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# Institutional investor heterogeneity and firm valuation: Evidence from Latin America

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ABSTRACT

This article analyses how the corporate valuation of Latin American firms is affected by the presence of a blockholder institutional investor. The study uses a data set of 562 firms from six Latin American countries for the 1997–2011 period. We found that the presence of an institutional investor has a positive effect of 8% on firm value, which increases to 21% for the cases where there is blockholder coalition with an institutional investor. After dividing the sample by investor type, we found that independent institutional ownership implies a positive premium on firms' Tobin's Q, while the presence of a grey investor has a negative effect on firm valuation.

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## 1. Introduction

Over the two last decades, the number of institutional investors has grown substantially in developed economies such as Canada, the United States and the United Kingdom, to the pint that they now control more than half of the corporate property (Aggarwal et al., 2011). Chong and Lopez-de-Silanes (2007) found that as the presence of large and multiple institutional investors in Latin America became widespread, so did the need for better corporate governance in firms and better investor protection standards in countries. According to the International Monetary Fund, institutional investors from around the world manage financial assets in excess of US$ 45 trillion (International Monetary Fund, 2005).

In Latin America, institutional investors currently manage considerable financial assets and have a real opportunity to influence the development of the region's capital markets (Blume and Alonso, 2007). Pension funds in particular have accumulated significant assets in the Latin American countries in which they have

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been established: Brazil and Chile account for approximately 80% of all pension assets in the region (OECD, 2000). They are also potentially the most powerful group of domestic investors with an interest in good corporate governance (OECD, 2011).

Studies regarding the role of institutional investors in shaping firms' corporate governance have focused on the case of the US and the role of mutual funds voting. According to Claessens and Yurtoglu (2013), studies on the role of institutional investors in discipline management in emerging markets are scarce and there is no solid evidence on their behavior. Many studies address blockholders' issues but they almost exclusively cover only North America and Europe. This study focuses on Latin America; a market with structural ownership concentration, a deepened capital market, and rising institutional ownership over the past two decades. For instance, some countries in the region have been pioneering pension fund reforms since the late 1980s, leading to the consolidation of dual regimes – individual savings capitalization and pay-as-you-go funding as in Chile, Colombia, and Peru – and he mutual fund industry; Brazil being one of the largest in the world today.

The presence of institutional investors in Latin American corporations has grown steadily since the 1990s. The data collected in this study show that in 1997, 97 out of 358 publicly owned real-sector firms had an institutional investor as the largest shareholder with average equity rights of 37%. Four of these shareholders were pension fund administrators. By 2011, this number had risen to 151 out of 496 listed firms, with average equity rights of 49%. In 12 firms, pension funds showed up as the largest blockholder, whereas second blockholders were mainly institutional investors. In 1997, 120 out of 316 listed real-sector firms had an institutional investor as their second blockholder. By 2011, this number had increased to 171 out 408 firms with multiple blockholders recorded. Their equity rights remained constant at 13%. In the same year, 25 pension funds showed up as the second largest shareholder.

These numbers suggest that the opportunity for institutional investors to contest control is important in direct monitoring (voice mechanism) in the region. Conversely, we might expect intervention through trading to be a less credible strategy for institutional investors due to natural liquidity constraints in emerging capital markets such as Latin America.

Both performance and firm valuation factors are seen as being dependent on ownership structure and control mechanisms (Sahut and Gharbi, 2010; Klapper and Love, 2004). Endogeneity is a first order issue when testing the relationship between institutional ownership and firm value. Institutional investors tend to prefer larger firms, firms with less concentrated ownership, firms that are better governed, multinational firms, US cross-listed firms, or firms that pay higher dividends. For instance, the significant and positive relationship found in this study for independent investors may be related to institutional investors choosing more highly valued firms. In this sense, firm valuation and institutional ownership may be jointly determined. We tackle the potential simultaneity bias by means of instrumental variables estimations and setting a system of simultaneous equations for ownership and firm valuation using three-stage least squares.

The aim of this study is therefore to ask whether institutional investors have had a positive influence on firm valuation across larger real-sector firms in the region. The study seeks to make a three-fold contribution to the empirical literature on corporate governance in emerging markets. First, this is one of the first papers that tests institutional shareholder monitoring across larger Latin American corporations. Results show that when this type of blockholder is involved, firms' Tobin's Q ratio increases by 8%. This premium is lower than it is in the United States; however, it confirms the fact that institutional investors diminish agency conflicts between blockholders and minority investors. Second, we look at the effect that independent (investment firms) versus grey institutional investors (pension funds and insurance companies) may have on firm valuation as one source of investor heterogeneity. Our results show that those effects are not homogeneous for these types of institutional investors. In particular, in contrast to what has normally been observed for developed capital markets, the overall effect of grey investors is negative. The explanation for this finding is that grey investors still face several constraints caused by a deepening capital market, and financial regulations that restrict equity investment in their portfolio structures. Chile provides the empirical test that proves this argument. Value regressions for Chilean firms show that grey investors have a positive effect on firm performance. In Chile, financial regulation allows higher caps for equity investments and the private pension industry started 10 years before that of any other country in Latin America.

Third, we used an improved and more accurate method to empirically model the behavior of institutional blockholder investors, by measuring their Shapley coalitional value. Studies on blockholders and ownership structure highlight that coalitions across large shareholders increase firm cash flow diversion and tunneling.

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