



Diversification and tunneling: Evidence from Indian business groups

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ABSTRACT

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We provide evidence suggesting an important yet largely unexplored motive for the diversified structure of emerging economy business groups is to facilitate expropriation of minority shareholders by controlling insiders through tunneling. Using firm level panel data from India, and defining the core firm of a group as the one with the largest asset base, we find that the relatedness of the activity of a group affiliate to the activity of the core firm is correlated with the wedge between control and cash flow rights of insiders as well as with the opacity in insider ownership. Firms with ownership-control wedge lower and ownership opacity higher relative to a group's core firm are more likely to be in activities unrelated to that of the core firm. Our findings are strengthened by evidence of tunneling in the same direction, from affiliates with wedge equal to or higher than that of the core firm to affiliates with wedge lower than that of the core firm. Taken together this suggests an expropriation motive for diversification: affiliate firms are located away from a business group's core firm to serve as destination points for funds tunneled from the group's core. *Journal of Comparative Economics* 39 (3) (2011) 349–367. Sam M. Walton College of Business, University of Arkansas, AR 72701, USA; HEC Montréal, 3000, chemin de la Côte-Sainte-Catherine, Montréal (Québec) H3T 2A7 Canada; Indira Gandhi Institute of Development Research, Gen. Vaidya Marg, Goregaon (E), Mumbai 400 065, India.

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1. Introduction

Business groups are a prominent feature of the organizational landscape of many emerging economies. Such groups dominate private-sector industrial activity in economies such as Brazil, Chile, Hong Kong, India, Indonesia, Malaysia, Pakistan, South Africa, South Korea and Taiwan, among others. A striking characteristic of these entities is their diversification across disparate industries. Despite the well-known costs of diversification, why are they so widely diversified? Based on a study of diversified business groups in India, we provide evidence suggesting an important, yet largely unexplored motive for the diversified structure of emerging economy business groups is to facilitate expropriation of minority shareholders by controlling shareholders through tunneling.

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Minority shareholder expropriation through tunneling usually takes place in business groups with pyramidal structures through intra-group transfer of resources from affiliates where the wedge between control and cash flow rights of controlling shareholders is higher to affiliates where this wedge is lower. Since tunneling is by definition clandestine, controlling shareholders have incentives to make it difficult for outside investors to detect expropriation. A business group within the same industry is arguably easier for investors and minority shareholders to scrutinize than one that is created through a network of firms in disparate industries, i.e., through unrelated diversification (Dewenter et al., 2001). Such diversification can make it difficult for outside investors to decipher the activities of the business group and thus facilitate tunneling. It therefore seems logical to ask: is the diversified structure of a business group driven by the motive of controlling shareholders to engage in the covert expropriation of minority shareholders?

The potential link between tunneling incentives inherent in business group ownership structure and the strategy of unrelated diversification pursued by such groups is underscored by anecdotal and empirical evidence pertaining to expropriation in diversified business groups. However, as Delios and Ma (2010) in their review of diversification strategy of business groups in emerging economies have pointed out, while ownership issues have become a strong area of research in the context of these economies, there has been little research on how variance in ownership and control structures across business groups can influence diversification strategy and performance of groups and their affiliates.¹ In this paper, we provide insight into this issue by focusing on how expropriation (tunneling) incentives in-built in pyramidal group structures of business groups determine the extent of group diversification into unrelated activities.

Our paper also contributes to the understanding of the motives behind business group diversification in emerging economies and the costs of group affiliation. While a body of literature exists on the performance effects of business group diversification, the findings of which are largely ambiguous (Peng and Delios, 2006; Khanna and Yafeh, 2007), there is not much by way of systematic evidence on the determinants of business group diversification in these economies that is comparable in scope to large sample empirical studies on the motives of conglomerate diversification in developed countries. As Hill and Hansen (1991) remark, performance effects of diversification cannot be understood well without understanding the original motives or causes of diversification. The uniqueness of business groups as an organizational entity and the institutions in which they are embedded in emerging economies are in more ways than one distinct from those of conglomerates in developed countries. As a result, findings in the context of the latter may not necessarily be applicable to the former.

To establish the link between diversification and tunneling, we conduct two sets of empirical analyses on a sample of 2128 group-affiliated firms for four consecutive years, 2002–2006. First, we empirically estimate the extent to which a business group's decision to diversify away from its core activity depends on its incentive to tunnel as proxied by two key indicators related to the ownership structure of a firm namely, the ownership-control wedge and ownership opacity. Second, given incentives to tunnel and its potential link with diversification, we test for the presence of tunneling in our sample of diversified business groups. India provides a natural setting for testing these issues primarily due to the persistence of diversified business groups (Sarkar, 2010) with complex ownership structures in-built into which are the incentives of controlling insiders to tunnel (Masulis et al., 2009),² along with anecdotal and empirical evidence on the expropriation of minority shareholders by controlling insiders through such tunneling (Bertrand et al., 2002).³

Tunneling motives in pyramidal business groups have been captured in several recent papers (which we cite in detail later) in terms of the wedge between ownership and control. To this widely-used measure we add a new one – the opaqueness in ownership structure as manifested in the extent to which an outside investor can decipher, by using publicly disclosed information on shareholding patterns, the convoluted chains of control among group affiliates that come from pyramidal ownership and cross-holdings. Information on such control webs can be pivotal in detecting expropriation that may occur through tunneling. We believe the inclusion of this additional measure is useful, because while business groups in many emerging economies are set-up through pyramidal ownership chains, they are not always associated with a wide divergence between ownership and control (Almeida and Wolfenzon, 2006).

Results of the first test indicate that the extent to which an affiliate is located away from a group's core activity is related to its ownership characteristics, specifically the wedge between control and cash flow rights of insiders and the opacity in its ownership structure. Affiliates with wedge lower than the core firm of a group (the affiliate with the highest proportion of a group's assets) are more likely to be operating in unrelated activities: located away from the core than at the core. We also find that along with the ownership-control wedge, ownership opacity matters: affiliates with opacity higher than that of the core firm are more likely to be away from a group's core activity.

With regard to the second empirical exercise, we provide supporting evidence for the findings of the first test by examining the presence of tunneling in Indian business groups. To this end, we adopt the estimation approach adopted by Bertrand et al. (2002) to ferret out tunneling in business groups. Our exercise confirms the presence of tunneling. We find that low-wedge affiliates are more sensitive to an own industry shock than high-wedge affiliates as tunneled resources flow

¹ A parallel argument has been made at the firm level in the context of US markets. As argued in Stulz (1988) in the context of tender offers, and Shleifer and Vishny (1997) in the context of expropriation, the allocation of cash-flow and control rights can affect corporate policies and firm value.

² Comparative estimates of the presence of group affiliated firms and the existence of pyramidal structures in the US and India show that the percentage of group affiliated firms controlled through pyramids is 10.02% and 0.90%, respectively.

³ Between 2003 and March 2010, 767 cases of misappropriation and diversion by controlling insiders have been filed with the Serious Fraud Investigation Office of India against 31 companies several of which belong to business groups.

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