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Corporate governance and firm performance in Arab equity markets: Does ownership concentration matter?[☆]

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Abstract

The paper works with a sample of 304 firms from different sectors of the economy, and from a representative group of Arab countries (Egypt, Jordan, Oman and Tunisia) where related data could be gathered. We first present crucial descriptive statistics on the firms' corporate ownership, identity, and their performance and market measures, and then use unstructured but credible equations to capture the relationship between these variables. Specifically, we study the determinants of ownership concentration; the effect of ownership concentration on firms' performance and market measures, after controlling for the endogeneity of ownership concentration through the use of country and firm characteristics as instrumental variables; and, the effects of ownership identity and blockholdings. The broad conclusion that emerges is that ownership concentration is an endogenous response to poor legal protection of investors, but seems to have no significant effect on firms' performance.

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1. Introduction

Does ownership matter? And what are its implications for corporate governance, and its effects on firm performance? The easiest to answer of these three questions is probably the first, since the bulk of the evidence shows that privately-held firms are more efficient and more profitable than publicly-held ones – although the evidence differs on the relative merit of the identity of each private owner.[1] The second question is perhaps the most interesting because it has spawned a rich research agenda pioneered by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998, 1999, 2000). The upshot of their findings is that when the legal framework does not offer sufficient protection for outside investors, entrepreneurs and original owners are forced to maintain large positions in their companies which result in a concentrated form of ownership.[2] What makes this finding interesting is its implications for the third question, since most of the evidence shows that there is no significant effect of ownership concentration on firm performance. As a result, one is led to conclude that corporate governance or the lack of it is immaterial to firm performance.[3]

☆ The views expressed in this paper are entirely those of its authors and do not necessarily reflect those of the Cairo and Alexandria Stock Exchanges (CASE), the board of directors, or CASE policy. They do not also represent the views of the Arab Monetary Fund.

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[1] This is particularly true for enterprises that are not monopolistic in nature. See Shirley and Walsh (2001).

[2] They also find that common-law countries generally have the strongest, and French civil-law countries have the weakest, legal protection of investors, with German and Scandinavian civil-law countries located in the middle. In addition, they argue that the legal system is a more fruitful way to understand corporate governance and its reforms than the conventional distinction between bank-based and market-based financial systems.

[3] See Denis and McConnell (2003) and Berglof and von Thadden (1999).

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In fact, the widely-held firm is not a widely-observed phenomenon in most countries. This could be attributed to several reasons. In the developed countries, it could be a rational response to a legal system that does not protect minority investors (ala La Porta et al.), but it could also be the result of entrenched financial structures and practices that determine and shape the enactment of corporate law.[4] For developing countries, in addition to the aforementioned reasons, it could also be due to the underdeveloped nature of their financial markets – that would allow limited access to external financing – and the preponderance of family firms.[5] But perhaps what is more important as far as this phenomenon is concerned, especially in developing countries, is that sound governance should go beyond the textbook example of the widely-held firm and concentrate on redesigning corporate practices that are more peculiar to their case, such as: lack of agency between concentrated and minority owners, reduced liquidity of shares, cross ownership and pyramiding of shareholdings, dual-class shares, and the like.[6] This is of course an ambitious agenda, but it reflects better the corporate structure of these countries and in the process acts as a better guide for future corporate reforms.

In this context, the Arab economies are no exception. Their corporate legal system largely follows the civil-law system, but one can reasonably argue that the relation between legal origin and financial arrangements in the Arab countries merely reflects the influence of a third exogenous variable, which is the role of the state or the nature of the political system and its national governance. Here, and to nobody's surprise, the Arab world does not fare well, having a relatively closed and highly concentrated political system with a poor mode of national governance.[7] This naturally spills over to its system of corporate governance, as the majority of Arab firms are either government- or family-owned with stock markets still in a rudimentary stage. But firms are changing, prompted by increased competition from trade openness, by privatization, and by the need for more external financing. And, to better understand their future trajectory, we need to understand their current corporate make-up and performance.

In fact, most of previous research studies on corporate governance and firm performance issues have been, mainly, limited to those of developed economies or large emerging economies. It seems, then, that small economies such as those of the Arab countries are very much understudied in the literature, so in this paper we try to fill this gap by looking at the determinant of ownership concentration and the impact of both ownership concentration and ownership identity on firm performance.

Using a sample of more than 300 representative Arab firms, we find that ownership concentration in these firms seem to be negatively associated with legal protection. In addition, more active stock markets and fewer restrictions on economic activity are correlated with dilution and less concentration of corporate ownership. Hence, if the latter is desired in its own right, then naturally better laws protecting investors and their implementation and more developed stock markets are surely welcome. Also, the results indicate that ownership concentration does not seem to have a significant effect on Arab firms' profitability and performance measures. Nor does the separation between CEO and chairperson positions. This means that-given the fact that firms typically raise equity not so much in public markets but through family ties or personal relationships-legal protection of creditors is more important than improving other aspects of corporate governance since any substantial growth in external finance is likely to be debt.

The rest of the paper will be organized as follows: in Section 2 we present crucial descriptive statistics on the firms' corporate ownership, identity, and their performance and market measures, whereas in the following sections we use unstructured but credible equations to capture the relationship between these variables. Specifically, in Section 3 we study the determinants of ownership concentration as given by firm and country characteristics; while in Section 4 we look at the effect of ownership concentration on firms' performance and market measures, after controlling for the endogeneity of ownership concentration through the use of country and firm characteristics as instrumental variables. Sections 5 and 6 follow largely the same approach as in Section 4, but with Sections 5 and 6 dealing, respectively, with the effects of ownership identity and blockholdings on performance and market measures. Lastly, Section 7 closes the paper with a conclusion and some policy recommendations.

2. Data and descriptive statistics

The countries under study provide a selective but representative coverage of the Arab regions – Oman (the Gulf), Egypt and Jordan (the Mashreq) and Tunisia (the Maghreb). As important, and as Table 1 shows, the sample of firms from each country covers all major sectors–industry (both manufacturing and non-manufacturing), financial institutions and services (other than financial); with manufacturing firms comprising close to half the total of 304 firms, and financial institutions slightly more than a quarter. All firms, whether majority-private or majority-government owned, are tradable on their respective stock markets (see Appendix A for data sources).

[4] For example, countries with a tradition of strong bank involvement in corporate control and ownership have often found ways of accommodating this tradition in legal practice (as in Japan and Sweden).

[5] The evidence on family firms – especially in East Asia – is that they are robust over time, dispelling the notion that their ownership becomes dispersed over time. See Claessens, Djankov, Fan, & Lang (2000).

[6] See Berglof and von Thadden (1999). For instance, Lins (2003) finds for a sample of 1433 firms from 18 emerging countries that when a management group's control rights exceed its cash-flow rights then firm values are markedly lower.

[7] See Sadik, Bolbol, and Omran (2004).

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