CHAPTER II

LITERATURE REVIEW

The diffuseness in ownership structures that brought to the separation of ownership from control in the modern corporations has long been recognized. The research on the implications of the separation of ownership and control on firm performance found its root in the classic of Berle and Means (1932), *The Modern Corporation and Private Property*. From a sample of 200 largest nonfinancial corporations in 1929 and 1930, they found that 44% of these firms to be subjected to management control, 21% were controlled by a legal device, 23% minority controlled, 5% majority controlled and 6% were under private ownership control. According to Berle and Means, this transfer of power from owners to professional managers revealed a revolutionary transformation in property relations. They asserted that potential conflict might arise between professional managers and dispersed shareholders when the managers do not have ownership interest in the firm.

Following the landmark study of Berle and Means, numerous research works have been conducted to explore the relation between ownership structure and firm performance. Most of economists have distinguished between owner-controlled and management-controlled firms, and examined the relationship between ownership types and performance. Organizational theorists, on the other hand, have investigated the impacts of ownership types on structure, strategy and top executive characteristics. The results of the studies, however, are rather mixed. For instance, Monsen, Chiu and Cooley (1968), Boudreau (1973), and Morck, Shleifer and Vishny (1988) provide empirical evidence that ownership structure has important implications on firm performance. Kamerschen (1968), Jensen and Meckling (1976), and Demsetz and
Lehn (1985) have claimed that no significant relationship exists between ownership concentration and profitability.

Monsen, Chiu and Cooley (1968) examined the effects of management-controlled and owner-controlled firms on firm performance over the period 1952 to 1963. The study used a sample of 500 largest industrial firms taken from 1964 Fortune Directory. These firms were classified into twelve industrial types by major product. A firm was considered to be owner controlled if one party holding at least 10% of the voting rights, whereas a management controlled firm with less than 5% of the voting stocks. Monsen et al. assumed that the value of firm performance that measured by net income to net worth ratio was determined by four variables i.e. control type, industry type, size of the firm and time. Owner controlled firms reported a mean net income to net worth value that was 75% higher than that of management controlled firms. Thus, this study provides strong empirical evidence that owner controlled firms outperform the management controlled firms. The drawback of this study is the use of non-market measures for firm performance.

The study of Radice (1971) concluded that owner controlled firms show superior performance on both profitability and growth rate than management control firms. These findings gave support to Monsen et al. (1968)'s work. However, the results may be suffered from selective bias due to the owner-controlled sample firms are all very large in size and have a well-developed managerial hierarchy in the United Kingdom.

In general, two managerial hypotheses have been developed from the earlier literature. The first hypothesis states that executives of manager-controlled firms are less likely to engage in strictly profit-maximizing behavior relative to executives of owner-controlled firms, meanwhile, the second hypothesis claims that executives of
manager-controlled firms tend to be more risk-averse due to asymmetries to managerial reward structures. Differ from most of previous literature, Bothwell (1980) believes that both of the managerial hypotheses are not mutually exclusive and should be tested together. The writer, therefore, employed the Capital Asset Pricing Model (CAPM) to test the effect of the separation of ownership and control on both profitability and risk. The CAPM is used to build a new specification to examine the correlation between corporate control and economic performance by taking into account the effects of portfolio risks and the corporate income tax. There was a significant larger profit margins reported for both weak and strong owner-controlled firms compared to management-controlled firms. The results were not significant regardless of the measure of market structure used. In short, this study provides additional support for the first managerial hypothesis but not for the second one.

Demsetz (1983), in contrast, claimed that both of ownership concentration and profitability are unrelated. According to Demsetz, the decision to loosen owners’ control over managers is an awareness to gain benefit from this transfer of power. The higher costs incurred through this transformation should be offset by lower capital acquisition cost. Demsetz and Lehn (1985) further regressed the accounting profit rate of 511 large U.S. corporations in 1980 with three measures of ownership concentration. The results lend no support to Berle-Mean thesis.

Jensen and Meckling (1976) formalized the relationship between corporate value and managerial equity ownership. They claimed that the value of firm increases as the fraction of the shares owned by inside shareholders (managers) increases, which is consistent with convergence-of-interest hypothesis. Stulz (1988) and Morck, Shleifer and Vishny (1988) further revealed the nonlinear relation between the
corporate value and ownership structure from the theoretical and empirical front respectively.

Stulz (1988) presents evidence that the market value of a firm that is a potential takeover target first increases, and then decreases as the fraction of shares controlled by insiders increases. From his model, if there is no voting rights controlled by managers, \( \alpha = 0 \), a takeover attempt will succeed even at a premium that is less than the maximum premium the bidding firm willing to pay. When there is an increase in \( \alpha \), the hostile bidder has to pay a higher premium and the probability that the takeover will succeed decreases. If the managerial ownership is large enough that is at 50\%, the probability of a successful takeover will be zero due to highly effective opposition to takeovers from the managers. These findings support the study of Weston (1979) that firms with at least 30\% ownership in the hand of insiders had never been acquired in a hostile takeover up to the period covered in his study. This result, thus, implies a curvilinear relation between the firm value and the fraction of share owned by inside shareholders.

Morck, Shleifer and Vishny (1988) investigated the correlation between management ownership and Tobin’s Q which is a proxy for value of the firm by using 371 Fortune 500 firms in 1980. The results showed a positive relation between ownership and Tobin’s Q for the board ownership ranging from 0\% to 5\% and negative relation in the 5\% to 25\% range. When board ownership increases beyond 25\%, Q continues to rise slightly. It is found that Tobin’s Q for the firm run by a member of the founding family is lower than that run by an officer unrelated to the founder. The increases of Tobin’s Q with ownership reflecting the convergence of interests between managers and outside shareholders whereas the decline resulting from entrenchment of the management team. However, Morck et al. did acknowledge
the drawbacks of the study that the sample firms are all very large and therefore relatively old as well as ignored the heterogeneity of members of director board.

McConnell and Servaes (1990) explored the cross-sectional relation between Tobin's Q and the structure of equity ownership for a sample of 1173 firms in 1976 and 1093 firms in 1986. The results showed a significant curvilinear relation between Tobin's Q and the fraction of shares owned by corporate insiders which is consistent with Morck et al. (1988) i.e. the relation is positive at low levels of insider ownership and the other way round at high levels of insider ownership. The curve slopes upward until insider ownership reached around 40% for 1986 and 50% for 1976 and then slopes slightly downward. When institutional ownership entered the model, a positive relation was found with Q which is in supports of the efficient-monitoring hypothesis of Pound (1988). No significant relation was reported between Q and blockholder ownership. The writer also used a set of control variables including financial leverage, research and development intensity, advertising intensity and the replacement value of assets to measure the sensitivity of these variables as the determinants of Tobin's Q. All of these control variables are significantly related to Q except for the replacement value of assets in 1976. Both of research and development intensity and advertising intensity with positive coefficients suggest that these expenditures are value-added for the firm's intangible assets. Negative coefficient in replacement value of assets indicated that firm size is negative correlated with Q. After controlling the firm size effect, the relation between distribution of ownership and Q remains the same. Hence, the size effect does not significantly influence the results of this study.

Saunders, Strock and Travlos (1990) investigated the ownership structure and risk-taking behavior in banking firms from 1978 to 1985. This study tested for two
hypotheses as follows: (H1) stockholder-controlled banks have an incentive to take more risk than those of managerially control bank; (H2) these differences in risk-taking behavior should be more pronounced under periods of deregulation. According to Saunders et al., risk taking for the bank is an endogenous decision that is determined by ownership structure, financial leverage, operating leverage, bank size and the regulatory environment. This is in contrast to Demsetz et al (1985) who treats ownership structure as an endogenous variable and risk as exogenous in a similar model. Bank risk that is measured by seven different capital market risk measures is regressed on the fraction of shares owned by officers and directors, the book value of capital-assets ratio, the ratio of fixed assets to total assets and the total assets for 38 banks over the eight-year period. The results are quite mixed but still provide some support to H1. Time trend dummies further entered the model to test the correlation between risk and ownership structure during the deregulation period of 1979 to 1982. It was found that in five out of seven capital market risk measures, the coefficient that relating ownership structure to risk is significant positive. It is consistent with H2 and implies that ownership structure is one of the factor that contributing to the increase in risk-taking behavior in period of deregulation. The regulatory bodies, therefore, are suggested to increase the frequency of examination for stockholder-controlled banks.

Gorton and Rosen (1995) argued that the entrenched bank managers who receive private benefits of control and imperfectly monitored by outsiders, such managers will tend to take on excessive risk when the industry is unhealthy. In contrast, the entrenched managers will tend to behave too conservatively when the industry is healthy. It is found that entrenched bank managers in U.S, i.e. insiders holding at least 20% of bank common stock have an incentive to make more risky commercial real estate construction and development loans relative to safer consumer
loans during the 1980s. Throughout the 1980s the U.S. banking industry was hit by increased riskiness and declining investment opportunities that led to sharply rise in cases of bank failure. The findings of this study provide empirical evidence that corporate control problem is a major factor in explaining the unhealthy banking industry especially the problem of adequately-capitalized large U.S. banks during the 1980s. Hirschey (1999) hypothesized that the underperformance of closely-held banks results from size differences. The rationale lies on the fact that insider ownership or closely-held shares tend to be highest and pronounced among the relatively small banks but become less significant in ownership structure of larger banks. Thus, underperformance of small banks may simply reflect diseconomies of small-scale operation rather than high level of insider ownership. A pooled cross-section sample of 777 commercial bank holding companies from 1992 to 1996 has been taken from Compustat. Bank performance is assumed to depend on total assets, the rate of growth in total assets, leverage and managerial equity ownership. The results for the all sample provide some evidence of limiting influence of bank managerial equity ownership on the accounting performance and capitalized market value of assets on commercial banks. After controlling for bank size effect, however, no significant inverse relation is found between closely-held banks and bank performance. This finding is consistent with the study of Demsetz et al. (1985) that no significant relationship can be drawn between ownership concentration and the firms’ performance. Thus, inferior performance of closely-held bank is unrelated to ownership concentration and may simply due to diseconomies of small-scale operation.

In Malaysia, the studies on ownership and corporate control have gained attention from researchers such as Puthucheary (1960), Mamajiwalla (1968), Yip
(1969), Hirchman (1971), Sieh (1978), Lim (1979), Yeboah-Duah (1992) and Sew (1995). In general, the earlier studies that were carried out before 1990s only concentrated on the ownership and control structure in Malaysian corporation without exploring further its impact on firm performance. Puthucheary's work (1960) has been credited as the pioneering effort in this field. In this study, he found that economies of Malaya and Singapore were dominated by foreigners especially on the hands of British. The corporate economy i.e. mining, rubber, commercial and manufacturing sectors was primarily under control of big business units. The drawback of this study was the weak and unsystematic manner on data presentation.

The study of Yeboah-Duah (1992) is the first attempt to look into how ownership distribution contributes to firm performance. He took a sample of 210 KLSE listed companies under industrial, finance, property and plantations sectors over the period 1984 to 1991. This study employed Jensen's alpha and risk adjusted Jensen's alpha as measurements for the firm performance under different economic environment: bull, bear and relatively stable. No significant differences in performance are observed between owner controlled firms and managerial controlled firms. Likewise, no differences in performance are reported for the firms controlled by Chinese, Bumiputera and foreign investors. These findings are inconsistent to both managerial hypothesis and agency theory. However, the means for insider ownership of sample firms increased significantly throughout the study period.

Sew (1995) used a cross-sectional sample of 312 KLSE listed companies under different industries in 1992 to test the relationship between ownership structure and firm value. She used market capitalization of firm normalized by total assets to represent the firm value and regressed it to insiders ownership, institutional investors shareholding and a set of control variables viz financial leverage (total long term
liability-total assets ratio) and capital investment intensity (purchased of fixed asset-
total assets ratio). The result showed no significant relation between firm value and
equity ownership whether for firms of different sizes or under different industry
sectors: industrial, finance, hotel, property, tin and plantations. The most significant
finding is the positive relationship of capital investment intensity on firm value
especially for larger firms due to well-developed managerial hierarchy. There is some
evidence that leverage ratio is negatively related to firm value. These results run
contrary to Modigliani-Miller (MM) model that states the expected rate of return on
the common stock of a levered firm reflected on market value should increase in
proportion to the leverage ratio.