

Can Ownership Concentration Reduce Firm Performance? Evidence From Firms Listed in the Colombo Stock Exchange Under Banks, Diversified Financials and Insurance Industry Groups

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Abstract

Concentrated ownership generally leads to concentration of power within few dominant investors and can result in increased agency costs and poor performance. However, corporate governance literature provides conflicting empirical evidence on this topic. For example, some studies argue that owner-managers in firms with concentrated ownership have better incentives to enhance firm value. Therefore, this study investigates whether ownership concentration affects firm performance using data gathered over 2015 to 2019 from 66 firms listed under banks, diversified financials, and insurance sectors in the Colombo Stock Exchange. Herfindahl-Hirschman Index, calculated based on the proportion of shareholdings of the ten largest shareholders, was used to measure ownership concentration. Firm performance was measured using Tobin's Q. A fixed-effects panel regression was used to assess the effect of ownership concentration on the firm performance while controlling for firm size and leverage. The findings suggest that higher ownership concentration improves performance supporting the stewardship theory.

Keywords: *ownership concentration, firm performance, Herfindahl-Hirschman index, Tobin's Q*

1. Introduction

Separation of firm ownership from control generally results in conflicts of interest between owners and managers. Modern firms adopt corporate governance best

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practices that align management interests to owners' interests to alleviate this agency conflict. These best practices largely stem from the agency theory and are prescribed mainly for firms with dispersed ownership in developed countries. Nevertheless, firm ownership in developing economies is highly concentrated in the hands of few dominating shareholders (Wei & Geng, 2008). In this context, ownership concentration can have two opposing effects. For example, as the stewardship theory suggests, when firm ownership is concentrated, the controlling shareholders have more incentives to monitor the activities of the management and thereby improve performance (Shleifer & Vishny, 1986; Short & Keasey, 1999). In contrast, as argued in the agency theory, ownership concentration may lead to additional agency conflicts between larger shareholders and minority shareholders and create substantial downward pressures on firm performance (Faisal, Majid, & Sakir, 2020).

Though concentrated and family ownership characteristics in the Sri Lankan firms have been identified as a potential reason for contradictory empirical evidence relating to the effectiveness of corporate governance best practices, less has been documented on the extent of ownership concentration. Moreover, the existing limited work on corporate governance in Sri Lanka have often excluded the financial sector given their unique characteristics and the specificity of the regulatory provisions. This lack of evidence and conflicting viewpoints calls for carrying out novel corporate governance studies using recent data on a more regional basis while paying due attention to specific contextual settings (Hermalin & Weisbach, 2003). Hence, while documenting the extent of ownership concentration in the financial sector, this study examines whether ownership concentration can reduce firm performance as alleged by most corporate governance literature relying on market-based practices of Anglo-Saxon origin. For this purpose, this study collects data on all the firms listed in the Colombo Stock Exchange (CSE) under banks, diversified financials, and insurance industry groups.

2. Literature Review

The majority of models in corporate governance have focused on the agency theory, which argue that conflicts of interest between principles and agents due to the separation of ownership from the control lead to reduce firm performance (Berle & Means, 1932). In this context, the concentration of ownership can further increase agency costs as larger shareholders can continually be elected to the board of directors and enjoy excessive powers. For example, as Lubatkin (2007) claimed, owner-managers can hide important internal information from dispersed owners. Thus, larger shareholders can abuse their power to extract private benefits and expropriate minority stakeholders' wealth (Friedland, 2003). Consequently, this

expropriation behavior may decrease firm performance.

In contrast, the stewardship theory claims that ownership concentration results in efficient monitoring since it provides stronger incentives and greater power to larger shareholders. Thereby, they acquire enhanced access to information and discipline management actions (Burkart, Gromb, & Panunzi, 1997; Campbell & Mínguez-Vera, 2008). Hence, concentrated ownership may improve performance (Lee, 2008; Thomsen & Pedersen, 2000). However, some studies such as Machek and Kubíček (2018), Sánchez-Ballesta and García-Meca (2007), and Zouari and Taktak (2014) have not observed any association between ownership concentration and firm performance.

This literature review provides three main implications. First, the debate on the relation between ownership structure and firm performance is unresolved in the corporate governance literature. Second, the effects of ownership concentration as a governance mechanism remain largely unknown. Finally, the association between ownership concentration and firm performance is highly contextual. These facts make the relation between ownership structure and firm performance an exciting area for further research.

3. Methodology

This study investigates whether ownership concentration reduces the firm performance using a panel dataset collected over the five years from 2015 to 2019 on all 69 firms listed in the CSE under banks, diversified financials, and insurance industry groups. Nevertheless, three firms were dropped from the sample due to the unavailability of data consistently over the entire sample period making the final sample of 66 firms. Ownership concentration was measured through the Herfindahl-Hirschman Index (HHI) which is calculated using the proportion of shareholdings of the ten largest shareholders. This study employs Tobin's Q as the proxy for the firm performance because it reflects a long-term perspective of the business. Two control variables, namely firm size (SIZE) and leverage (LEV), were also added to the model to minimize the specification bias. This study used the natural logarithm of total assets to measure firm size. Leverage was measured using the debt-to-equity ratio. Moreover, year dummies for 2015-2019 were added to control for time-variant effects. As suggested by the Hausman test, the fixed-effects panel regression model was chosen to assess the association between ownership concentration and firm performance as specified in equation (1).

$$TobinsQ_{it} = \alpha + \beta_1 HHI_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \lambda_t + \mu_{it} \text{----- (1)}$$

4. Findings and Discussion

As shown in Table 1, the ownership is substantially concentrated in the selected firms. The highest ownership concentration can be observed in the firms in insurance and diversified financial industry groups where the average stake of the largest shareholder was around 60 percent of the total shareholdings, and HHIs in these groups were higher than the overall average of 4,000. Nevertheless, the ownership concentration is moderate in the banking sector, as indicated by an average HHI of 1,230 and the stake of the largest shareholder also remained around 24 percent in the banking industry group.

Table 1: Ownership Concentration

| Indicator | Mean | SD | Min | Max |
|---|-------|-------|-------|--------|
| Stakes of the largest ten shareholders | | | | |
| Stake of the largest shareholder (L1) | 53.99 | 27.13 | 9.63 | 100.00 |
| Stake of the 2 nd largest shareholder (L2) | 12.35 | 10.05 | 0.06 | 44.34 |
| Stake of the 3 rd largest shareholder (L3) | 6.26 | 5.49 | 0.03 | 25.09 |
| Stake of the 4 th largest shareholder (L4) | 3.88 | 3.61 | 0.00 | 15.88 |
| Stake of the 5 th largest shareholder (L5) | 2.67 | 2.91 | 0.00 | 13.78 |
| Stake of the 6 th largest shareholder (L6) | 2.11 | 2.32 | 0.00 | 9.41 |
| Stake of the 7 th largest shareholder (L7) | 1.64 | 1.86 | 0.00 | 7.57 |
| Stake of the 8 th largest shareholder (L8) | 1.22 | 1.36 | 0.00 | 8.07 |
| Stake of the 9 th largest shareholder (L9) | 0.96 | 0.98 | 0.00 | 4.61 |
| Stake of the 10 th largest shareholder (L10) | 0.79 | 0.84 | 0.00 | 4.03 |
| Stake of the largest shareholder (L1) | | | | |
| Banks ($n = 59$) | 23.49 | 17.99 | 9.63 | 70.83 |
| Diversified Financials ($n = 220$) | 60.91 | 24.51 | 15.00 | 100.00 |
| Insurance ($n = 49$) | 59.66 | 22.08 | 17.14 | 100.00 |
| Herfindahl-Hirschman Index (HHI) | | | | |
| Banks ($n = 59$) | 1,230 | 1,342 | 220 | 5,073 |
| Diversified Financials ($n = 219$) | 4,685 | 2,632 | 671 | 9,972 |
| Insurance ($n = 48$) | 4,280 | 2,147 | 884 | 8,142 |
| Overall ($n = 326$) | 4,000 | 2,712 | 220 | 9,972 |

Notes: SD, Min and Max stand respectively for standard deviation, minimum and maximum

The fixed-effects model was selected based on the Hausman test ($\chi^2(7) = 70.08, p < .001$). The panel regression model was statistically significant ($R^2 = .0779, F(7,252) = 12.65, p < .001$), and the model explains around 7.8 percent of the variation in Tobin's Q. As shown in Table 2, the results indicate that ownership concentration is significantly positively associated with firm performance measured using Tobin's Q ($\beta = 0.001, p = .011$). This finding is supported by some of the

previous corporate governance literature claiming that ownership concentration could improve the firm performance by reducing agency costs (Chandrasena & Kulathunga, 2015; Manawaduge & De Zoysa, 2013). Nevertheless, these results contradict Earle, Kucsera, and Telegdy (2005) and Lee (2008), which suggest that concentrated ownership possibly increases agency problems and leads to poor firm performance due to the lack of convergence between the interests of the majority and minority shareholders. Furthermore, firm size measured using the natural logarithm of total assets was negatively associated with Tobin's Q ($\beta = -5.291, p < .001$), indicating that large firms perform poorly compared to their smaller counterparts. It can be an indication of higher agency costs prevailing in larger firms. There is no statistically significant association between leverage and Tobin's Q ($\beta = 0.112, p = .579$). Further, as indicated by year dummies, there are statistically significant time fixed-effects for 2017, 2018, and 2019.

Table 2: Fixed Effect Regression Results

| Dependent Variable: Tobin's Q | | | | |
|---|---------------|---------------------------|-----------------------|------------|
| $R^2 = 0.078; F(7, 252) = 12.65; p < 0.001$ | | | | |
| Variable | Symbol | β | t | VIF |
| Hirschman-Herfindahl Index | HHI | 0.001** | 2.55 | 2.98 |
| Firm Size | SIZE | -5.291*** | -8.70 | 7.66 |
| Leverage | LEV | 0.012 | 0.56 | 1.35 |
| Year Dummy ₁ | 2016 | 0.740 | 1.25 | 2.03 |
| Year Dummy ₂ | 2017 | 2.460*** | 4.04 | 2.06 |
| Year Dummy ₃ | 2018 | 2.867*** | 4.40 | 2.07 |
| Year Dummy ₄ | 2019 | 3.057*** | 4.62 | 2.08 |
| Constant | | 121.324 | | |

Notes: The symbols (***), (**) and (*) indicate statistical significance at 1%, 5% and 10% levels respectively

This positive effect of ownership concentration can be justified using the claims made in the stewardship theory suggesting that higher concentration provides large shareholders with stronger incentives and greater power to monitor management at a lower cost, consequently increasing firm performance. For example, large shareholders tend to be continually elected to the board and actively involved in the corporate decision-making process. This involvement would increase their expertise in the firm and facilitate the firm's protection by reducing information asymmetry and agency costs. In this sense, ownership concentration can act as a mechanism to mitigate principal-agent conflicts in firms, particularly in emerging markets.

5. Conclusions and Implications

Since previous research has provided conflicting evidence on the relation between ownership concentration and firm performance, this study sheds light on the association between ownership concentration and firm performance taking all the firms listed in CSE under banks, diversified financials, and insurance industry groups. Overall, the findings of this study reveal that ownership is highly concentrated in Sri Lankan firms, and the wide prevalence of family ownership and weak legal protection in the market would be the reasons behind this concentrated ownership. Moreover, the results of this investigation reveal a positive association between ownership concentration and firm performance supporting the claims made in the stewardship theory. Especially in emerging markets characterized by weaker institutions, bank dominant financial systems, and inefficient capital markets, concentrated ownership can improve firm performance. This study contributes to this body of knowledge by revealing novel evidence on the role of ownership concentration in corporate governance and its effects on firm performance in a sector that has often been neglected in corporate governance studies in Sri Lanka. Thus, these findings provide numerous policy implications on the design of corporate governance best practices for emerging markets in the Asian region such as Sri Lanka.

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