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Financial centers and ownership concentration: When is ownership concentration value relevant? Evidence from an emerging market

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ABSTRACT

Does the location of a firm's headquarter effect ownership concentration? Do stock market participants value ownership concentration differently for firms located at different geographic locations? Using data from India, this paper shows that firms headquartered in Mumbai, the main financial center of a country, have lower ownership concentration than firms headquartered elsewhere. We argue that clustering of firms in the financial center reduce information asymmetries and lower the incentives for concentrated ownership. Our results also show that as the extent of analyst following increase, the difference between ownership concentration of firms headquartered in Mumbai and firms headquartered elsewhere goes up. We argue that higher analyst coverage reduces information asymmetries quicker for firms headquartered in the financial center and results in larger difference between the two groups. In addition, we also show that ownership concentration is value relevant only for firms headquartered in the non-financial centers. We show no relationship between ownership concentration and firm performance and valuation in the financial centers. This paper provides evidence that location of a firm's headquarter in the financial center can significantly alter its information environment. Reduced information asymmetries lower the incentives for concentrated ownership in the financial centers.

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1. Introduction

Why do certain firms have higher ownership concentration than the others? Does the extent of ownership concentration always signal the amount of information asymmetries in firms? Given the separation between ownership and control, when is ownership concentration related to agency problems and when is it not related to agency conflicts? The answers to above questions have formed the basis for plentiful of previous literature (Mitton, 2002; Claessens and Fan, 2002).[1] Most of this literature revolves around understanding how firm-specific and country-specific characteristics affect incentives to have concentrated ownership and how do these incentives lead to positive/negative firm performance. Dharwadkar et al. (2000),

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[1] Given the separation between ownership and control, ownership concentration can be considered as a tool to reduce agency conflicts between managers and owners. Ownership concentration would, therefore, be considered as value enhancing mechanism. However, ownership concentration results in agency conflict between controlling shareholder and minority shareholders. Therefore, it may be considered as value destroying mechanism. Without documenting the performance, it is hard to find whether ownership concentration is good or bad.

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for example, highlight importance of country-specific factors by showing that weakness in investor protection mechanisms translate into concentrated ownership structures in emerging markets, while Demsetz and Lehn (1985) document importance of firm-specific by identifying that larger firms are less likely to have concentrated ownership than smaller firms. An important factor that has been overlooked in the prior literature is how a location of firm's head office within a country affects ownership concentration. This paper is an attempt to fill this gap by documenting the relationship between the two. We would like to stress here that this paper is not about the location decision. It is about firms which are located in Mumbai look like regardless of when and why they chose to be located there.

This paper argues that one of the channels via which location of a firm's head office affects ownership concentration is its ability to improve firm's information environment. Using a large dataset from India, we documents significant clustering of Indian firms in Mumbai, the main financial center of a country, during the period between 2001 and 2013. Our data shows that almost one third of Indian firms are headquartered in Mumbai. We argue that clustering of firms in one geographic location attract significant interest from stock market participants. We posit that clustering of firms in the financial center reduces cost of information acquisition for stock market participants and lead to better information of these firms relative to firms headquartered elsewhere. One implication of better information environment of firms headquartered in the financial center relative to firms headquartered elsewhere is that it lowers the incentives for concentrated ownership. Firms with better information environment, i.e. firms headquartered in the financial centers, have lower information asymmetries. Therefore, there is lower need on part of investor/shareholder to amass ownership for the purpose of monitoring. On the other hand, lower information asymmetries also reduce the ability of controlling shareholder to expropriate resources out of firm. As a result, there will be lower ownership concentration in firms headquartered in the financial center. Consistent with our expectation, we show that there is almost a difference of 3 percentage points in the ownership concentration between the two groups, i.e. firms headquartered in the financial center and firms headquartered elsewhere.

In addition, we also show that the relationship between ownership concentration and location of firms' headquarters is an increasing function of analyst following. We show that difference in ownership concentration is insignificant 1.0692% for a sample of firms with less than five analysts following them, 3.1095% for a sample of firms with analyst coverage of between five and ten analysts, and 10.1496% for a sample of firms with analyst coverage of at least ten analysts. These results show that as the analyst following increase, the information asymmetries are resolved faster for firms with headquarters in the financial center. As a result, the incentives to have ownership concentration in these firms also diminish, thereby causing higher difference in ownership concentration between firms headquartered in the financial center and firms headquartered elsewhere.

An important implication of our findings is that ownership concentration should not be value relevant for firms headquartered in the financial centers. Since, incentives to have ownership concentration for the sake of monitoring or expropriation are lower in the financial centers, the impact of ownership concentration on firm performance or valuation are also lower for firms headquartered in the financial centers. Our results show no relationship between ownership concentration and firm performance (as measured by returns and return on equity) for firms headquartered in the financial center. Expectedly, these results become significant for firms headquartered in the non-financial centers. Our results show that ownership concentration is value relevant only for firms headquartered in the non-financial centers. We show that a significantly positive relationship exist between ownership concentration and firm performance (as measured by returns and return on equity).

Our results advocate superior information environment for firms headquartered in the financial center of a country relative to firms headquartered elsewhere. We believe that our results have implications for investors and regulators. Investors, especially foreign investors, can avoid some of the genuine unknowns by investing in firms headquartered in the financial centers. Similarly, regulators may put most of their efforts to scrutinize firms headquartered in the smaller cites. Firms headquartered in the smaller cities have more information asymmetries and thus are more prone to agency problems.

The remainder of the paper is structured as follows: Section 2 briefly discusses motivation and background for this study. Section 3 summarizes the data used in this study and Section 4 presents assessment of our hypothesis. The paper ends with Section 5 where we present conclusions.

2. Motivation and background

Why some firms have lower ownership concentration than the others? What are the factors that result in high/low ownership concentration? Given the importance of ownership concentration for corporate governance, these questions have attracted significant interest in the prior literature. Claessens et al. (1999), for example, document that ownership concentration diminishes with the level of country's economic development. While, Black and Gilson (1998) argue that younger firms are more likely to have concentrated ownership than older firms. A casual look at the prior literature suggests that it focuses on how firm-specific or country-specific factors affect ownership concentration. An important factor that has been overlooked in prior literature is the location of a firm's head office within a country. This paper aims to fill this gap by documenting why a firm headquartered in a certain location has higher/lower ownership concentration than a firm headquartered in certain other location.

Anecdotal evidence suggests that emerging market firms are, generally, clustered in and around the main financial center of a country. Farooq and El Ouadrhiri (2014), for instance, show that almost 30% of Indian firms are headquartered in Mumbai, the biggest financial center of the country. This paper argues that clustering of firms in one geographic location (financial center in our case) can have significant implications for the information environment of firms. Clustering of firms

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