Institutional Determinants of Firm Performance: Evidence from Pakistan

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Abstract

Owner structure (OS) is an imperative feature of a firm and firm performance (FP). Recent studies have debated the effect of OS and FP around the world. Studies argue that OS is one of the important factors of decision making since principals expect wealth maximization while agents try to increase their personal gains. However, investor protection (IP) adds to the decision making with regards to OS since IP ensures that shareholders' finds shall not be expropriated and that IP enhances the trust of all stakeholders and help in making informed decision. Based on this premise, we investigate the effect of OS on FP in the presence of IP. Using secondary data from Pakistan's capital market for the years 2008-2015 and applying panel data techniques, we find that not only OS affects FP but the interaction term of IP and OS also has a significant on FP. These results indicate that capital markets in developing countries rely more on OS since it ensures that managers do not expropriate investors' funds and thus make informed decisions.

Key Words: Ownership Structure, Managerial Ownership, Institutional Ownership, Tobin's Q, Leverage

Introduction

Business organizations are made for the purpose to make profits and to increase wealth of shareholders, which depend upon the decision making mechanism of organization. The decision making also affects their capital plan of either they want to go for debt financing or for equity financing (Raji, 2012). Business law and corporate law of many countries describe that stakeholders are owners of a firm who hire managers to act as agents for operation of the firm and thus they expect an increase in shareholders' wealth. Due to business branches and economic

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growth, shareholders' control on the decision making which are reduced practically, because of extent stocks of corporation and a very small number of shareholder, will participate in selecting board members and managing directors. However most of shareholders invest in corporation for profit rather than control (Kedar, 2006).

The controlling and decision making or increasing wealth create problems for organization's performance. The transformation from individual ownership to collective ownership cause difficulties in financial resource management of corporations. A large number companies are not managed by their owners and due to this agent-principal problem, firm's efficiency reduces (Berle & Means, 1932). This creates conflicts between managers and investors called Agency problem (Jensen, 1976). Agency problem postulates that managers try for personal gains at the shareholder's expense. However, to remove the differences, firms usually offer ownership to managers to bring them at par with shareholders. Thus, fiduciary duty of manager requires them to increase the stakeholders' wealth (Meckling, 1976).

Prior literature report that these agents are self-centered rather than protecting their shareholders in increasing their wealth and thus intend to consume their bonuses based on the premise of they being not the co-owners in the firm. Leland and Pyle (1977) report that those managers who own some stakes in a firm use these to indicate that they are running huge project successfully. Under these philosophies, more MO result in higher performance of the firms with such projects (Leland & Pyle, 1977).

The above stated lines show that agency problem has influence on efficiency of corporation but Berle and Means (1932) reported that the structure of owners affects firm's performance. Demsetz (1983) argue that OS is an endogenous determinant of higher profits and the resultantly higher valuation of a firm's shares. Ownership structure is defined as how much a person own a stake and its relative voting rights along the identity of equity owners. Literature argues that OS is important not only for firms' operations but also for the overall institutional and regulatory environment that determine the incentives of the firms' mangers and also its relative performance (Meckling, 1976).

Another strand of literature (e.g., Zhuang, 1999) report that OS is an important element of an effective IP system of a country. Shleifer and Vishney (1997) report that some form concentrated ownership (CO) and IP are the best system to operate a firm as this reduces the agency conflicts. Zhuang (1999) reports two features of OS and argues that the degree of OC in a firm regulates distribution of control power among agents and principals. Studies report that dispersed ownership normally results in weak monitoring of a firm and its management (Zhuang, 1999).

The agency problem, though impossible to be completely eradicated, can be controlled up to certain limit. One of determinants is the institutional ownership (IO) since institutions are an active mechanism of monitoring the performance of the firms (Crutchley et al., 1999). Thus, IO increases monitoring of a firm in a

strong IP environment and hence improve firm performance (Agrwal & Knoeber, 1996). The inadequate outcomes of earlier studies on the IO and FP relationship may stem from irregularity in variable calculation, time periods, model estimation and, in particular, the endogeneity problem of a firm's OS (Villaonga & Domaetz, 2001). Maug (1998) argues that IO determines the investment decisions of the firm based on the size of its ownership. If IO is high, then shares are less traded and are kept as a long term investment. Alternatively, with low shareholdings in a firm, institutions tend to trade their shares on relatively shorter period if firms do not perform. Thus, IO also determines the level of monitoring since the period of holding a stake in a firm motivates institutions to either monitor the performance of the firm on long term basis or short term bases. Prior studies conclude that one of the aim of IO is to maintain liquidity and to increase short term performance and the resultant need for short-term profit compensates management's monitoring with the intention of improving long-term effectiveness (Maug, 1998).

The above literature suggests that OS, IP and FP have been investigated in different context in many of the capital markets of the world with varying degree of results (Demsetz, 1983; Conyon & Thomsen, 2012). These studies have varying results; for example, one strand of research finds that the relation of OS and IP is positively while others report a negative association between OS and FP. One of the main aspects of this strand of literature is the reference to IP and regulatory environment of these countries but there is very little research that investigates the combined effects of OS and IP on FP. This study aims at not only examining the effect of OS and FP but also investigates whether IP in combination with OS affect FP in a country which have Common Law characteristics as per La-Porta et al. (1998). However, in reality, these countries portray the characteristics of code law system having with weak implementation of rules and concentrated and institutional ownership structures.

We have downloaded secondary data from KSE for the period 2008-2015 for 85 firms. The total firm-year observations for the study are 680. The data was downloaded based on the availability and the time period for minimum 5 years. For missing observations, we use median of the available variable. We use OS and IP as independent variables while RoA and Tobin's Q are used as proxies for FP. Using panel data analysis techniques, the study finds that OS positively affects FP in a developing country perspective. Moreover, we find that IP is also positively associated with FP. Using an interaction model OS and IP, the study finds that the interaction effect is also positively associated with FP. We, thus, conclude from these findings that a firms' OS is an important element of operating performance with IO and CO if operating in a developing country tend to require IP as a moderating variable. This confirms the theoretical underpinning of Shleifer and Vishney (1997) who conclude that some of OC (family ownership and/ or IO) along with strong IP is an ideal corporate governance system for firm and thus enhances FP.

The remaining paper is scheduled as follow; section 2 reports literature review; section 3 discusses and reports methodology; results are presented in section 4; while section 5 presents conclusion of the papers.

Literature Review

Owner Structure (OS) is defined as how much stakes a person, company or institution owns in a firm. Based on this perspective OS can be divided into individual stakes (IS), MO, IO and concentrated (CO) and dispersed ownership (DO). Prior literature has reported different argument and results based on different research settings. For example, one strand of literature reports that firms with CO results in better performance (Pedersen, 2000). Others report the opposite. Moreover, another strand report that firms with dispersed ownership perform better provided these firms operate in a stringent regulatory environment. These studies report that firms in strong IP environments are well governed and adheres to the rules and regulations of the countries, thus managers tend to make the best informed decisions that help improve performance of the firm. These arguments are presented in many studies with different strands; e.g., Luez et al (2003) reported that countries with Common Law characteristics provides better protection to its investors and thus managers tend to not indulge in earnings management practices and presents the true value of the firms. They also reported that one of the causes of low EM practices in these countries are the strong monitoring system based on the concentrated ownership structure which oversee the performance of the firms and take actions in case of any deviation from the rules and regulations. Others (Bhattacharya et al., 2001) report that in order to avoid costly litigations, firms do not engage in insiders trading which reduces their cost of capital. But they also report that OS is an important element in reducing insiders trading and they refer the effective monitoring of concentrated ownership. The following paras provide more insights into the different aspects of OS, IP and FP.

Managerial Ownership and Firm Performance

Berle and Mean (1932) initially started the idea of whether OS has any effect on FP. They demonstrate that dispersed ownership structure is affecting firm's performance negatively (Berle & Mean, 1932). They report that Thomsen and Pedersen reveal that an OC positively affect FP. Moreover, they conclude that management play their more actively when there is dispersed ownership (Pedersen, 2000). In addition, Demsetz and Villalonga (2001) reported that MO stands for the *"shares owned by members of the corporate board, the CEO and top management"*. Further, a number of studies show that MO positively affects FP (Haniffa, 2006). Daraghma (2010) reports positive association of MO and

performance. Similarly Morck (1988) has studied US market for the relative effect of OC on operational performance and finds that MO and FP have a positive association.

Shleifer and Vishny (1997) reported that CO increase controlling power of shareholders. Therefore, management engage in productive activities and in turn, it creates advantageous position in term of growth of a company. In addition, Stulz (1988) demonstrates that MO increased their power of internal control and decreased control of external parties. Similarly, MO reported that shareholding power motivate managers and they make efficient investment decisions for their private as well all stakeholders. Hence, it positively affects their firm performance. This is also reported that leverage decision also affects firm performance as repeated in classical corporate financial literature (Modigliani & Miller, 1963). The impact of MO is also investigated by Mande (2003) and he has found that MO positively affects performance. Moreover, it shows that IO positively affect firm's performance. Pounds (1988) studied relationship between IO and firm performance. Mørck et al. (1988) further investigate the association of board structure (BS) and FP and find that BS has a positive effect on FP. They report that when MO increases, the market value of firms is negatively affected and thus has portrayed a decreasing trend. However, others show that agency cost of equity can increase MO in the firm, hence managers show efficiency in their actions to increase their wealth (Jensen & Meckling, 1976). They also reported that MO acts as monitoring tool therefore the performance of firm is increasing. They further conclude that when firms cannot use debt financing then agency problem is reported between management and owners. Further, Pounds reports that institutional investors act to monitor the overall operations of organization and finally conclude that their monitoring either positively or negatively affect the firm's performance.

Institutional Ownership

Alfaraih (2012) investigates Kuwait's capital market for the association of IO and FP. His results show that Kuwaiti listed firms reveal a significant and positive effect of IO on FP. In addition, there are studies which provide contradictory results such as Cornett, Marcus and Tehranian (2007) report that IO and FP, when tested at firm-level, have either a positive or a negative relation with FP. Moreover, McConnell and Servaes (1990) find that performance of the firm increases with IO. Moreover, firms with IO are less profitable as compared to individual ownership (Anderson & Reeb, 2003). In addition, they find curvilinear relationship of IO and performance. However, Pound (1988) reports that institutional investors either positively or negatively affect performance of firms. Furthermore, it is reported that efficient monitoring act of these investors show positive performance

of firms. However, the effect is negative if institutional investors and managers use fiduciary responsibility for their private benefits.

Further, literature reports that IO in developed and emerging economies act as active owners, thus act as active monitoring tool. Finally, their monitoring behavior increases the level of management effectiveness because management utilizes resources efficiently and work with great competency.

Board Size and Firm Performance

Previous literature reveals inconclusive and inconsistent results with respect to the effects of BS on FP and as such are reported that there is either a positive relationship reported or contrary to it a negative effect on FP is presented in these studies. Jensen (1993) reports that small BS increases the performance of firms because large board cannot be easily controlled by CEO and their function is not monitored transparently. However, Hermalin and Weisbach (2001) report that in large board members instead of their basic function engage in symbolic activities. Garg (2007) and Ghosh (2006) find that BS negatively affect firm performance.

Research Methodology

All firms listed on Karachi Stock Exchange (KSE) have been taken as the population of the current study. However, we use filter/ minimum criteria for selecting a company in the sample. The sample period is from 2008-2015. The year 2008 is selected since some of the data for firms earlier to this date was not available. Moreover, a company is counted as a sample observation if the data for all variables are available for minimum five years. For missing observations, we use median of the available data since it is one of the best substitute for a missing observation (we do not use mean since it is affected by extreme values). The sample is limited to 85 companies based on the above convenience sample technique. The total five-year observations for the data are 680. We downloaded data from KSE, State Bank of Pakistan, Companies' Websites, and Open Doors website.

The study uses both univariate and multivariate analyses to empirically examine the association between OS, IP and FP. For univariate analysis, we use descriptive statistics while for multivariate we use both correlation and regression models. The data is secondary and panel in nature. Thus, for the causal association, the study proposes the following generic model:

$$FP = \alpha + \beta_1 OS + \beta_2 IP + \beta_3 OS*IP + \beta_4 CV + e \qquad (1)$$

Here FP is performance of a company and is being represented through RoA and Tobin's Q; OS is ownership structure that is measured through two main variables namely managerial ownership (MO) and institutional ownership (IO); IP

is investor protection and is measured as members in the BoD of a firm; CV are control variables and are proxied by log of total assets; leverage and age of the firm. Tobin's Q is a market performance measure and is normally proxied and measured as total market value of the firm over total book value of firm assets. MO is a FP proxy and is calculated as what percentage of shares are owned by company's managers. IO stands for the shares owned by any institution and is taken from company's financial reports. LEV is how much debt is used in obtaining a firm's assets over the years and is measured as total debt over total assets; size is taken as log of the total assets of the firm while age refers to age of the firm in years.

Results

As explained earlier in the paper, we empirically examine the association and test the causal relationship of OS, IP and FP in the context of a capital market of Pakistan. This section presents results of the study and refers to analyses based on descriptive statistics, correlation and finally the causal association is presented through regression model specifically panel data analysis.

Descriptive Statistics

Table 1 presents data characteristics in the form of univariate analysis i.e. descriptive statistics of the data comprising mean, median, standard deviation, minimum and maximum values, and normality and peakedness (skewness and kurtosis) of both dependent and independent variables. The results show that overall, most of the firms are performing well in the market which is evident from RoA being an accounting performance measures while the market based performance measures show a negative value showing that the Pakistan's capital market is not performing well based on the above measure reported but individual firms are producing positive results. The dependent variables' skewness and kurtosis values indicate normality of the data. Regarding independent variables of MO, IO and IP, all these variables show that these tend to be normal based on their overall descriptive values.

The values of OS show that companies are more concentrated in Pakistan. Earlier literature reports that firms with Common Law characteristics shall present dispersed ownership and have a strong IP base. However, as is evident, firms in Pakistan are mostly concentrated and have more family ownership than reported in the extant literature. These results are in contrast to the views presented in the ground-breaking paper of La-porta et al. (1998) who show that Common Law Countries are more dispersed and provides better IP to its shareholders.

Table 1: Descriptive Statistics of FP, OS, IP, Size and Age

Variables	Mean	Med	St. Dev	Min.	Max.	Skew.	Kurt.
RoA	2.33	3.11	2.23	-4.34	16.45	2.34	2.86
TQ	-0.80	-0.51	1.58	-4.23	2.95	-1.17	-2.11
MO	15.76	0.49	19.98	0.00	65.30	1.15	-0.02
IO	56.91	80.53	36.87	0.51	95.70	-0.27	-1.75
IP	4.55	5.99	2.31	6	17	2.88	-1.99
LTA	22.57	23.20	1.34	19.86	24.64	-0.76	-0.45
Lev	21.76	22.38	1.49	16.36	23.70	-1.34	2.12
Age	7.23	8.87	2.45	4.00	25.00	2.98	3.12

RoA and TQ are dependent variables while MO is managerial and IO is institutional ownership. LTA is size of the firm; Lev is leverage and age of the firms represents controls the presence in the capital market.

Correlation

Table 2 presents correlation results. The correlation shows that both TQ and RoA are proxies of firm performance since both variables have a high correlation. Relating dependent and independent variables, all the correlation among them is theoretically correct as in the context of Pakistan, firms portray an ownership that is in line with developing countries structures.

Table 2: Correlation Statistics of FP, OS, IP and Control Variables

Variables	RoA	TQ	MO	IO	IP	LTA	Lev.
TQ	0.35*						
MO	0.23**	-0.24**					
IO	0.32**	0.36*	0.52***				
IP	0.27***	0.12.*	-0.16*	-0.21**			
LTA	0.41**	0.32*	-0.76***	0.835**	0.32*		
Lev	-0.23	0.03	-0.42***	0.483**	-0.22*	0.66***	
Age	0.18*	-0.11	0.22*	0.33***	0.27**	0.41*	0.09**

***, **, * represent significance levels.

RoA and TQ are dependent variables while MO is managerial and IO is institutional ownership. LTA is size of the firm; Lev is leverage and age of the firms represents controls the presence in the capital market.

For example, MO is correlated with FP and this association is statistically

significant. Firms in emerging economies and developing economies, portray and present managerial, familial and institutional ownership which is clear from the correlation table.

Regression Results

To provide empirical evidence, we investigate the causal relationship of OS, IP and FP. Firms in Pakistan are concentrated, and family owned and thus portray a Civil Law Characteristics. Moreover, IP is weak and limited to a certain limit and thus needs further investigation. Next table presents results of Panel data regression. However, the panel nature of the data requires us to determine which of the panel data techniques need to be applied on the available data. Thus, we run diagnostic tests on the data to determine the nature of model to be used for this causal association. Following table presents the results of Hauman Test. The diagnostic test result indicates that Random Effect Model (RE Model) is the suitable technique for examining the association of OS, IP and FP.

Table 3: Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	33.54	5	0.90

Table 4 Panel A presents results of RE model for RoA. Results show that firms with both managerial and institutional ownership perform well in the market. OS and IO are both positively associated with FP and that, as per significance, both these associations are significant. The results reported here are in line with earlier literature of OS and FP wherein it has been reported that both are positively associated. These results indicate that firms where managers are also the owners, they tend to make informed decisions in the shareholders' interest thus improving firm performance. Moreover, firms with IO tend to perform better since IO monitor the performance of the firm more than individual owners and firms do not get free rider environment.

Moreover, results for IP and FP are positive and significant. These results indicate that firms that operate in strong IP environments better perform based on them being well governed as they follow all the regulations of the country as well as regulatory bodies. For example, firms have audit committees, internal audit system, properly disclose accounting information and have a high accounting and audit quality. Since these governing rules and regulations are to protect investors as well make sure that everyone in the firm adhere to these result in high performance of these firms.

Table 4: Random Effect Model of RoA and TQ with FP, OS, IP and Control Variables

Panel A:		RoA		Panel B:	Tobin's Q		
Variables	Coef	t-value	p-value	Coef	t-value	p-value
Constant	-1.33	-0.76	0.451	0.33	-1.76	0.088
MO	0.026	4.94	0.000	0.13	3.21	0.000
IO	0.012	3.31	0.000	0.09	2.97	0.003
IP	0.023	6.12	0.000	0.05	4.32	0.000
MO*IP	0.32	7.22	0.000	0.53	5.22	0.000
IO*IP	0.12	2.11	0.080	0.22	2.00	0.090
LEV	-0.336	-1.72	0.092	-0.14	-1.82	0.082
TA	0.457	1.28	0.207	0.46	2.28	0.076
Adjusted R^2		34.22%		Adjusted R^2		41.22%
F-statistics		123.64***		F-statistics		103.64***

*, **, *** represents 1%, 5% and 10% level of significance, respectively.

RoA and TQ are dependent variables while MO is managerial and IO is institutional ownership. LTA is size of the firm; Lev is leverage and age of the firms represents controls the presence in the capital market.

Shleifer and Vishney (1997) report that firms with some kind of ownership concentration and investor protection is the best CG structure of a firm. Based on this theoretical underpinning, this study investigates whether firms with MO and IO perform better in the presence of a determinants of CG; i.e. BoD. We use interaction term of MO and IP, and IO and IP to determine whether the above premise holds true in the case of Pakistan. Both the interaction effects (MO & IP and IO & IP) have a significant positive association with FP. These results confirm Shleifer and Vishney (1997) conclusion of OS and IP as the best ingredients for FP.

Since CO and IP both provide a strong monitoring system for the firm's managers to oversee their investment and other decisions of the company. Panel B reports results for the dependent variable Tobin's Q with MO, IO, IP and their combined effect. All the results hold true and are statistically similar to those of RoA confirming the results of not only prior literature but also the other performance measure of RoA. Both models are statistically significant as is evident from the F-statistics and their respective p-values. Moreover, adjusted R-squared are somewhere in the close range confirming all the results and presumption of this

study. Concluding, these results indicate firms in Pakistan are somewhat owned by either institutions or family owned. These firms also have managerial stakes which is a tool used to avoid the expropriation of the management and thus reduces the agency issues of separation of ownership and control bringing managers at par with owners for such decisions which not only benefit the firm but also shareholders as well as managers.

Conclusion

This study empirically provides evidence on the relationship of OS and IP with FP. Based on the theory that OS and IP affect firm performance since both provide a strong oversight of the firm. OS is the stakes of a person or family or institution with voting rights. OS in this paper is limited to the use of MO and IO. IP is represented by BoD while FP is measured and represented through both accounting based performance measure (RoA) as well as market based performance measure (Tobin's Q). We use secondary data from KSE for the period 2008-2015 for 85 firms (680 firm-year observations). Data is panel in nature and are downloaded from Companies' websites, KSE, SBP and Open Doors website. We use FP (RoA and Tobin's Q) as dependent variable and MO, IO and IP as independent variables. We also control firm size, leverage and age of firm. Using diagnostic test (Hausman), results show that RE Model is the appropriate and suitable model for data analyses. Results of the RE Model show that firm with both MO and IO perform better in the market both in terms of accounting performance as well as market based performance measures. Moreover, strong IP is also a determinant of high performance.

Based on the theory that IO and IP are best monitoring mechanism, we investigate the combined effect of MO, IO and IP on FP. Results confirm the hypotheses that firms with MO perform well in the presence of an IP system. Further, IO and IP also have a strong combined effect of FP. These results indicate that firms in developing countries require an efficient monitoring system for better performance. Our study adds to both accounting and CG/IP systems in many ways. First, we present an empirical evidence on the OS and FP on larger data scale and confirm the earlier results of the extant literature.

Second, we present evidence in the context of a developing country and present evidence contrary to La-porta et al. (1998) that Pakistan was a UK Colony before its independence and thus has been declared as is a Common Law country which shall portray dispersed ownership, strong IP and shall have a developed market. However, this study presents evidence contrary to the above findings since many of the companies have IO and/or family ownerships ranging upto 65%. These results though confirm the conclusions provide by Shleifer and Vishney (1997) that firms need to have some form of CO and IP to perform well in the market. Future research may include both family ownership and dispersed

ownership to determine the differences and investigate its respective effect on FP. Moreover, this study used a single factor of IP/CG system while future research may include multiple facets of IP system to empirically determine whether IP is still a FP determinant.

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