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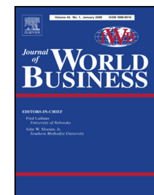

Corporate governance, board networks and growth in domestic and international markets: Evidence from India

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ABSTRACT

This paper examines the relationship between board structure and risk taking behavior of emerging market firms by looking at firms' growth strategies in foreign as well as domestic markets. More specifically, we study the individual and joint effects of board structure, network centrality through board interlocks and ownership structure on firm's growth strategies. With the help of longitudinal data on 2152 publicly listed Indian firms from 2002 to 2009, we find that boards that are structured keeping in view the resource dependence role are more helpful in pursuing growth strategies. We find that firms having more independent board members and CEO duality are more likely to pursue growth through new domestic ventures or new foreign investments. Moreover, firms that are more central in the network of other firms, based on director interlocks, are more likely to pursue growth in domestic as well as international markets. Further we find that board independence interacts with network centrality and family ownership in affecting a firm's growth strategies.

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1. Introduction

There are two broad streams of research linking corporate governance to firm level growth strategies. First, building on the tenets of agency theory, scholars have argued that managers want to pursue growth strategies by diversifying into new product and geographic markets to minimize their employment risks (Denis, Denis, & Sarin, 1997; Hoskisson & Hitt, 1990; Palich, Cardinal, & Miller, 2000) and increase their compensation (Anderson, Mansi, & Reeb, 2003; Hoskisson & Turk, 1990; Jensen & Murphy, 1990). These growth strategies may not be in the best interests of the principals and may not always result in enhancing the value of the firm (Comment & Jarrell, 1995; Lang & Stulz, 1994). This stream of research takes a negative view on managers and suggests that owners should employ mechanisms to align the interests of the managers with their own interests as well as to monitor the managers (Fama & Jensen, 1983, 1985). Board of directors and ownership concentration are two important mechanisms to make sure that managers are working in the best interests of the owners.

This view has been contested by scholars who question the basic assumptions of the agency theory that managers want to maximize their personal gains at the cost of the organizations that they serve (Lane, Cannella, & Lubatkin, 1998). This stream of research takes a more positive view of managers and argues that managers are good stewards who pursue strategies keeping in mind the interests of the firms in which they serve (Davis, Schoorman, & Donaldson, 1997; Donaldson & Davis, 1991). Both these streams, however, make strong assumptions about managerial behavior and the motivation and incentives of the owners to monitor the managers. While agency theory based explanations consider human actors to be inherently deceitful and untrustworthy, stewardship theory based explanations consider human actors to be always driven by the 'good intentions'.

These conflicting views call into question the appropriate role of different corporate governance mechanisms in a firm. Should the board of directors focus on monitoring the managerial actions (monitoring role) or should they focus in assisting the managers in strategic planning and accessing resources from the external environment (resource dependence role) (Hillman & Dalziel, 2003; Zona, Gomez-Mejia, & Withers, 2016)? Furthermore, recent research has shown that the interests of the owners and managers may not necessarily be divergent, particularly in contexts where owners are actively engaged in the management (Carney, 2005; Dharwadkar, George, & Brandes, 2000). In situations where owners are involved in the management of the firm, traditional agency problems become less important. Different corporate governance

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mechanisms such as board of directors and ownership concentration are traditionally designed to minimize the conflict between the owners and the managers. For example, one of the important functions of the board members is to limit the extent of unrelated diversification that managers want to pursue (Hoskisson & Hitt, 1990; Ramaswamy, Li, & Veliyath, 2002). However, if unrelated diversification enhances the value of the firm, as is the case in some emerging markets (Khanna & Palepu, 2000a; Khanna & Rivkin, 2001), then what is the appropriate role of different governance mechanisms?

In this paper, we address the above question by examining the linkage between two important governance mechanisms (board of directors and ownership structure), and two important growth strategies (growth through new domestic ventures and growth through new international investments). In the case of emerging economies such as India, the advisory and resource provisioning role of board members is more important than the monitoring role. Thus, independent board members, by virtue of their resource dependence role, help firms in pursuing growth, rather than constraining firms from taking risk. We further demonstrate the mechanism through which board members facilitate growth. Specifically, network centrality that a firm achieves through its board members is helpful in pursuing growth. Family ownership further conditions the effect of board independence on a firm's growth strategies due to differential preferences that family owners have for growth through domestic versus international expansion. We resolve the tension of agency based and stewardship based predictions by showing that the relative importance of different roles of board members is dependent on the external context and the governance environment.

2. Theory and hypotheses

2.1. Background

Strategic decisions, such as investments in new projects or new markets, have long term consequences for organizational survival and success. One of the fundamental issues in the management literature is to have the mechanisms to make sure that managers take these strategic decisions in the best interests of the owners. Board of directors and ownership concentration are two important mechanisms to make sure that managers are working in the best interests of the owners. There are two issues about the role of different governance mechanisms that require a closer scrutiny.

First, the performance consequences of growth strategies such as product and international diversification are not consistent across different contexts. With respect to the relationship between product diversification and firm performance, a general consensus, based on research in developed markets, is that moderate level of diversification in related areas has positive performance consequences while a high level of diversification in unrelated areas has negative performance consequences (Amihud & Lev, 1981; Hoskisson, Johnson, & Moesel, 1994; Lane et al., 1998; Thomsen & Pedersen, 2000). Likewise, with respect to growth through international diversification, scholars have shown that developed market firms experience negative performance effect at the low levels of international diversification, which turns positive at the moderate level and again negative at the very high level of international diversification (Contractor, Kundu, & Hsu, 2003; Lu & Beamish, 2004). Based on these findings several scholars argue that firms should have governance mechanisms in place to make sure that managers do not pursue excessive growth through product diversification or international diversification (Lane et al., 1998).

However, much of this theoretical development and empirical evidence is based on firms in the developed market contexts. These findings have been questioned in the context of emerging markets such as South Korea and India where firms have historically sustained a very high level of unrelated diversification and even outperformed their less diversified counterparts (Chang & Choi, 1988; Khanna & Rivkin, 2001). Khanna and Rivkin (2001) analyzed the diversification-performance relationship in 14 emerging markets and found that firms affiliated to diversified business groups were more profitable than the focused, unaffiliated firms in six of the fourteen emerging markets. Khanna and Palepu (2000b) provide a more detailed analysis of diversified business groups in India and find that firms affiliated to highly diversified business groups outperformed their counterparts that operated in single industries as well as other firms that were affiliated to moderately diversified business groups. With respect to international diversification, Gaur and Delios (2015) find that the effect of internationalization on performance is 'U' shaped in the case of firms from emerging markets such as India. Given that the performance consequences of growth strategies are context dependent, we need to reassess the role of governance mechanisms in affecting the growth strategies.

Second, much of the extant literature assumes that there is a divergence in the interests of the managers and the owners, and therefore, owners need governance mechanisms to make sure that managers pursue the interests of the owners and not their own interests (Daily, Dalton, & Canella, 2003). However, in certain contexts and situations, the interests of owners and managers may not be divergent (Carney, 2005; Jensen, 1998; Zahra, 2003). For example, Carney (2005) argues that in firms with high family ownership, there is minimal need to monitor the managers as the owners are themselves engaged in the management of the firm. Such firms have relatively reduced incidence of principal-agent conflict. While there are some costs of having a high level of family involvement, there are different expectations from different governance mechanisms in firms where traditional principal-agent conflict is less important. These variations necessitate that we examine the interplay between firm governance and the institutional environment in which firms are situated (Aguilera, Desender, Bendar, & Lee, 2015), while ascertaining the strategic choices that firms make.

In the following sections, we develop our arguments about the impact of board structure and ownership structure on a firm's growth strategies.

2.2. Board structure, roles and growth strategies

One of the biggest constraints firms face in their attempt to grow is the availability of qualified personnel (Penrose, 1959). In order to grow successfully, firms need to have a good understanding of their internal resources and capabilities (Barney, 1991) as well as the external environment (Porter, 1980). Developing an understanding of the external environment requires careful scanning, monitoring and assessment of the potential opportunities and threats. Once a firm identifies the right set of opportunities, they need substantial resource commitments to make use of the available opportunities. Human capital becomes one of the most important resources that firms need to successfully manage growth initiatives (Hillman, Withers, & Collins, 2009).

Firms in emerging markets structure their boards keeping in mind the resource dependence and advisory role of the board rather than just the monitoring role of the board. Firms in emerging markets are often relatively small (Gaur & Kumar, 2010), with significant involvement of members of the founding family. In such cases, the resource provisioning role of the board is often more important than the monitoring and control role for several reasons. First, emerging economy firms are characterized with ownership concentration and high level of family involvement,

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