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The benefits and costs of group affiliation: Evidence from East Asia

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Abstract

This paper investigates the benefits and associated agency costs of using internal capital markets through affiliating with groups using data of 2000 firms from 9 East Asian economies. We find that mature and slow-growing firms with ownership structures more likely to create agency problems gain more from group affiliation, while young and high-growth firms lose more. Agency problems are important determinants of the distribution of internal markets value gains in economies outside Japan, but less so in Japan. Consistent with the literature, financially constrained firms benefit from group affiliation. Our results are robust to different time periods and estimation techniques.

JEL classification: G31; G32; K10; O34; O4

Keywords: Business groups; Agency costs; Emerging markets

1. Introduction

In this paper, we empirically examine the benefit and costs of group affiliation for a large sample of East Asian corporations. A group can be described as a corporate organization where a number of firms are linked through stock-pyramids and cross-ownership. Relative to independent firms, group structures are associated with greater use of internal factor markets, including financial markets. Through their internal financial markets, groups may allocate capital among firms within the group, which can lead to economic benefits especially when

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external financing is scarce and uncertain, such as for young and fast-growing firms or for firms which face temporary financial distress. These benefits of internal markets may in turn be reflected in higher firm valuation and better firm performance. Typically in a group, a single individual, family or coalition of families controls a number of firms. Internal markets in combination with the typically complex ownership and control structure of group-affiliated firms may, however, lead to greater agency problems. The relative importance of the benefits of internal markets, the agency costs associated with corporate groups and the relationship of these benefits and costs with specific firm characteristics are the issues investigated in this paper.

Groups and the role of group affiliation have been the subject of much analytical analysis and empirical investigations. The economic benefits of internal markets compared to external markets have been discussed in Coase (1960) and Williamson (1985). They highlight the role organizations play in reducing transaction costs in various markets. In particular, when frictions in financial markets are severe, internal financial markets can provide benefits in allocating capital more efficiently (Stein, 1997). This role of internal markets can include providing funds to firms that have growth potential, but which are financially constrained or temporarily financially distressed.

As external financial markets are typically less sophisticated at early stages of development, groups can be expected to be common in emerging markets (Amsden, 1989; Aoki, 1990). Existing cross-country work supports the prevalence of groups in emerging markets (Chang et al., 1999; Claessens et al., 2000) although many continental European countries also have substantial group structures (Barca and Becht, 2001; see also La Porta et al., 1999 for cross-country evidence). The more complex ownership structure in a business group–involving pyramiding, cross-holdings and dual-class shares–may, however, lead to greater agency cost. The use of internal markets may thus involve cost, especially in emerging markets with weak institutions.[1]

Indeed, recent literature suggests that misallocation of resources in diversified and agglomerate organizations can arise from of agency issues (Scharfstein, 1997; Shin and Stulz, 1998; Rajan et al., 2000; Scharfstein and Stein, 2000). In the context of groups, agency issues center mainly on conflicts among shareholders due to the fact that a corporation that belongs to a business group is typically managed by the controlling owner himself thus obviating many owner–manager conflicts. Group-affiliated firms are, however, characterized by more complex ownership structures compared to independent firms. In particular, deviations of voting from cash flow rights–through stock pyramids, cross shareholdings and, to a lesser extent, dual-class shares–will often be used to allow a controlling shareholder behind the group or intermediate firms to gain effective control of a firm with low cash flow rights. As argued by Stulz (1988) and Shleifer and Vishny (1997), and shown by Claessens et al. (2002) and La Porta et al. (2002), such ownership structures can in the context of managerial entrenchment affect corporate policies and firm value. Firms with large controlling

[1] The costs of internal markets have already been suggested in case of firm diversification, a form of firm investment that involves internal market, even in more developed countries. Early findings pointed to strong evidence that corporate diversification hurts firm valuation in the U.S., although more recent evidence is less negative (see Lang and Stulz (1994) and Berger and Ofek (1995) among others). The latest findings for US firms point to a more mixed picture with some evidence reported that diversified firms do not trade at value discounts or allocate resources worse than other firms do. This more positive evidence is largely available for the U.S., as it relies on more detailed measures of firm activities and investment patterns. Lins and Servaes (1999 and 2002) investigated the effects of diversification on firm valuation in an international context, however, and also found more mixed evidence.