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Leverage and business groups: Evidence from Indian firms

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Abstract

The motivation of this paper is that information problems and other market imperfections, which explain the business group phenomenon of firm ownership structure in emerging markets, also underpin mainstream theories of firm leverage. We draw from elements of theories of business groups as well as capital structure theories to specify a generic model of capital structure, which is then estimated and tested on a sample of 1652 quoted non-financial firms in India, including group-affiliated and independent firms. It is found that the leverage decisions of group-affiliated firms are significantly different from those of non-affiliated firms, suggesting that the business group ownership structure creates *virtual* (or internal) capital markets. Further evidence indicates that group-affiliated firms enjoy exceptional access to government and foreign loans, as proposed by the market failure and policy distortion theories of business groups.

Keywords: Capital structure; Firm leverage; Business groups; Emerging markets; India

1. Introduction

Business groups are an important firm ownership feature of the private sector of many emerging as well as developed markets. La Porta, Lopez-de-Silanes, and Shleifer (1999), investigating firm ownership in 27 economies, find that many firms are typically controlled by families through pyramidal structures. The resultant group of firms, controlled by a single family, is referred to as a family business group by Almeida and Wolfenzon (2006). Other forms of business groups include collections of firms that are linked through a common main bank, interlocking directorships, cross holdings of equity, or other non-family social ties (see Khanna & Rivkin, 2006).

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Since the seminal works of Leff (1976, 1978), there has been an increasing research interest into the question of why firms constitute themselves into business groups.[1] Among other reasons, it is argued that firms form business groups in order to influence the way they are governed and the means by which they raise capital (Khanna, 2000). Overall, the pivotal argument is Leff's market failure theory. Accordingly, groups are dominant in emerging markets because of the prevalence of market imperfections and information problems.

It is interesting to note that information problems and other market imperfections, which underpin the main theories on business groups, also underpin the theories on the determinants of capital structure. Hence, the paper synthesizes two strands of the literature by investigating the effect of group affiliation on the firm's leverage decision. The investigation is conducted in the context of emerging markets and focuses on India for the reasons outlined in Khanna and Palepu (2000a). First, there are many business groups in India (around 400), which vary greatly in terms of size and the level of diversification. Second, it is not cumbersome to establish the affiliation status of firms in India, unlike the case in other markets.[2] Third, business groups in India are representative of business groups in many emerging markets in at least two ways: they are often linked to a particular family; control is typically achieved either through appointing family members and friends to directorship and top managerial positions, or through direct and indirect ownership.

In India business groups are referred to as Business Houses and their origin dates back to the Managing Agency System during colonial times. The system had begun to evolve in the late 18th century and when the English East India Company lost its monopoly over trade. At that time employees of the company and some locals from the trading communities started to trade on their own account as free merchants. Through trade the free merchants accumulated wealth and started to diversify their activities.[3] The way these entrepreneurs organized themselves is what later became known as Agency Houses. Particularly the managing agent – be it a partnership, a firm, or an individual – would set up a new business using his and his family's wealth. Once the business was up and running he would sell it off, usually leaving a fraction of shares in his name, and enter a managing agency contract with the new owners. The capital gains from the sell of the business would be used to set up another business and to repeat the process.[4]

Following Indian independence in 1947 the Agency House had evolved into a Business House (business group). The Indian business group, like many other business groups around the world, is typically a collection of legally independent firms in a wide variety of industries. The group is often associated with a particular family and the firms in the group are linked through interlocking

[1] Leff (1976, 1978) notes that the lack of research into the business group phenomenon may be due to the fact that groups are usually well diversified, thus their central role in business and the large portion of their holdings are not always obvious.

[2] Granovetter (1995) discusses what he terms 'the invisible problem of business groups', or the question of why there have only been relatively few studies of this important phenomenon. One explanation put forward is the difficulty in establishing group affiliation. For example, Khanna and Palepu (2000b), in their study of business groups in Chile, note the difficulty they encountered in uncovering data on group affiliation. Specifically, they note that in Chile it is extremely difficult to identify the controlling family since control is disguised by pyramiding. Khanna and Rivkin (2006) note a similar obscurity for the case of Nicaragua.

[3] Rungta (1970) notes that the Europeans who previously worked in the service of the English East India Company were well positioned to become entrepreneurs: they usually possessed technical knowledge in various fields; had the administrative experience necessary to run a business concern, and – as employees of the English East India Company – had the opportunity to develop political connections.

[4] Sometimes, however, an established firm would invite an Agency House to enter a managing agency contract with it. The motivation for the established firm would be the Agency House's access to capital, its reputation or its experience.