



# Does founder ownership affect foreign investments? Evidence from India



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## ABSTRACT

We study the effect of founder ownership on foreign investments for Indian firms. We show that foreign investors underinvest in firms with higher level of founder ownership, since these firms are more vulnerable to information problems and expropriation risk. This effect is particularly stronger when founder ownership exceeds a threshold beyond which founders hold effective control on firms. We exhibit that information problems are the main cause of the relation between foreign investments and founder ownership. This is because the relationship is more pronounced in case of business group firms and firms that are engaged in more earnings management.

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## 1. Introduction

Due to liberalization, foreign capital has gained importance as a source of capital in many markets, particularly in emerging markets where the capital market is yet to be developed (Bekaert et al., 2002). In addition, emerging markets offer more attractive opportunities to foreign investors compared to developed markets, because of their relatively higher growth prospects (Batten and Vo, 2015). Given the growing importance of foreign investments, it is imperative for an incumbent manager to understand the factors that attract foreign investors. Several studies illustrate that corporate governance, both at the firm and country level, is one of the important factors to attract foreign investors (Aggarwal et al., 2005; Leuz et al., 2010). Miletkov et al. (2014), for example, document that foreign investors are inclined to firms with more independent boards. In this paper, we examine how the concern of expropriation by insiders, coupled with poor governance, affects foreign equity investments. Particularly, we study the effect of concentrated founder ownership on foreign investments for Indian firms where concentrated founder ownership is the norm, rather than the exception (Chauhan et al., 2016; Claessens et al., 2002).

The extraction of private benefits by a firm insider or a founder is well documented in the literature, particularly for emerging markets (Claessens and Yurtoglu, 2013; Claessens et al., 2002; Bertrand et al., 2002; La Porta et al., 1999). This is because founders not only decide how the firm would be run, but also how the profits are distributed among shareholders (Claessens et al., 2000).

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**Table 1**

Description of variables.

The table presents the definition of variables used in this study.

Variable	Definition
Founder ownership ( <i>FO</i> )	A ratio of the number of shares held by founders to total outstanding shares.
Foreign investments ( <i>FI</i> )	A ratio of the number of shares held by foreign investors to outsider ownership, including mutual fund, retail investors, and banks etc.
Foreign ownership	A ratio of the number of shares held by foreign investors to total outstanding shares.
Leverage ( <i>Lev</i> )	A ratio of book value of total borrowings to book value of total assets.
Tobin <i>q</i>	Total stock outstanding stocks multiple by the year-end stock prices plus total borrowing, divided by total assets.
Return on Assets ( <i>ROA</i> )	A ratio of operating profits to total assets.
Business Group ( <i>Group</i> )	A dummy variable that takes a value 1 for firms that belong to a business group and 0 for standalone firms.
Firm size ( <i>Size</i> )	A natural logarithm of the book value of total assets
Current ratio ( <i>CR</i> )	Current assets divided by current liabilities
Dividend dummy ( <i>Divi</i> )	A dummy variable takes a value 1 for firms with dividend, and 0 otherwise
RD dummy ( <i>R&amp;D</i> )	A dummy variable takes a value 1 for firms with R&D, and 0 otherwise
Beta	The coefficient of the market model, estimated using daily returns. The market portfolio is the equal -weighted portfolio of our sample firms.
Board Size	The number of board of directors
% Ind	The percentage of independent directors in a corporate board
Earning managements	We follow Jones's (1991) methodology

This problem is further exacerbated in countries, like India, where equity ownership is highly concentrated with the few founder's family and/or controlling shareholders that facilitate them to hold more control with executive representations (Jameson et al., 2014). In such firms, founders become entrenched by their effective control with low cash-flow rights and therefore, their decisions may expropriate the rights of outside investors (see Claessens et al., 2002). As a result, these firms, in order to conceal the behavior of founders, disclose less firm-specific information. This raises information problems for outside investors when they invest in these firms (Fan and Wong, 2002; Attig et al., 2006). Anecdotal evidence shows that information problems adversely affect foreign investments because firm with greater information problems require intensive monitoring, thereby increasing foreign investors' monitoring costs (Choe et al., 2005; Kang and Stulz, 1997; Brennan and Cao, 1997). We believe that such monitoring costs to foreign investors would be more for Indian firms where a corporate board is not independent to founders (Jameson et al., 2014). In such circumstances, foreign investors would not anticipate to earn reasonable returns on their investments. As a result, foreign investors who are likely to enjoy only security benefits may be reluctant to hold stocks of firms with higher founder ownership.

On the other hand, foreign investors who maintain large presence in emerging markets may be valuable to the firm, particularly when the monitoring of domestic institutional investors is limited (Khanna and Palepu, 1999). This is because foreign investors not only bring new capital, but also global-level standard practices and monitoring skills (Aggarwal et al., 2005). This is especially favorable to firms with higher founder ownership because these firms are vulnerable to lower valuation as a consequence of the potential expropriation risk (Mahajan, 1990; Villalonga and Amit, 2006). Founders of these firms, therefore, may use foreign ownership, as an alternative governance mechanism, to convey a signal to minority shareholders that their interests would not be expropriated,<sup>1</sup> particularly in a country where legal protections of minority shareholders are weak. We posit that founders may encourage foreign investments to potentially mitigate any adverse impact of ownership.

We focus on Indian market to study the aforementioned relationship. Indian market offers several advantages for our study. First, in our sample firms, founders own, on average, 50% of total share outstanding. Such a structure gives founders, on the one hand, sufficient control to extort private benefits, on the other hand, strong incentive to improve firm value because both human and financial capitals are associated with it. Second, as a result of the dominance of business group<sup>2</sup> wherein founders control the firm by a complicated ownership, founders can extort more private benefits, thereby imposing additional monitoring costs to outside investors (Khanna and Palepu, 1999). Furthermore, India has the highest number of business group firms (1821 during 1990–97, Table 1, Khanna and Yafeh, 2007). Therefore, it allows of examining the role of business group affiliation with greater variation. Third, Khanna and Palepu (1999) suggest that Indian domestic institutional investors are ineffective monitors. Therefore, the role of foreign investors, as an effective monitor, may be more demanding. Finally, the emerging interest of foreign investors<sup>3</sup> in India is also motivating to conduct a study to understand the determinants of foreign investments. Because of these rationales, we, therefore, believe the effect of founder ownership on foreign investments would be more prominent for Indian firms.

In our empirical analysis, we make use of more than 9000 firm-year observations from 1621 Indian firms over the period 2002 to 2014. The results support our hypothesis that founder ownership is significantly related to foreign investments in Indian firms. Specifically, we document an *inverted U-shaped* relationship between founder ownership and foreign investments: foreign investors reduce their holdings only when founder ownership exceeds a threshold beyond which founders hold an effective control

<sup>1</sup> Mutton (2002) suggests that firm can deploy corporate governance to ensure the interest of minority shareholders.

<sup>2</sup> Business groups account for almost 67% of the total market capitalization of Bombay Stock Exchange, the largest stock exchange in India (Basu and Sen, 2015).

<sup>3</sup> As per a survey conducted by Bank of America Merrill Lynch, India has emerged as the most preferred equity market for foreign investors for the year 2015 at 43%, ahead of China at 26%. Backed by falling interest rates and improving earnings forecast in 2015, foreign investments in India have reached record highs of US \$ 89.5 billion, of which US \$ 57.2 billion was supplied in debt and the remaining US \$ 32.3 billion was put in the equity market (The Economic Times, March 3, 2015).

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