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Foreign institutional investment, business groups and firm performance: Evidence from India

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ABSTRACT

The article tries to examine the relationship between equity ownership held by the foreign institutional investors and firm performance both in a static and a dynamic framework. We also examine how the relationship differs between group-affiliated and stand-alone firms. By employing the 2SLS panel data estimation technique on 137 BSE listed Indian firms, the study finds that foreign institutional investment has a positive influence on the firm performance as measured through Tobin's Q and ROA.Application of linear dynamic panel data estimation in a dynamic framework also yields similar results.The latter method also shows that FII has a positive significant effect on Tobin's Q in group-affiliated firms. The results are analysed from the perspective of a multi-theoretic approach consisting of agency theory, information asymmetry theory, institutional theory and resource dependency theory.

1. Introduction

The relationship between equity ownership structure and firm performance has been discussed in detail in the literature of corporate finance.However, the majority of the studies pertaining to this issue have been carried out in developed countries like US and UK where the institutions are characterised by very low concentration of ownership with portfolio investors playing significant role as large owners of the corporations.The empirical studies on the relationship between equity ownership and firm performance have produced conflicting results. In emerging countries like India, ownership structure of the firms is dominated by concentrated ownership with insider control. Further, the relationship between the equity ownership held by foreign institutional investors and firm performance has not been explored much in India. Foreign institutional investment has become an important source of capital in India since the economic reforms in 1991.

Foreign Institutional Investment in India is a part of Foreign Portfolio Investment. A major proportion of FPI comes from FIIs. Foreign Institutional Investors (FIIs) as defined by the Securities and Exchange Board of India (SEBI) are institutions that

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have their entities established or incorporated outside India but propose to invest in securities in India. These institutions are registered with SEBI as FIIs (Foreign Institutional Investors) in accordance with the SEBI (FII) Regulations 1995.These investors are highly specialised and apart from investing their own funds, can also invest the funds of their overseas clients (Sub-Accounts) that are registered with the SEBI. According to SEBI, FIIs include (i)foreign pension funds, (ii) mutual funds, (iii)charitable/endowment/university funds, (iv) asset management companies and (v) other money managers.However, with the introduction of FPI (Foreign Portfolio Investors) regime with effect from June 1, 2014, a new investor class named “Foreign Portfolio Investors” (FPIs) has been formed by merging erstwhile three investor classes i.e,FIIs, Sub Accounts and Qualified Foreign Investors (QFIs).

Liberalisation of the foreign investment policy as a part of the financial sector reform process which was initiated in the early 1990s, facilitated the inflow of foreign capital into the Indian market. Liberalising the inflow of foreign investment was necessary to combat the severe balance-of-payments crisis and the problems arising out of current account deficits. Not only can FII supplement domestic saving and reduce the savings investment gap, but it can also reduce the dependency on the debt generating foreign capital.

According to Khanna and Palepu (2000a) and Baek, Kang and Park (2004), active monitoring by the foreign investors has a positive impact on the firm performance. Foreign investors act as a complement of domestic institutional investors. In the developing economies, insiders as controlling shareholders have the reasons to exploit the outside minority shareholders for their personal benefits. Such problems can be reduced by the monitoring activities of the outside blockholders who have the incentives to do so and thus the outsiders act towards increasing the firm value (Shleifer and Vishny, 1986). Lins (2003) shows that outside ownership has a positive impact on firm performance in emerging economies. However, in emerging economies, domestic institutional investors facing lack of funds, political constraints and various other reasons may not perform monitoring activities efficiently. So, in emerging markets, foreign institutional investors can have a positive impact on firm performance.

Inspite of the fact that FIIs have potential to exert positive influence on firms by disciplining management through its threat of exit and alleviating financing constraints by increasing liquidity, the FIIs can also act as a destabilizing agent because of its volatile nature and a tendency of sudden reversals. So, it is required to know whether foreign institutional investment has any impact on Indian firms' performance. This issue is extremely important for contemporary policy making to take a decision to what extent FII should be monitored and regulated. Further, more often than not, it has been seen that market players who gain from the status quo have been adversely affected due to structural reforms and the resulting changing governance standards. Conversely, it can also create new players that gain from the reforms resulting in the new set of gainers and losers.

In the pre-liberalisation period, capacity regulation and monopoly regime forced the business groups to go for the diversification.However, post liberalisation era usher in more freedom to these business entities helping them to restructure their business in line with their comparative advantage and core competency. However, these business groups in contrast to the stand-alones are more rigid and bureaucratic in their organisational structure and hence may need more time to respond to the fast changing market environment. In this context, we have to highlight the roles of business groups vis-à-vis stand-alone firms

Therefore, the objective of this study is to find out the impact of FII on firm performance and to investigate whether this performance differs between groups and stand-alone firms. We try to study this relationship both in static and dynamic framework by employing two-stage least squares (2SLS) and dynamic panel data estimation procedures. Based on balanced panel data of 137 BSE listed Indian manufacturing firms over the period 2000-01 to 2012-13, we find that FII positively and significantly affects the performance of the firm measured by Tobin's Q and ROA. However, the impact is larger in case of Tobin's Q than that of ROA. Further, while 2SLS estimation procedure finds that FII has a larger influence on Tobin's Q for group affiliated firms, dynamic panel data estimation method suggests that this impact is higher in case of stand-alone firms. However, when performance variable is taken as ROA,we find that the impact of FII on ROA is not significantly different between group-affiliates and stand-alone firms. Earlier studies, in this context, used either instrumental variable 2SLS or 3SLS techniques in a cross-sectional setting (Graham and Bhattacharya, 2009). The contribution of the present study is that we apply the 2SLS in a panel set up and also use the dynamic panel data estimation method as a robustness analysis, which is an improvement on the earlier studies.

The rest of the paper is structured as follows. Section 2 presents the review of literature. In Section 3 we describe the data and the variables selected for our study. Section 4 presents the methodology adopted for the empirical analysis. Section 5 contains analysis of our findings and Section 6 comprises conclusion.

2. Review of literature

2.1. Theoretical framework

It has been argued by several researchers that the relationship between ownership and firm performance in emerging market context should be analysed from the perspective of multi-theoretic approach combining resource dependency theory, institutional theory, information asymmetry theory along with agency theory (Hoskisson et al., 2000; Eisenhardt, 1989; Oliver, 1997; Douma et al., 2006; Lynall et al., 2003; Hillman and Dalziel, 2003). In this view, we adopt a multi-theoretic approach here to explain the relationship between equity ownership and firm performance.