CHAPTER 2

LITERATURE REVIEW

This chapter begins with an introduction of the theoretical framework and empirical studies examining the ownership structure and corporate performance on foreign corporations. We then describe the empirical studies conducted on the Malaysian corporations. A summary of empirical studies examining the ownership structure and corporate performance is included to explain on the different measurements of ownership and performance conducted by previous researchers.

The origins of the issue on distribution of share ownership and corporate performance are often traced to Berle and Means (1932) in their publication of *The Modern Corporation and Private Property*. In their study, they pointed out the potential conflict of interest between the managers and diffuse shareholders when the managers do not have any ownership interest in the firm. They recognized that more concentrated ownership will establish a stronger link between managerial behaviour and owner interests, ought to yield higher profit rate.

Jensen and Meckling (1976) formalized this relation by showing how the allocation of shares among managers and owners can influence the value of the firm. They defined the firm as a set of contracts among factors of production, whereas the agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. As both parties are utility maximizers, there are reasons to believe that the agents will not always act in the best interest of the principals. They pointed out two potential sources of conflict that may arise when owner-manager's fraction of equity falls, for instance managers might have the tendency to appropriate perquisites out of the corporation resources for his own consumption. Besides, the manager's incentive to devote in new profitable investment also falls. They also described the agency cost as an unavoidable cost result from this agency relationship. Thus, it suggested that increase in managers' equity ownership would resolve the conflict of interests problem and improve the corporate performance. Besides, the issue of agency problem is always associated with the "separation of ownership and control" in the modern diffuse ownership corporations.

Fama (1980) described how the separation of equity ownership and control of a typical large corporation could be an efficient form of economic organisation. He explained the theory of firm in the function of management[5] and risk bearing within the firm (the sets of contracts). He pointed out that diffuse ownership structure is beneficial in term of an optimal allocation of risk bearing, but its consequence is that the corporate shareholders are generally too diversified across the shares of many firms to take much direct interest in a particular firm. He examined two conditions where the manager is the sole shareholder and where the manager is no longer the sole shareholders. In the condition when the manager is no longer the sole shareholder, the manager has an incentive to consume more on the job, through job shirking, perquisites or incompetence than as agreed in his contract.

Fama and Jensen (1983) demonstrated various possibilities that managers who own enough stock to dominate the board of directors could expropriate corporate wealth. Stulz (1988) explained how owning large blocks makes it easier for managers to be entrenched. Thus, greater stock ownership by managers increases the power of the internal constituency, but decreases the power of the external constituency in influencing corporate performance.

Besides the theoretical studies, several empirical studies had been conducted to investigate the existence of ownership structure problem against the corporate performance. Table 1 showed the summary of empirical studies examining ownership structure and performance. The results are mixed, due to the variation in measures of ownership and performance.

[5] Management is a type of labour but with a special role, i.e. co-ordinating the activities of inputs and carrying out the contracts agreed among inputs, all of which can be characterized as "decision making".

Demsetz and Lehn (1985) studied the structure of corporate ownership on 511 US corporations. They used three measures of ownership concentration, those are the percentage of top five largest common equity shareholders, percentage of top twenty largest shareholders and the Herfindahl measure of ownership concentration. The analysis was done by using ordinary least squares (OLS) regression estimates of the ownership concentration on three alternative measures of profit instability and four other control variables. It found no significant relationship between ownership concentration and accounting profit rates. The result showed no support to Berle-Means hypothesis.

Morck, Shleifer and Vishny (1988) and McConnell and Servaes (1990) examined the relationship between ownership structure and corporate performance using different methodologies, but similar measures of ownership and performance. Morck, Shleifer and Vishny estimated a piece-wise linear regression in which the dependent variable, Tobin's Q[6] ratio was used as proxy for corporate performance and the primary independent variable is the fraction of shares owned by corporate insiders. This study found evidence of a significant non-monotonic relationship on 371 Fortune 500 corporations. It supports the view that insider ownership did have a positive effect on corporate performance. McConnell and Servaes demonstrated that Q ratio is non-linearly (curvilinear relation) related to the degree of insider ownership. It suggested a positive effect of institutional ownership on corporate performance. The results are consistent with the hypothesis that corporate value is a function of equity ownership structure.

Holderness and Sheehan (1988) demonstrated the role of majority shareholders in publicly held corporations. The authors observed the relationship between majority shareholders and the performance of the corporation, which is measured by the accounting return, Tobin's Q, investment policies and the frequency of corporate control transactions. The

[6] The market value of debt plus the market value of equity divided by the replacement cost of all assets.

result showed no difference between the performance of the majority owned and diffusely held firm.

Murali and Welch (1989) examined the differential performance exists between closely and widely held firms. The tests were conducted using two models. The performance were measured by stock market efficiency and firm specific accounting measures, i.e. return on assets (ROA) and return on equity (ROE). The result found no difference between a majority held and widely held corporations whether using the stock market efficiency measure or accounting profitability ratio.

Hill and Snell (1989) developed a slightly different model to test the influence of ownership structure on corporation. They used the corporate productivity as the measure of performance. The study found a positive and significant effect of ownership concentration on productivity, but insignificant effect of managerial ownership against productivity. Oswald and Jahera (1991) investigated the link between managerial shareholdings and performance, which was measured by excess return, ROA and ROE. The findings supports Berle and Means hypothesis that positive relation exists between managerial ownership and performance.

The effort was continued by Xiaonian Xu and Yan Wang (1997). The study examined the ownership structure and corporate performance of the Chinese Stock Companies. The study employed three accounting ratios to measure the corporate performance, i.e. market to book value ratio (MBR), return on equity (ROE) and return on assets (ROA). The three accounting ratios were used to replace the Tobin's Q, as adopted by other studies. The author has given the reasons that as only few of the Chinese stock companies issue debt securities, it is impossible to estimate the market value of the companies' debt. Besides, the information needed to calculate the replacement cost of assets is not available. The authors defined the ownership concentration ratio as the percentage of shares controlled by the top 10 largest shareholders. Other factors that might affect the corporate performance, such as sales, debt to asset ratio and growth in net income are also incorporated in the regression. The result showed that ownership structure has positive and significant effect on the corporate performance in Chinese stock companies.

Claessens, Djankov, Fan and Lang (1998) examined the link between ownership structure and corporate performance in nine East Asian countries. The study considered the market valuation and accounting measure, and adopted the excess value[7] of the corporation as the industry-adjusted market measure of performance. The result of the study showed a negative and significant relationship in more developed countries, whereas a positive and significant effect in less developed countries.

Recently, Han, Lee and Shuk (1999) in their study showed a mixed and weak effect of the ownership structure on corporate performance for 2000 corporations in G7 countries. This study was conducted first by using the return on equity as a measurement of corporate performance. The control variables are ratio of capital to labor, total assets, ratio of long-term debt to market value of equity and a dummy to indicate the SIC code. The result found no evidence that corporate performance was improved by the concentration of insider ownership. A further analysis was conducted by replacing the return of equity with the market to book value equity. A similar result showed no relationship between the insider ownership concentration with the market value of the firm.

At the same time, Himmelberg, Hubbard and Palia (1999) extended the cross-sectional result of Demsetz and Lehn (1985) to explain the link between the ownership and performance. The study cannot conclude that changes in managerial ownership affect corporate performance, which yield similar result as Demsetz and Lehn.

[7] The ratio of firm's actual value to firm's imputed value. The actual value is measured by market capitalization, market value of common equity plus book value of debt. The imputed value is the median market to sales ratio for each industry in each country using only single segment firm.

In Malaysia, Puthucheary (1960), Sieh (1978), Lim (1981) and others studied the problem of ownership and control of Malaysian economy in early years. In recent studies, Kwabena (1993) and Yee (1998) in their thesis empirically examined the ownership structure problem on Malaysian companies.

Kwabena (1993) investigated 210 companies listed under the KLSE in the period from 1984 - 1991. He used the risk adjusted Jensen's alpha as a measure of corporate performance. Initially, the study was done by examining the relation between ownership concentration and performance. Then, he examined the link between managerial ownership and performance. Both analyses showed insignificant effect on ownership structure with performance.

Yee (1998) examined the relationship between ownership and return in Malaysia. The sample was selected from 427 companies listed under the KLSE, which comprised of various sectors of the main board companies and second board companies. The ownership concentration was measured by the percentage of top ten largest shareholders and growth in net income was used as a proxy for the corporate return. The result showed that some of the sectors yield a negative relationship between highest shareholders and performance of the companies. However, the overall result showed no significant relationship between ownership concentration and performance of corporations for both 1993 and 1995.

Several studies had been conducted on the effect of ownership structure on corporate performance in Malaysia. Study by Claessens, Djankov, Fan and Lang (1998) on nine East Asian Countries corporations, including Malaysia demonstrated a positive and significant relation between ownership concentration and corporate performance. However, local study by Kwabena (1993) and Yee (1998) showed an insignificant effect of ownership concentration on Malaysian Corporation. Therefore, we would expect that the findings of this study would contribute additional evidence to one of the studies.

TABLE 1: SUMMARY OF EMPIRICAL STUDIES EXAMINING OWNERSHIP STRUCTURE AND PERFORMANCE

Study	Sample (study period)	Measures of Ownership	Measures of Performance	Result *
Demsetz and Lehn (1985)	511 US (1976-1980)	Ownership concentration - % of top 5 - % of top 20 - Herfindahl index	Firm size (Total equity) Market rate of return Return on equity	0
Morck, Shleifer and Vishny (1987)	371 Fortune 500 companies (1980)	Board ownership	Tobin's Q Profit rate (net cash flow)	+
Holderness and Sheehan (1988)	114 US (1978-1984)	Ownership concentration	Tobin's Q	0
Murani and Welch (1989)	126 US (1977-1981)	Ownership concentration	Stock market efficiency ROA ROE	0
Hill and Snell (1989)	122 Fortune 500 Companies (1980)	Ownership concentration Managerial ownership	Productivity (Value added per employee)	+ 0
McConnell and Servaes (1990)	1173 (1976) 1093 (1986) US	Managerial ownership	Tobin's Q	+
Oswald and Jahera (1991)	645 US (1982-1987)	Managerial ownership	Excess return ROA ROE	+
Kwabena Yeboah-Duah (1993)	210 Malaysia (1984-1991)	Ownership concentration Managerial ownership	Risk measurement of Jensen 's alpha	0 0
Xiaonian Xu and Yan Wang (1997)	59 (1992) 177 (1993) 291 (1994) Shanghai & Shenzen	Ownership concentration - % of top 10 - Herfindahl index	ROE MBR ROA	+
Claessens, Djankov, Fan and Lang (1998)	10,000 Nine East Asian countries (1991-1996)	Ownership concentration	Excess value	+ / -
Yee Hooi Seng (1998)	427 Malaysia (1993-1995)	Ownership Concentration - % of top 10 shareholders	Growth in net income	0
Han, Lee and Shuk (1999)	2000 G7 countries (1991-1994)	Managerial ownership	ROE MBR	0
Himmelberg, Hubbard and Palia (1999)	600 Fortune 500 and non-Fortune 500 (1982-1984)	Managerial ownership	Tobin's Q	0

*+ = positive and significant effect, - = negative & significant effect, 0 = no effect