



# Does control-ownership disparity matter to foreign investors in Korea?☆



Youkyoung Lee, Myeonghyeon Cho \*

Korea University Business School, Korea University, 145, Anam-ro, Seongbuk-gu, Seoul, Republic of Korea

## ARTICLE INFO

### Article history:

Received 30 December 2012

Received in revised form 14 April 2016

Accepted 18 April 2016

Available online 22 April 2016

### JEL classification:

G32

G34

F21

### Keywords:

Foreign portfolio investors

Foreign strategic investors

Corporate governance

Control-ownership disparity

## ABSTRACT

This study examines the effect of control-ownership disparity on foreign investors investing in Korean firms. Control-ownership disparity occurs when certain shareholders of a firm have actual voting power that exceeds the corresponding equity ownership. This may matter to foreign investors because the disparity gives rise to the risk of tunneling by the controlling shareholders. The empirical results show that foreign investors prefer firms with low control-ownership disparity, suggesting that they are sensitive to corporate governance of firms they invest in. More interestingly, foreign portfolio investors are more sensitive to control-ownership disparity than foreign strategic investors who are usually corporations in related industries. Further, the control-ownership disparity has stronger negative effects on foreign portfolio investors when they invest in Chaebol-affiliated firms than non-Chaebol firms.

© 2016 Elsevier Inc. All rights reserved.

## 1. Introduction and motivation

Foreign investors have a significant influence on the Korean stock market. Choi (2010) reported that, as of 2009, foreign investors held the listed shares of 683 companies (i.e., 96.1% of all 711 listed companies), accounting for 31.9% of the total market value of listed companies. In addition, 76 listed companies were more than 30% foreign-owned as of January 2011. The number of foreign investors in Korean firms has been continuously increasing due to deregulation and relaxing of the rules on foreign investment since the Asian financial crisis in 1998. Previous studies show that foreign investors prefer firms with large size, low debt ratio, high liquidity, and strong profitability (Dahlquist & Robertsson, 2001; Liljeblom & Loflund, 2005).

In the literature on foreign investment, it is customary to treat foreign investors homogeneous. Few studies have investigated whether differences across foreign investors in terms of their nature (i.e., portfolio investor vs. strategic corporate investor) affect their investment patterns in Korean firms. Wu, Shen, and Lu (2015) show that more foreign strategic investor enhances earnings smoothing and that this effect is stronger for banks with foreign strategic investors, using Chinese bank data. Foreign portfolio investors are typically institutional investors who invest in Korean firms for capital gains such as Fidelity or Vanguard Funds. On the other hand, foreign strategic investors are usually foreign corporations which invest in Korean firms in related industries for strategic cooperation purposes. For instance, Philips' investment in LG Display in 1998 to establish a stable supply chain for its flat display panel TV would be a case for investment by a foreign corporation for strategic reasons.

☆ This paper is a continued work to the Ph.D. dissertation of Lee, Youkyoung.

\* Corresponding author.

E-mail addresses: [artisee@korea.ac.kr](mailto:artisee@korea.ac.kr) (Y. Lee), [chom@korea.ac.kr](mailto:chom@korea.ac.kr) (M. Cho).

Brickley, Lease, and Smith (1988) establish that some investors might want to protect existing or potential business relationships with firms and are therefore less willing to challenge management decisions. Therefore, it would be interesting to examine whether foreign strategic corporate investors, who usually have strong business ties with the firm in which they invest, show investment patterns different from foreign portfolio investors who usually do not have such strong business ties. Regardless of their type, foreign investors face a major risk of losing money to the expropriation of assets by controlling shareholders of a local firm in which they invest. This risk is especially high when the controlling shareholders own a small portion of the firm because the incentive to tunnel out firm assets for private benefit is strong when control-ownership disparity is large (Kim, Kim, Kim, & Byun, 2010). Control-ownership disparity refers to the difference between cash flow rights and control rights. Large control-ownership disparity indicates that controlling shareholders can effectively exercise voting rights beyond their contributed equity. Therefore, control-ownership disparity may matter to foreign investors because the disparity gives rise to the risk of tunneling by the controlling shareholders. Despite their relatively low ownership, it is documented that Korean conglomerate business groups, so called Chaebols, exercise their excessive voting powers through their affiliated companies due to a high level of control-ownership disparity (Jin & Song, 2003). The Korean Fair Trade Commissions pays strong attention to the control-ownership disparity of Chaebol-affiliated firms because of potential risk of expropriation of assets by controlling shareholders.

Separation of ownership and control exist in many countries around the world (Cronqvist & Nilsson, 2003; Franks & Mayer, 2001; Kuan, Li, & Liu, 2012; La Porta, Lopez-de-Silanes, & Shleifer, 1999). Claessens, Djankov, and Lang (2000) find that the divergence of ownership and control is prevalent in East Asia and it has often been implemented through pyramidal shareholding. Discrepancy between ownership rights and control rights is usually made through pyramidal shareholding structure or cross-shareholding (Bebchuk, Kraakman, & Triantis, 2000). In particular, pyramidal shareholding has played a key role in the formation of control-ownership disparity in Korea. The pyramidal ownership structure in Korea has developed as a result of the controlling shareholders' attempts to expand their businesses by utilizing capital from affiliated firms instead of injecting their own money. This is consistent with the argument by Almeida and Wolfenzol (2006) who have shown that controlling shareholders create pyramids because such structures provide a financing advantage in setting up new firms and businesses when the pledgeability of cash flows to outside financiers is limited.

This pyramidal structure has allowed controlling shareholders to maintain their control over newly expanded businesses with a small percentage of ownership which, in turn, has resulted in control-ownership disparity. Under the pyramidal ownership structure, controlling shareholders have incentives to increase their wealth by expropriating other shareholders' wealth through tunneling among affiliated firms. That is, controlling shareholders would have incentives to transfer wealth from affiliated firms with a large control-ownership disparity to those in which they hold high ownership rights and, especially, to privately held affiliated firms. This tunneling phenomenon in large Korean business group, so called Chaebol, has been documented in previous studies (i.e., Joh, 2003).

This raises some interesting questions. Would corporate governance matter for foreign investors when they invest in Korean firms, particularly in view of certain practices such as pyramidal and family management which could be risk factors? If so, would portfolio investors and strategic investors perceive the risk associated with the corporate governance differently and display different investment patterns? Further, would foreign investors disfavor Chaebol firms in which the controlling shareholders tend to have more opportunities of expropriation?

If bad corporate governance carries a risk that is not fully reflected in the share price, then investors should prefer firms with good governance. Several studies indeed find that investors do invest more in better governed firms (Ahearne, Grier, & Warnock, 2004; O'Connor, Kinsellar, & O'Sullivan, 2014). Kim et al. (2010) find that foreign investors own more equity in Korean firms with foreign outside directors in their board, arguing that foreign directors would be more independent. It is thus likely that foreign investors should prefer good governance regardless of whether they are portfolio investors or strategic corporate investors. In addition, foreign investors may rely more on effective corporate governance than local minority shareholders because monitoring corporate management is more difficult for them due to the physical distance between investors and firms (Bushman, Chen, Engel, & Smith, 2004; Brennan & Cao, 1997; Klapper & Love, 2004; La Porta et al., 1999).

On the other hand, if the share price fully reflects the possibility of being expropriated, concerns about risk and return alone cannot justify the preference for good governance documented in the literature (Kim, Sung, & Wei, 2011). In this case, we may need an alternative explanation. A possible explanation would be one by Brickley et al. (1988) who argue that some types of investors might want to protect existing or potential business relationships with firms through investment and are, therefore, less willing to challenge management decisions. Since strategic corporate investors are the ones who invest in Korean firms to strengthen current or future strategic business relations, we may hypothesize that preference for good governance is weaker for strategic corporate investors. The 'familiarity bias' would be another explanation. The familiarity bias usually refers to investors favoring firms in geographically or culturally close countries (Grinblatt & Keloharju, 2001; Huberman, 2001). A strand of research in behavioral finance shows that physical distance, linguistic similarity, and volume of bilateral phone calls appear to be determinants of bilateral capital flows. If we extend this to characteristics of corporate governance, the preference for good governance may be weaker for strategic corporate investors, who are usually familiar with the firms they invest in. Therefore, the nature of investors may matter. Kim et al. (2011) show that foreign investors from countries of good corporate governance disfavor bad corporate governance stocks, suggesting that familiarity bias exists.

This paper, thus, investigates whether the type of foreign investors (portfolio vs. strategic) affect their investment patterns with regard to control-ownership disparity. Existing studies have examined the behavior of average foreign investors with regard to corporate governance of the firms in which they invest. Some have found that foreign investors hold fewer shares in firms with

Download English Version:

<https://daneshyari.com/en/article/5083315>

Download Persian Version:

<https://daneshyari.com/article/5083315>

[Daneshyari.com](https://daneshyari.com)