Chapter 1

Introduction

Expropriation by controlling shareholders is an important issue in emerging economies. Concentrated ownership and family dominance in Indian business groups make outside investors vulnerable to expropriation. Furthermore, weak investor protection makes the Indian setting more conducive for the expropriation of minority shareholders. This book investigates whether inside-concentrated ownership provides opportunities for expropriation of minority shareholders and results in value loss. To provide evidence, we examine the market valuation of ownership rights and related-party transactions (RPTs) of group-affiliated firms in India.

This chapter begins by highlighting the group structure and its inherent problems. The second section describes the underlying motivation of the book, followed by a section that outlines the main research objectives. The fourth section highlights the contribution of the book, and the final section outlines how the book is organized.

Statement of the problem

The business group structure has a significant impact not only on emerging economies but also on developed nations such as the US and Japan.[1] Although business groups have contributed significantly to the wealth of emerging economies, our understanding of the operations of these groups remains insufficient (Yiu et al., 2005). This study expands our understanding of the

[1] The business groups are found in several developed and emerging economies; including the US, Japan, India, South Korea, Russia, and China. Davis, Diekmann, and Tinsley (1994) and Dewenter, Novaes, and Pettway (2001) highlight the role of diversified business groups in the economies of developed nations and other studies like Bhattacharya and Ravikumar (2001), Perotti and Gelfer (2001), and Yiu, Bruton, and Yuan (2005), in emerging economies.

concentrated ownership, and RPT phenomenon within business groups in India, which is one of the fastest emerging economies in the world. Khanna and Yafeh (2005) identify that the role of business groups in India is poorly understood. As the existence of concentrated ownership is the primary feature of business groups, business-group membership can affect firm value in one of two competing ways: the entrenchment effect and the alignment effect. The entrenchment effect presents incentives for controlling shareholders to expropriate the wealth of minority shareholders (Fama and Jensen, 1983b). The alignment effect presents the competing view that concentrated ownership creates greater monitoring by controlling shareholders and, thus, higher firm value (Demsetz and Lehn, 1985). This study disentangles the incentive and entrenchment effects of controlling shareholders of Indian group firms. Specifically, the effect of the controlling shareholders' direct and indirect ownership rights on firm value is examined to seek evidence on the alignment or entrenchment effects. This study also examines whether differences in ownership structure at the firm level can explain the variation in the value relevance of RPTs. In particular, this study examines whether the use of RPTs is viewed as efficient and valued positively, or entrenchment and valued negatively.

A business group is a collection of firms which are separate legal entities, but are bound by economic (equity and debt) and social (family and kinship) ties. Groups might be vertically controlled through a pyramid structure, or horizontally linked through cross holdings. Khanna and Rivkin (2001, 47) define a business group as 'a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action.' This implies that each firm is a separate legal entity under the Indian Companies Act, 1956 but are associated with each other in terms of ownership and management. As each firm is a distinct legal entity, annual reports are prepared and issued at the firm level and each firm has its own board of directors. However, the business decisions are often taken by considering the group as a whole and personal interests at firm level are ignored (Gopalan, Nanda, and Seru, 2007). This may impose costs on minority shareholders and consequently lead to an agency conflict between controlling and minority shareholders.[2]

The existing literature suggests that these groups have a significant effect on emerging economies. For instance, in India, group-affiliated firms

[2] This issue is discussed later in the chapter.

accounted for 89 per cent of total sales and assets of the private sector in 1993 (Ghemawat and Khanna, 1998). Group firms account for 60 per cent of the 500 largest Indian companies and 65 per cent of total capitalization of the largest 500 companies (Chakrabarti, Megginson, and Yadav, 2008). Of the total industrial production of China, 60 per cent is contributed by business groups (SSB, 2000). In South Korea, 40 per cent of total output is contributed by the top 30 business groups (Chang and Hong, 2000). Despite the significant contribution of business groups to the Indian economy, studies examining these groups have been limited to the evolution and transformation of business groups (Kedia, Mukherjee, and Lahiri, 2006), group performance (Khanna and Palepu, 2000b), the tunneling behaviour (Bertrand, Mehta, and Mullainathan, 2002; Kali and Sarkar, 2011) and the investment behaviour (Lensink, van der Molen, and Gangopadhyay, 2003) of these business groups. However, there is no empirical evidence on valuation of RPTs amongst group-affiliated firms.

Family members often control these group firms by boarding memberships, recruiting top management, coordinating actions among member firms, and lobbying the government (Khanna and Palepu, 2000b). It is important to note that affiliation can be associated with a conflict of interest between controlling and minority shareholders. Family members can enforce their controlling power to benefit other firms in the group which might not be in the best interests of public shareholders. The controlling shareholders have even greater incentives to expropriate the wealth of minority shareholders when they have lower cash-flow rights. Bertrand et al. (2002) provide evidence of tunnelling among Indian business groups.

Studies such as those of Khanna and Yafeh (2005) and Hoshi, Kashyap, and Scharfstein (1991) highlight the risk-sharing phenomenon among member firms. Ghemawat and Khanna (1998) suggest that business groups operate an internal capital market when the external market is inefficient because of informational problems. Similarly, Gopalan et al. (2007) suggest significant operational and financial inter-linkages between member firms in the group. There could be several motives for the transfer of resources across member firms, including:

- Investments: resources can be transferred from one firm to the other to finance profitable new investment opportunities. Stein (2003) suggests that an internal capital market structure can economize the cost of financing. A similar situation may be that of a group cross-subsidizing a firm in the group involved in a price war to obtain market share, such as an airline in fare discounting.

- Support: another motive behind the transfer of resources can be to support firms in financial distress. Group firms might be concerned about their reputation because a default by any firm in the group may send a negative signal to the market about group performance.
- Tunnelling: controlling shareholders may have incentives to transfer resources from a firm with low cash-holding rights to firms with higher cash-holding rights. Bertrand et al. (2002) find evidence supporting a significant amount of tunnelling among Indian business groups.

Gopalan et al. (2007) also examine the functioning of internal capital markets and report that a significant amount of loans have been provided across group firms. A firm in a better financial position tends to provide loans to weak firms. They further examine the subsequent performance of firms that receive loans, and found that receiving firms significantly underperform in the subsequent two years, which is inconsistent with the notion that loans are used to finance profitable investment opportunities. Furthermore, the results suggest marginally greater support in the form of loans to higher insider holdings firms in a group. The support provided by group loans is found to be an important factor in avoiding the bankruptcy of weak firms. Group loans are also typically provided at an interest rate that is significantly lower than the market borrowing rate, by almost 10 per cent.

The findings mentioned above suggest that group loans are often provided on favourable terms and for non-profit investments, which reveals the cost for the firm which provides the loans. In other words, these group loans involve costs for the firms providing the loans, and this might be a way to expropriate the wealth of minority shareholders by transferring funds from firms with lower cash-flow rights to firms with higher cash-flow rights. The bankruptcy of any group firm signals negative information about the group and it leads to a reduction in the total external financing (debt and equity) by other healthy firms in the group. It appears that group firms support weak member firms to reduce bankruptcy probability as the bankruptcy event within the group is followed by a fall in the investments of healthy firms in the group. This also suggests that personal interests of individual firms are ignored to save the image of the group as a whole.

Motivation for the study

The literature on agency theory reveals two types of agency problems. The first type arises from the separation of ownership and management, which is the case in non-family firms. The second type arises due to conflicts between controlling and minority shareholders, which is a characteristic of family firms (Demsetz and Lehn, 1985). Family firms face less severe Type 1 agency problems because they are likely to be actively involved in management. Controlling shareholders hold significant stock ownership, which gives them incentive and power to monitor any opportunistic behaviour. Moreover, family members have better knowledge of their business activities, which enables them to detect any irregularities. However, family firms face the second type of agency problem. The boards of family firms tend to be less independent and more dominated by family members and, consequently, there is a risk of expropriation of minority shareholders by controlling shareholders. As a result, family firms face more severe Type 2 agency problems. Consequently, the overall effect on firm value cannot be predicted and it becomes an empirical question. The motivation of this book is to expand our knowledge on the agency problems of family-controlled group firms.

Research objectives

We address two broad questions regarding the underlying benefits and costs involved in family ownership. The first objective of this study is to disentangle the incentive and entrenchment effects of controlling shareholders of Indian group firms. The second objective is to examine the valuation of RPTs and if these transactions are opportunistic or efficient. Within the framework of the research objectives, we will address the following questions:

1. Which of the two opposing forces (convergence-of-interest or entrenchment effect) dominates at different levels of ownership rights of controlling shareholders.
2. Whether the market values RPTs based on the nature of the transaction, the relationship with the party involved in RPTs, and the personal incentives of controlling shareholders.

Contribution

Firms with high ownership concentration suffer from unique agency problems arising from principal–principal conflict. The conflict between controlling and minority shareholders has been examined mainly in the context of East Asia and South Korea and, to lesser extent, in the context of India (Claessens et al., 2002; Joh, 2003; and Bertrand et al., 2002). Family dominance in

India, together with inadequate regulation and weak enforcement, generates an environment best suited for extraction of firm resources. The aim of this study is to employ the framework of two competing forces (that is, alignment effect and entrenchment effect) to demonstrate accountability issues in firms with concentrated ownership.

Several studies investigate the expropriation of outsiders by controlling shareholders. Claessens et al. (2002), Joh (2003), Lemmon and Lins (2003), and Lins (2003) provide evidence on the extraction of firm resources by controlling shareholders from Asian and other emerging markets, whereas Bertrand et al. (2002) and Kali and Sarkar (2011) provide evidence of tunnelling in Indian business groups. We contribute significantly to this body of literature in a number of ways which have not been examined in previous studies. We adopt the view that useful insights into the extent of resolution of the principal–principal conflict are obtained by examining the multiple control mechanisms. We note that a key aspect of much of the prior research is that the ownership rights of the controlling group are assumed to operate to alleviate or aggravate agency costs in isolation, and the role of other blockholders such as institutional investors is often ignored. We suggest that important linkages should not only exist among the shareholdings of different groups but also among other governance mechanisms such as board members and CEOs. Furthermore, prior studies on the expropriation of minority shareholders of Indian business groups provide indirect evidence only. For example, Bertrand et al. (2002) and Kali and Sarkar (2011) provide evidence of tunnelling through shock sensitivity. There are very limited studies which examined RPTs to seek evidence of expropriation of minority shareholders in the Indian context.

Prior studies on the valuation of RPTs do not identify the relationship of parties involved in the transaction. However, we examine whether RPTs involving subsidiary and holding firms are valued differently from RPTs involving member firms in the groups. Moreover, we also examine if the indirect ownership (obtained through cross holding) of controlling shareholders influences the valuation of RPTs. Earlier studies have not examined these issues on the valuation of RPTs. This work will add significantly to the extant literature on RPTs.

We extend Bertrand et al. (2002) and Kali and Sarkar (2011) in several ways. Firstly, our proxy to measure cash-flow rights is more appropriate than what was used in these studies. Bertrand et al. (2002) use director ownership to capture direct cash-flow rights of controlling shareholders, which tends to overstate direct rights if directors are not family members. In contrast, we obtain direct and indirect cash-flow rights of controlling families from disclosure information about shareholders. Second, we control for large blockholders (other than the founding family) which appear to challenge controlling families, which Bertrand et al. (2002) ignored completely. Third, we seek evidence of whether the expropriation of outsiders occurs through RPTs, which is a direct measure, while Bertrand et al. (2002) and Kali and Sarkar (2011) use an indirect measure via industry shocks to determine the extent of tunnelling.

This study has implications for various groups such as investors, forecasters, and policy-makers. The results are important from the standpoint of outside investors. Not only do group-affiliated firms impose costs on outside investors in the form of entrenchment but outside investors can also be benefitted by the efficient use of RPTs. Khanna and Palepu (2000b) argue that group-affiliated firms overcome the imperfections of external markets with the help of internal institutions. Kohlbeck and Mayhew (2010) also argue that RPTs can fulfil the underlying needs of the firm.

As regulation affects shareholder wealth, our study has implications for policy-makers. The evidence of tunnelling requires stringent rules and regulations to restrict entrenchment effects by controlling shareholders. The message for policy-makers from this evidence of entrenchment consequences is quite clear: strong investor protection encourages not only domestic investors but also foreign direct investment (FDI). The findings of our study will bevery useful to policy-makers in India where corporate reporting practices are weak and in a very nascent stage. The standard-setting bodies are currently formulating adequate accounting regulations so that they are consistent with international practices. Regulators need to account for the potential conflicting interests between shareholders in the policy-setting process. However, the rent-seeking literature highlights that policy-makers may also exploit the competition between different interest groups for their own benefit. McChesney (1997) identifies that political officeholders exploit their incumbency to demand payments from economic groups. Payments can take the form of election campaign contribution or political support. The evidence of this rent-seeking behaviour can be found in the literature. For example, Bittlingmayer and Hazlett (2000) report that the antitrust scrutiny of Microsoft was partly a result of Microsoft's lack of 'Washington presence'. Microsoft contributed little to political campaigns in comparison with other large firms. Similarly, Sheila Dikshit's government in Delhi was accused of giving unfair advantage to Reliance Group, and the newly formed government of the Aam Aadmi Party (AAP) ordered an audit by the Comptroller and

Auditor General of India (CAG) of the private power distribution companies owned by Reliance Group (*TOI*, 2014).

In this framework, policy-makers might have incentives not to enforce legislation which protects outside investors if they receive payments from big business groups. This study raises questions about such a political environment and highlights the importance of a more transparent system to ensure investor protection. In particular, we highlight the nature of the transactions conducive for expropriation of minority shareholders and inadequate regulations pertaining to RPTs.

As we are using the Indian setting, the book will also help in understanding one of the most important emerging markets in the world which is relatively unexplored.[3] An enhanced understanding of Indian business groups will prove useful for other counterpart firms (local and foreign) that aim to compete against or establish links with these business groups (Kim, Kandemir, and Cavusgil, 2004).

There are several benefits of using India as a setting. First, India provides a large sample of firms for analysis because there are several thousand companies listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). Second, unlike Japanese *keiretsu*, groups are easily identifiable in India. Furthermore, firms are a member of only one group and, generally, there is no movement of firms across the groups because of strong family ties. Finally, despite the group affiliations, accounting standards require each firm to disclose financial information. As each firm is a separate legal entity, the ownership and financial information is available at the firm level for examination. Significant variation would be lost if the information is required to be analysed at the group level.

Structure of the book

The book is divided into nine chapters. These are as follows:

Following this introductory chapter, the next chapter provides some understanding of the Indian setting. It discusses the evolution and transformation of Indian business groups. A qualitative assessment of business groups in an international context is provided. Furthermore, the history and

[3] Claessens, Djankov, and Lang (2000), Ball, Robin, and Wu (2003), Lins (2003), Lemmon and Lins (2003), and Claessens, Fan, and Lang (2006) investigate the expropriation of minority shareholders and firm valuation in the Asian context but they exclude India.

present state of the Indian economy is provided in the chapter. It also discusses the Indian accounting standard-setting process, the weak enforcement system in India, and rules pertaining to RPTs.

Chapter 3 provides the theoretical framework on Type 2 agency costs, entrenchment effects, and alignment effects. Furthermore, the chapter reviews empirical studies conducted on business groups around the world. These include examination of the firm performance and market valuation of diversified business groups. The evidence on the effect of ownership on firm value is provided. This chapter also examines studies on the investment and tunnelling behaviour of family business groups and valuation of RPTs.

Chapter 4 develops hypotheses to empirically examine the effect of direct and indirect ownership rights on firm value. The effect of minority ownership on firm value is also predicted. Moreover, the hypotheses are developed to examine the valuation of various RPTs. The hypotheses are based on agency theory, with specific reference to the Type 2 agency problem as a result of conflict between controlling and minority shareholders. The entrenchment effect of controlling shareholders also provides support for the hypothesis development.

Chapter 5 outlines the methodology employed in this study. First, the sample selection procedure is illustrated. The description of the sample is provided in the next section. The proxies used to measure the key variables and the empirical models to be estimated are described in the last section.

Following the discussion of methodology, descriptive statistics and univariate analysis results are provided in Chapter 6. This chapter also provides a correlation matrix to identify any potential harmful levels of multicollinearity.

Chapter 7 presents the empirical results of the ordinary least squares (OLS) regressions used to test the developed hypotheses. First, the results for the effect of direct and indirect ownership rights of controlling shareholders on firm value are presented. The next section presents results on the association between minority ownership and firm value. Finally, results on the earnings-market valuation of various RPTs are presented.

Chapter 8 provides additional tests to support the main findings. First, the results of panel-based fixed-effect models are presented. The next section presents results for analysis of only RPT firms, followed by the results for the valuation of individual RPTs. Some governance variables are further explored to assess the robustness of the main findings.

Last, Chapter 9 summarizes the empirical findings and draws conclusions. This section also acknowledges the limitations of the study and recommendations for future research are provided.