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Controlling shareholders, board structure, and firm performance: Evidence from India☆

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A B S T R A C T

We examine the prevalence and performance impact of controlling shareholders and study corporate board structures and ownership structures in 1796 Indian firms. Families (founders) are present on the boards in 63.2 (65.5) percent of the sample firms. On average, founders own over 50% of outstanding shares. In contrast to the findings of Anderson and Reeb (2003) in the U.S. context, we find that controlling shareholder board membership in Indian firms has a statistically significant negative association with Tobin's Q. Higher proportion of independent directors, higher institutional ownership or larger firm size does not appear to mitigate this relationship. Overall, board membership of controlling shareholders appears to be costly for minority shareholders.

1. Introduction

In this paper, we use data from a large sample of Indian boards of directors to investigate the relationship between ownership concentration, governance structure, and corporate performance. Berle and Means (1932) highlighted the prevalence of widely held corporations in the United States and the agency conflicts that can arise from the separation of ownership and control. Subsequently, several studies show that even among the largest U.S. firms, there is modest equity ownership concentration (Anderson and Reeb, 2003; Demsetz and Lehn, 1985; Holderness and Sheehan, 1988; Morck et al., 1988; Shleifer and Vishny, 1986). Studies of other developed economies document an even more significant concentration of ownership (Faccio and Lang, 2002; Franks and Mayer, 1994; Gorton and Schmid, 1996). In contrast, ownership in developing economies is highly concentrated (Claessens et al., 2000; La Porta et al., 1998, 1999). The dominant shareholder is most commonly the firm's founder or descendants.

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The existence of concentrated blockholdings raises a variety of questions. Is ownership concentration beneficial, or is it harmful to minority shareholders? Empirical results are mixed. In the U.S. corporate context, Holderness and Sheehan (1988) find that family firms have lower firm performance (measured by Tobin's Q) than nonfamily firms, while Anderson and Reeb (2003) find the opposite. Agency theory provides arguments both for and against concentrated ownership. Some assert that a blockholder's incentive and capacity to monitor management mitigates principal–agent problems associated with dispersed ownership (Anderson and Reeb, 2003; Davis et al., 1997). Others argue that it generates its own conflict between controlling and minority shareholders (Burkart et al., 2003). Assuming that this latter conflict imposes a cost on concentrated ownership, how effective are corporate governance mechanisms (such as board representation for independent directors, or institutional ownership) at controlling these costs? How are the answers to these questions affected by the institutional framework of the market, including particularly the strength of minority shareholders' rights?

We shed light on these issues by documenting the prevalence of controlling shareholder board presence, board structures and ownership patterns in a sample of 1796 Indian firms. In addition to investigating the corporate governance issue, we provide, to our knowledge, the first comprehensive large sample evidence on board structures of Indian firms. We document board characteristics such as board size, board independence, incidence of combined board chair and CEO positions, number of directorships held by directors, age of directors, and incidence of families, founders, women directors and "busy" directors. In addition, we document ownership patterns by collecting data on founder ownership, institutional ownership and retail ownership for sample firms. We also report how these characteristics vary with firm size and with the board presence of controlling shareholders.

We use these data to study the relationship between corporate governance and the impact of concentrated ownership on performance in the Indian context. Specifically, we consider the effect of certain board characteristics on corporate performance while controlling for the level of ownership concentration. Some of these characteristics are postulated to entrench the dominant shareholder (such as a board presence or CEO status), while others are thought to strengthen minority shareholders (for example independent directors or significant institutional ownership). We further examine whether this effect on performance depends on whether the dominant shareholder exercises control through the board or through a managerial role in the firm. In addition, we examine whether firms' proportion of independent directors, institutional ownership, firm size and founder ownership impact the controlling shareholder–performance relationship.

Using data from Indian corporations provides a valuable perspective on these issues. Despite the increasing importance of Indian equities in global portfolios, we are not aware of any large sample evidence on the corporate governance of Indian firms. Simply documenting the facts regarding boards of directors in India has its value. Moreover, the majority of governance studies to date have used data from the U.S. or from other developed markets. Yet, as noted by Fan et al. (2011), behavioral and institutional differences play a critical role in the agenda for future research on emerging markets and can provide insight into the functioning of corporate governance in a broader range of settings. Given the prevalence of controlling shareholders in emerging economies, more country level studies are needed to better understand the impact of controlling shareholders on minority shareholders in this context.

Our multivariate findings suggest that controlling shareholder presence on the board is negatively associated with Tobin's Q, consistent with Burkart et al. (1997) and Faccio et al. (2001) but in contrast to the findings of Anderson and Reeb (2003) in the U.S. context. This effect does not appear to be mitigated in larger firms or in firms with higher proportion of independent directors and institutional ownership. We find some evidence that this effect is accentuated in firms with higher levels of founder ownership. Our finding that independent boards do not mitigate the observed negative performance effect of controlling shareholder is contrary to the US-based findings of Anderson and Reeb (2004) who document that family founders have a positive impact on firm performance when there is greater board independence. We argue that these findings result from the strongly dominant position of controlling shareholders in India who hold, on average, over 50% of shares outstanding, coupled with the relatively weaker legal protections for minority investors in India. Together, these entrench the influence of dominant shareholders and diminish the effectiveness of internal and external disciplining mechanisms. Collectively, our results suggest that from the perspective of minority shareholders in India, the costs of having controlling shareholders on the board, on average, outweigh their benefits.

2. Related literature, institutional background and hypothesis development

2.1. Related literature: costs and benefits of controlling shareholders

There are potential benefits and costs to ownership of a controlling block by influential shareholders such as families and company founders. Much of the extant literature addresses the effects of family control although similar arguments can be extended to other controlling shareholders. Discussion of these costs and benefits in the literature has largely focused on the impact a controlling block has on certain agency conflicts in corporate governance. Family control can provide benefits since their concentrated ownership may overcome some of the principal–agent problems associated with dispersed ownership (Berle and Means, 1932). Davis et al. (1997) and Anderson and Reeb (2003) argue that family members act as stewards and have strong reputational concerns which improve firm performance. Families usually maintain substantial intergenerational ownership stakes, have a majority of their wealth invested in a single firm, and are often involved in managing the firm. Hence, controlling shareholders have the incentive and power to monitor management, thereby overcoming the free-rider problem found in firms with more dispersed ownership structures. Consistent with this argument, a number of studies present empirical evidence of better performance by family controlled firms: Westphal (1998), Anderson and Reeb (2003) for large U.S. firms; Maury (2006) for firms from 13 Western European countries; Andres (2008) for German exchange-listed firms, and Isakov and Weisskopf (2014) for Swiss-listed firms.

On the other hand, concentrated ownership generates its own set of agency conflicts between controlling and minority shareholders, inasmuch as large shareholders often wield substantial control and influence over firm actions. Controlling shareholders may