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Managerial incentives and strategic choices of firms with different ownership structures

Shantanu Banerjee[a,*], Swarnodeep Homroy[b]

[a] Department of Accounting and Finance, Lancaster University Management School, Lancaster, LA1 4YX, United Kingdom
[b] Department of Economics, Econometrics, and Finance, University of Groningen, 9700 AV, Netherlands

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ABSTRACT

We examine how ownership structure affects managerial incentive alignment mechanisms and strategic objectives. We compare large Indian firms with dispersed equity ownership with business-group affiliates operating within the same institutional frameworks. We find that the performance sensitivity of CEO pay and turnover differ significantly across group affiliates and stand-alone firms. The strategic choices of firms also differ in response to managerial incentives. However, we find that, regardless of those differences, firm performance is similar for both types of firms. Overall, this paper suggests that ownership structure and managerial incentives can adjust to optimize strategic choices and firm performance.

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1. Introduction

Business groups with concentrated ownership structures, often via a founding family are a common organizational form in emerging economies. Although debate over the relative costs and benefits of group affiliation is long standing, variations in managerial incentives and business strategy have received little empirical attention. In this paper we examine managerial incentive alignment mechanisms in firms with different ownership structures, and we examine how such incentives are associated with firm strategy and performance.

A popular view is that concentrated shareholding of the founding family is associated with weaker corporate governance (La Porta et al., 1999; Gibson, 2003). Holderness (2009) notes that most U.S. firms have large blockholders who may have conflicts of interest with managers and small shareholders. Moreover, dual class shares in the U.S. and the pyramid structure of cross-holdings in East Asian countries can lead to wide variations between control and cash flow rights (Masulis et al., 2009; Claessens et al., 2002), as well as expropriation of minority shareholders. Bertrand et al. (2002) find evidence of expropriation through

* Corresponding author.
E-mail address: s.banerjee@lancaster.ac.uk (S. Banerjee).

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tunneling of resources. Expropriation can lower the performance of group affiliates versus that of widely held firms (Holderness and Sheehan, 1988; Cronqvist and Nilsson, 2003). If institutional and minority investors rationally expect these costs, it will reflect in the stock prices of the group affiliates (Masulis et al., 2011).

There are many reasons for forming a business group. First, concentrated shareholding and family control offer the benefits of intergenerational ownership stakes and strong reputational concerns. This "Stewardship" role can improve firm performance (Anderson and Reeb, 2003; Maury, 2006). Business group affiliates can also leverage investments, production, and information through common ownership, while generating financing advantages through intra-firm loans (Gopalan et al., 2007). Khanna and Yafeh (2007) find that business groups are more common in markets with less developed institutions and are often formed with government support. Family-controlled business groups can reduce transaction costs with outsiders in an environment of inadequate laws but they can continue to exist when legal protection is adequate.

We examine the differences among incentive structures, strategic priorities and competitiveness between business group affiliates and stand-alone firms. Firms with different ownership structures naturally face different agency and transaction costs. Thus, we expect managerial incentive alignment mechanisms to differ as well. To that end, we use data from large listed Indian firms to compare incentives across business group affiliates and stand-alone firms. Specifically, we focus on differences in the performance sensitivities of CEO pay and CEO turnover between group affiliates and stand-alone firms with dispersed shareholding.

Our results suggest that CEO pay is higher in business group affiliates, but pay-performance sensitivity is also higher. On the other hand, CEO turnover is more sensitive to performance in widely-held firms than to that in business group affiliates. We distinguish further within a business group between firms with CEOs from the controlling family, and firms with outside CEOs. We find that firms with outside CEOs in group affiliates tend to offer managerial incentive structures that are similar to that of the CEOs in unaffiliated firms. Collectively, our results suggest that firms with different ownership structures tend to feature different kinds of incentive alignment mechanisms: performance-sensitive CEO pay (carrot-type incentives) and performance-sensitive CEO turnovers (stick-type incentives).[1] In business group affiliates with a family-CEO and intergenerational stakeholding, we find that carrot-type incentives are commonly used, while CEOs of widely held stand-alone firms are more likely to be at risk for dismissal over poor performance. However, we also find that, when business group affiliates have outside CEOs, the incentive alignment structure is similar to that in stand-alone dispersed shareholding firms. These types of incentives are not mutually exclusive but under incomplete managerial contracting, one of the two types tend to dominate.

Next, we investigate how managerial incentive design is associated with the strategic choices of business group firms and widely-held firms. There is some evidence that managerial incentives affect firm strategy (Ederer and Manso, 2016; Manso, 2011; Croci and Petmezas, 2015; Low, 2009). Siegel and Choudhury (2012) argue that affiliate firms of business groups pursue different strategies than unaffiliated firms, which we must consider when examining expropriation mechanisms in business groups. We compare group affiliates and unaffiliated firms on long- and short-term strategic objectives. Stand-alone widely held firms tend to emphasize short-term strategic goals such as the current ratio and the asset-turnover ratio; business group affiliates tend to focus more on long-term investments in research and development (R&D) and capital expenditures. We interpret these results to mean that faced with stick-type incentives, managers of stand-alone firms will prioritize shorter-term targets. The controlling shareholders of business group affiliates, because they enjoy longer-term control over their firms, generally invest more in longer-term strategies.

Finally, we examine the implications of the differences in incentive alignment and strategic objectives for firm performance. We find that performance does not seem to vary systematically with ownership structure. Notwithstanding the differences in managerial incentives and strategic priorities, firm performance appears similar for Indian business group affiliates and for widely held stand-alone firms.

We use data from Indian firms for several distinct considerations. First, India provides a unique setting from which to compare firms with different ownership structures within the same institutional and legal framework. Anglo-American type dispersed ownership firms, and concentrated shareholding insider-dominated business groups such as East-Asian firms are both common in India. Among the top 500 Indian firms, which constitute 99% of market capitalization, 32.67% are affiliates of diversified business groups, 17.63% are controlled by the state, and 49.7% are Anglo-American style stand-alone firms with dispersed shareholding. Second, India has a mature capital market, so the financial information and industry classifications are largely consistent and comparable (Jameson et al., 2014). Recent regulations in India have aimed to make governance frameworks and reporting standards consistent with those in the U.S. and the EU.

The economic liberalization of the Indian economy in 1991 relaxed investment and trade barriers and increased competition in most industries. The proportion of widely-held firms increased during the post-liberalization period. In this environment, the concurrent increase in competition would drive out less efficient ownership structures, but both business group affiliates and dispersed ownership firms have continued to coexist successfully for over two decades. In contrast, in Japan and South Korea, *keiretsus* and *chaebols*, respectively, have long been the dominant organizational forms, and the institutional framework

[1] Our definition of a stick-type incentive is based on the likelihood of CEO dismissal for poor performance. This is different from Dittman et al. (2010) formulation of minimum wage CEO pay as a stick type incentive within a loss-aversion framework.

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