market performance could be due to the fact that concentrated ownership to families or individuals could worsen market liquidity. Remarkably, negative market outcomes of such large shareholders seem to be mitigated on the presence of one of the big-4 auditors and of an independent board. We propose that firms with concentrated ownership to families and individuals would not be attractive for growth investors as they expect to earn a higher return through more liquid stocks. The scope of this study is limited to an analysis of ownership concentration disregarding the status of ultimate ownership. Such concentrated owners may also expropriate corporate resources at the cost of minority shareholders, which could be an agenda for future research.

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