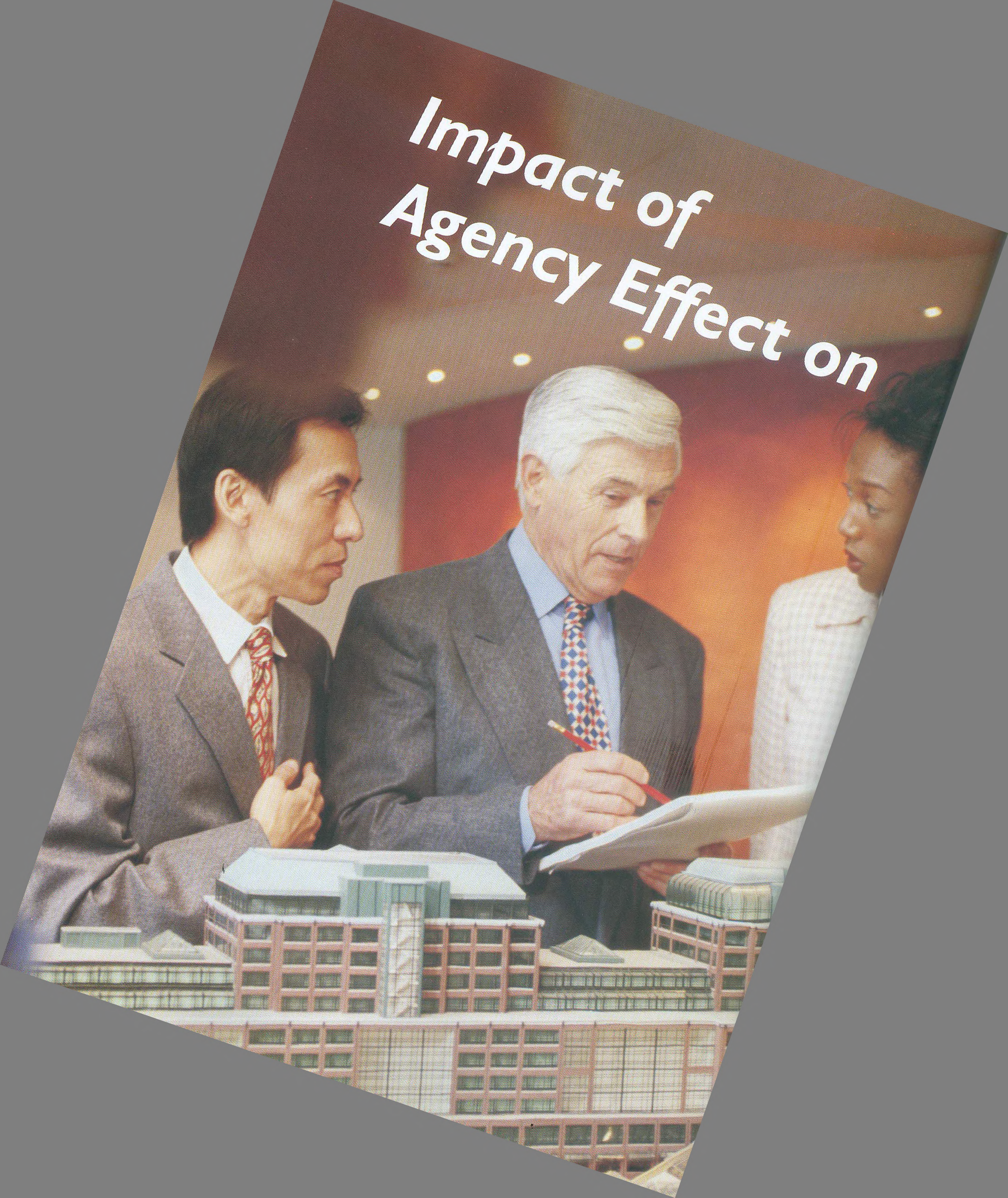
Impact of Agency Effect on



ABSTRACT

No promoter would like to share his power with other shareholders, be it managers, workers, government, public or institutional investors. But in order to succeed, he has to choose *between growth versus control. In order to grow at a rapid pace, promoters have to raise capital from the capital* market, which *will certainly dilute their control. The stake of different shareholders affects the core competencies of the* company, which *holds the key to success. The current article tries to find the similarities in the nature of agency effect among top five companies within each sector. The objective behind this study is to help promoters and government decide the optimal agency* effect, which *can lead to corporate success. Unique agency effect for each company plays a key role in its acquiring core competencies. Companies can formulate their strategies based on their core competencies and resources availability, which are affected by the nature of agency effect that the promoters are willing to accept. The current study captures this effect by adopting the methodology of the discriminant analysis.*

Corporate Performance: An Empirical Study

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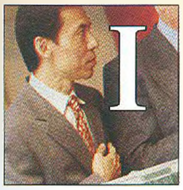
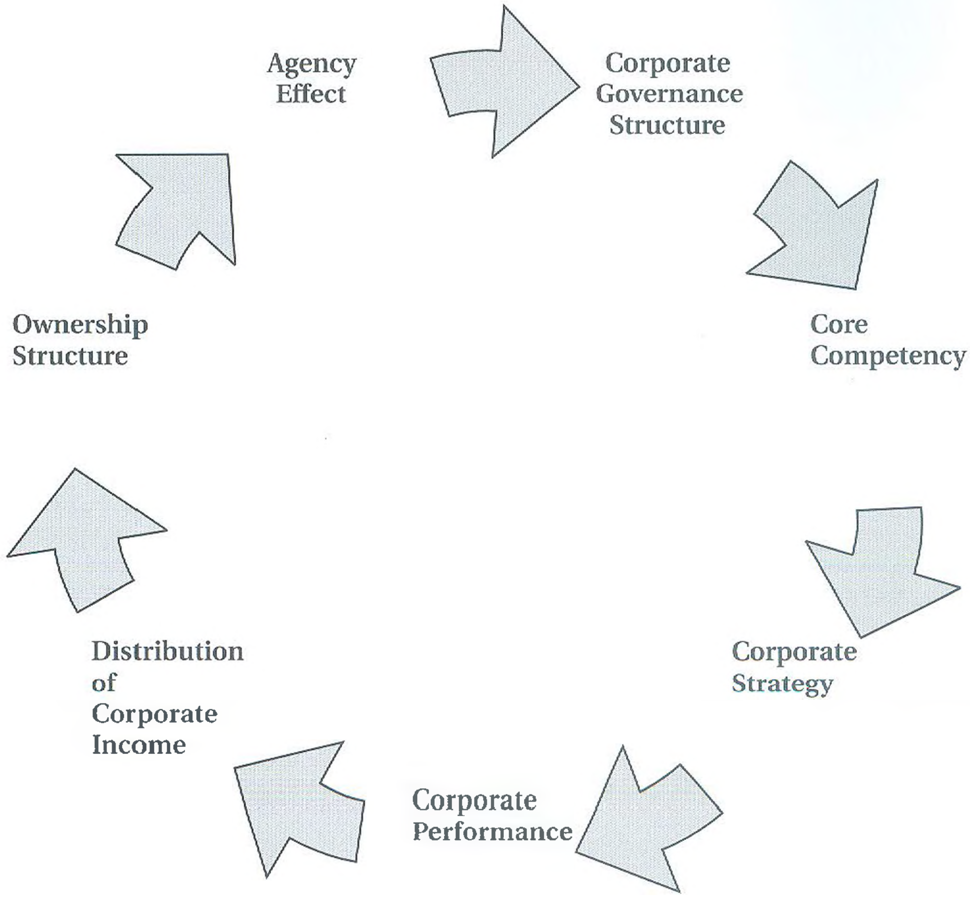


INTRODUCTION

The agency effect has a profound influence on the corporate performance. Dynamics of agency effect and its interaction with other key elements, which influence the performance of a company, has been shown below. Although the inter linkage between these key elements is interesting, though quite complicated, the present study only limits itself to the influence of the agency effect on corporate performance.



CLARIFICATION OF THE KEY CONCEPTS

Agency Effect - Agency effect may arise because of divergence or convergence between the interests of investors from the interests of the managers/promoters of the company, who are managing the company. This may lead to differences between governance and management of the company. In case of alignment effect, the interest of managers/promoters converges with the interest of the investors and it diverges in case of entrenchment effect (Laxmi, 2005).

Ownership Structure It shows the distribution of shares amongst major categories of shareholders like promoters, managers, institutional investors, government, workers, public etc. and their respective objectives for investing in the company. The objectives of major categories of shareholders could be either portfolio intention to earn maximum returns or it may be strategic to serve their own purpose (Han, Lee and Suk, 1999).

Corporate Governance Structure - It analyses the nature of relation between major categories of shareholders i.e., whether it is entrenched or aligned with each other and its impact on core competencies and corporate strategy (Abe, 2002)

Core Competency - Core competencies are the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies. (Prahalad et al, 1990).

Competitive Strategy It is about being different. Strategic choice requires trade-offs. Trade-offs occurs when activities are incompatible (Porter, 1996).

Corporate Performance Different researchers have used different firm performance proxies. While Morck et al. (1988) and McConnell et al. (1995) have used Tobin's Q, Demsetz and Lehn (1985) as well as Denis and Denis (1994) have used accounting measures of performance. In the present study, the corporate performance has been evaluated in terms of market leadership (Welch, 2004).

Distribution of Corporate Income - This has significant influence on the ownership structure. According to Baumol (1973), promoters tend to concentrate on profits and adopt strategies to implement it. As the companies grow in size, the power of promoters tends to decrease and that of managers increase. Managers use this power to maximize the sales of the company so that their emoluments are maximized. Hence, increase in the agency effect tends to shift the corporate objective from profit maximization to sales maximization.

The Noble laureate, Galbraith (1962) conceptualized the concept of agency effect in terms of dependence of the company on capital market for expansion and diversification. With the increase in the power of managers and decrease in the power of promoters, a company depends less on capital market and more on internal resource generation by cutting back on dividend distribution. That is why most of the successful companies in USA do not pay any dividend to their shareholders. This policy is very important for professional managers because by decreasing the dependence on capital market, managers are able to reduce the power of shareholders and promoters.

BRIEF LITERATURE REVIEW

The nature of corporate governance and the presence of agency effect have been studied in detail by Ross (1973) who formalized conflict of interest arising from the separation of ownership and management as a principal-agent problem. Jensen and Meckling (1976) coined the phrase "agency costs" to represent the costs of all activities and operating systems designed to align the interests and/or actions of managers (agents) with the interests of owners (principals). Porta (1999) tried to correlate agency effect with corporate governance. According to him, corporate governance is a set of mechanisms through which outside investors protect themselves from expropriation by insiders. Insiders in this context mean not only managers but also promoters who can influence these managers. Outsiders mean all types of shareholders who are not promoters and managers of the company. Hence conflict may occur within insiders (i.e. between managers and promoters) as well as between insiders and outsiders. From the perspective of promoters, managers are agents whereas from the perspective of outside shareholders, even promoters can be considered as agents. In contrast, corporate governance structure, which depicts the agency effect in action, determines the alignment effect and the entrenchment effect between major categories of shareholders. This is the effect, which will be captured by the discriminant analysis.

Most of the previous studies have focused only on the entrenchment aspect of the agency effect. Based on this approach, various studies in India have shown an insignificant relationship between degree of stake of the promoters and the corporate performance of the company. The few industries where insider ownership is associated with performance can be seen as temporary aberrations and are industry, time period and performance parameter specific. These incidences tend to disappear in a short time span. (Phani et al, 2006)

The most important finding about the relation between managerial ownership and firm performance (when the managerial ownership is considered exogenous) is that of Morck et al (1988). They argue that at lower levels of managerial ownership, the managers would like to earn more profits and hence would align their interests with that of the shareholders. This, in the literature, is known as the alignment effect. But at higher levels of managerial ownership (at 5percent) the entrenchment effect and the empire building effect is higher than the alignment effect, and at still higher levels of managerial ownership (30percent) alignment effect dominates the entrenchment effect. The findings by Hermalin and Weisbach (1988) corroborate with the findings of Morck et al (1988). The alignment effect has been analyzed by Sarkar and Sarkar (2000) in the Indian context who have found that, except for the Institutional investors, the increase in the stake of all large shareholders beyond the threshold limit of 25percent increases the company value.

Although these studies have analyzed the performance of the companies from different perspectives, but none of them have studied the common factor amongst the corporate governance structure and market leadership specific to a sector, which can explain the relationship between these two. The current article tries to study the relation between agency effect and market success on the basis of entrenchment and alignment effect.

METHODOLOGY

Conceptual Issues in Defining Agency Effect

The current article studies the agency effect from the perspective of entrenchment and alignment between different categories of shareholders and its effect on corporate performance. Morck (1988) has analyzed it in the American context and Sarkar and Sarkar (2000) in the Indian context. Major shareholders have been categorized into four categories viz. foreign investment, institutional investment, promoters' investment and public investment. The data has been obtained from 'Capital Line Database'. An effort has been made to link the different corporate governance structures and their respective sectors' requirement of core competencies.

Four sectors have been chosen viz. metal, FMCG, Information Technology and energy. The companies have been chosen as per Sensex and CNX index. Sensex FMCG has 14 companies out of which 9 are MNCs. Sensex Metals has 13 companies out of which 10 are family businesses. Sensex IT has 10 companies out of which 8 are professional companies. CNX- Energy has 10 companies out of which 7 are PSUs. Table -1 gives details about this classification. Companies included in the index have highest market capitalization and sales turnover and hence could be accepted as most successful in their respective sectors.

Table-2 provides the mean values for all the four main categories of shareholders for the four sectors under study. Five companies, which closely represent the mean value for their respective sectors have been chosen for discriminant analysis.

Metal (code-1)

1. Hindalco Industries - K.M Birla Group
2. Ispat Industries - Mittal Group
3. Tata Steel - Tata Group
4. Mahendra Seamless - Mahendra Group
5. Jindal Stainless - Jindal Group

Energy (code-2)

1. Indian Oil - PSUs
2. NTPC - PSUs
3. Neyvali Lignite - PSUs
4. ONGC - PSUs
5. BPCL - PSUs

FMCG (code -3)

1. ITC - Subsidiary of BAT, an MNC.
2. HLL - Subsidiary of Uniliver, an MNC
3. Colgative Polmolive (India) - Subsidiary of Colgative Polmolive, an MNC
4. Nestle India - Subsidiary of Nestle International
5. Bata India - Subsidiary of Bata International

Information Technology (code-4)

1. Infosys Technologies - Started by N.R Narayana Murthy with his friends
2. Satyam Computers - Started by Ramalingam Raju along with his relatives
3. Patni Computers - Started by Patni
4. Hexaware - Started by Dr. Alka Nishar with investment from foreign software companies
5. HCL Technologies– Started by Shiv Nadir along with his friends

DEFINITIONS

The following criteria have been used to classify the companies between Family Businesses, MNCs, PSUs, and Professional Companies.

1. Family Business – Any company which is part of an Indian family business house.
2. MNCs – An MNC with more than 20 percent stake in an Indian company.
3. Professional Companies – Any private sector company that do not belong to either of these two groups.
4. Public Sector Undertaking – Owned by the government, directly or indirectly.

HYPOTHESES

Prahalad (1990) discussed about company specific core competencies. The present article deals with industry specific core competencies. Strategies are the embodiments of the organizational core competencies which ultimately affect the corporate performance. The unique core competencies required in FMCG, Metal, Information Technology and Energy Sectors are as follows: -

FMCG - In the FMCG sector, MNCs have been successful where local responsiveness combined with the experience of effective leveraging of marketing strategies of various countries is required. Managing brand equity is the key to success in this sector. These are the competencies required to succeed in FMCG sector and MNCs have been successful in acquiring these competencies.

Metal - Success in metal sector requires strength of the company to take advantage of economies of scale through mobilization of capital resources which Indian family businesses are competent to exploit. Since metals are generic commodities, marketing and brand building are not the key requirements of this sector as is the case with the FMCG sector. Generally speaking, family business houses are less effective in building brands and more effective in reaping economies of scale.

Information Technology - Highly qualified professional technocratic entrepreneurs have been successful in software sector. The low salary of knowledge workers in India as compared to developed countries and availability of skilled labour has made India a successful country in the software sector (Shirur, 2005). The competence required to succeed in this sector is the ability to effectively deliver the services within scheduled time, which are reliable and consistent.

Energy - India is mainly dependent on Middle East energy sources for its requirements and plays a critical role in managing its balance of payment account. Prices of energy products are highly volatile and also highly politically sensitive issue. Due to these factors, government has decided to retain this sector. Hence most of the companies in this sector are PSUs. Core competencies required in this sector is ability to manage two things. One is to negotiate prices for bulk purchase of energy products. Another is to manage the political establishment. When ever price in the internationa markets shoots up, top management of the oil companie have to convince the political establishment to either raise th price or issue oil bonds. This can be successfully done by PSUs

FINDINGS

Data collected and tabulated from Capita Line database has been shown in Table -3 Discriminant analysis has been used t select the linear combination of variou percentage stake of four categories c shareholders that best discriminate between the four sector Discriminant analysis is a technique that will be able t discriminate between categories of the dependent variables i the best possible way.

Since the five most successful companies have been selecte hence the objective of the study is to find common factors within the sector, which are different from other sectors in terms of corporate governance structure.

Discriminant analysis has been highly successful in correct classification between sectors. 18 out of 20 items have been correctly classified, which means that 90 percent of original grouped cases have been correctly classified.

Whether classification has been effective or not can be judged by its Eigenvalue and Wilk's lambda as specified in Table 5&6. For each discriminant function, the Eigenvalue is the ratio of between-group to within-group sums of squares. Large Eigenvalue imply superior functions. Wilks' lambda for each predictor is the ratio of the within-group sum of squares to the total sum of squares. Large value indicates that group mean do not seem to be different. Small values of lambda indicate that the group mean seem to be different. The sign of goodness of fit is that Eigenvalue should be higher than 1 and Wilk's lambda should be lower than 1. Function – 1 has an Eigenvalue of 6.673, which is able to explain 69.8percent of the variance. Wilk's lambda has a value of .027 with chi-square of 54.2721 for degree of freedom of 12 with significance level of zero. Function -2 , with Eigenvalue of 2.506 which is able to explain 26.2 percent of the variance. Wilk's lambda has a value of .206 with chi-square of 23.707 for degree of freedom of 6 with significance level of 0.01. Both these functions are very successful in discriminating between sectors. Function-3 is not important for explaining the variance, as it is able to explain only 4percent of the variance. Hence further analysis will only deal with Function 1&2.

As per Canonical Discriminant Function as mentioned in Diagram -1, there is a clear categorization of code 2 & 4 i.e., 'information technology' and 'energy sector.' Centriods of energy sector is equal to information technology sector as far as function 1 is concerned whereas energy sector has higher value for Function-2 as compared to 'information technology'. In case of information technology sector, stake of foreign investors is very high whereas in case of energy sector, stake of promoter is very high.

There is ambiguity between code 1 &3 i.e., metal and FMCG sector. Both have fairly close centroids. Hence the classification in not clear. Distinction between FMCG and metal sector could be derived from entrenchment and alignment effect. In case of FMCG sector, there is alignment between foreign investors and promoters because promoters are mainly MNCs. In case of metals, there is alignment between institutional investors and promoters.

INTERPRETATION OF DISCRIMINANT ANALYSIS

Data has been interpreted as per Table- 4. It is logical to believe that in all the four sectors, promoters have strategic stake while public has portfolio intentions while investing in a company. Distinguishing factor is the way by the two functions of the discriminant analysis.
foreign and institutional investors align or entrench with the promoters and their basic intentions behind the investment. This is what has been captured by the two functions of the discriminant analysis.

Although 90 percent of original grouped cases have been correctly classified, this does not necessarily mean that accuracy is of that high order. In fact, so many factors have a bearing on the success of a company that it is not possible to explain it solely from the point of view of governance structure.

ANALYSIS OF THE DATA

Metals - Since all the companies under the study in this sector belong to prominent family business houses, hence there is a strong possibility of the institutional investors supporting promoters of the company. Stake of institutional investors is high compared to other sectors. The investment by institutional investors has been strategic by nature. Ever since India got independence from British rule, government has encouraged family business houses to invest in basic sector and development banks have been asked by the political establishment to invest in family business houses promoted ventures. Over these years, family business houses have also developed their core competency in rapid expansion of physical assets and create large factories. Compared to other sectors, division of family businesses is easier if the assets are in physical form. In case of FMCG sector, assets are mostly in the form of brand equity which are very difficult to value and there is always a fear of ugly family dispute. Similarly, in case of IT sector, assets are mainly embodied in knowledge workers, who are difficult to manage with family business patriarch mindset of taking advantage of economies of scale and reducing average cost of production by sacrificing quality (Shirur,2005). Due to these factors, family businesses have been successful in the basic goods sector. There has been a strong alignment of interest in most of the cases between institutional investors and family business houses.
Indian family businesses derived pleasure in owning the company and building huge Business Empire and creating physical capacity. This mind-set matches the competency required to succeed in metal sector where creation of physical capacity, taking benefit of economies of scale and positioning the product as value for money makes sense.

FMCG - In case of FMCG sector, most of the successful companies are subsidiaries of MNCs and some belong to the family business houses. In the case of MNCs backed companies, foreign investment and promoters' stake tends to merge and it is difficult to separate the two. Hence, there are strong alignments between foreign investors and promoters in case of HLL, ITC and CP. FMCG sector companies acquire core competency by developing capability in local responsiveness. Products in FMCG sector cost very small portion of the consumer income and has a very low involvement in purchase. Consumer's tendency is to increase value by increasing benefit rather than seeking low prices. One of the reasons for this is low price elasticity. Rather than economies of scale or technology base, major competency required to succeed in FMCG sector is local responsiveness (Shirur, 1999).

This can be acquired only if a company is close to the customers. That is the reason why MNCs contract out manufacturing to other companies and concentrate on marketing front. It is also important to delegate power to the employees so that they can take immediate action regarding local advertisement and sales promotion decision depending on the policies of the competitors and varying local consumer demand due to cultural conditions.

Product life cycle is getting shorter. When a new product is successful, rivals are quick to copy it. FMCG industry has very low barriers to entry and it is difficult to create barriers to entry in FMCG industry through patents. The degree of consumer loyalty towards any one brand is also decreasing, which increases the uncertainty in the FMCG industry. MNCs are more successful in FMCG sector as compared to Indian professional companies and family businesses. MNCs operate in many countries and have experience in adapting to local conditions in different countries. When MNCs enter India, they bring this experience with them, which is an intangible asset of great value.

Information Technology - On an average, foreign shareholders have high stakes in this sector. In the knowledge based sector like software, R&D cost is high and creative people have to be hired. It is important for companies to leverage the knowledge by empowering its people. The main competitive advantage of Software companies' is nurturing knowledge and transferring it to its knowledge workers. In this sector, Indian professional companies like Infosys Technologies, Patni Computers and Satyam Computers have succeeded. Traditional family business houses have not been successful in this sector except TCS. In software sector, successful entrepreneurs were from non traditional business communities. They were highly qualified and knowledgeable and had the confidence to attract and work with highly qualified employees. In the service sector, centralized control of the 'family business' paradigm will not work. Professional companies are more successful in this sector than MNCs and family businesses.

In case of Infosys Technologies, Patni Computers and Satyam Computers, stake of foreign investors is very high. Some of the foreign investors may be portfolio investors, but some may have invested for strategic reasons, especially those foreign clients who have given high worth critical contracts to these companies. In order to keep a check on the order delivery process, they have invested in these companies. Since a major proportion of the sales revenues are generated from foreign clients, a high foreign investment stake keeps the company alert to the needs of the clients. That is why, professional software companies try to get themselves listed on the NASDAQ. This also proves the credibility of the company in the eyes of the foreign clients. Hence, there is an entrenche relation between foreign investors and Indian promoters.

Energy Energy and religion could be considered to be tw major sources of conflict in the global political scenario Energy sector has been too important a sector to be left to th whims and fancies of the private sector. Even its role i economic development could not be undermined. India' import bill was US $40 million in the first eleven months o fiscal 2005-06 (Ministry of Finance, 2006). It has to spend major chunk of its foreign exchange reserves on oil import Prices of energy products are highly volatile and also high politically sensitive issue. Due to these factors, governme has decided to retain this sector. Prices of energy products a tightly controlled by the government. Hence most of th companies in this sector are PSUs. Objective of the oil PSUs not to earn profit but to maintain price stability and ensu regular supply. In case the international price shoots up, c companies are made to absorb the increase in cost witho passing it on the public. This is not possible in case of priva sector oil companies. Hence, government stake as promoter very high in this sector. Since government does not have to fe hostile takeover threat as they are protected by statuto provisions, hence entrenchment and alignment effect pla an insignificant role in this sector. Hence foreign a institutional investors are passive investors and have no ro to play in strategic formulation.

ECOMMENDATIONS

Ownership structure has significant effe on the success of the companie Government as well as promoters have t ability to influence the ownership structu and thereby the development of co competencies and market success. Hen promoters should choose the other major sharehold depending on their affect on core competencies. Governme with their legislative acts can influence the ownersh structure. While drafting the industrial and investme policies, government should also take into consideration, impact on the ownership structure as well as agency effe and its impact on corporate performance.

ONCLUSION

It is the nature of the agency effect th explains the common factors amongst in sector corporate governance structu which are distinct from other sectors un study. Most of the companies in the me sector are part of family businesses and ha been actively supported by institutional investors. In case information technology, most of the companies a professional Indian companies with major stake with fore investors. FMCG sector is dominated by MNCs while ene sector is dominated by PSUs.

Table -1
Classification of the Companies

Nature of Governance Structur Sector	Total	MNCs	Family Businesses	Professional	Public Sector Undertaking
FMCG (sensex-FMCG)	14	9	5	Nil	Nil
Metals (sensex – Metals)	13	Nil	10	Nil	3
Energy (CNX – Energy)	10	Nil	3	Nil	7
I.T (sensex –I.T)	10	Nil	2	8	Nil

Table 2
Mean and Standard Deviation of Different Categories of Shareholders

Group Statistics

Code		Mean	Std. Deviation	Valid N (listwise)	
				Unweighted	Weighted
1.00	Foreign	15.3640	12.50968	5	5.000
	Institution	20.0620	9.43182	5	5.000
	Promoter	38.3660	11.21449	5	5.000
	Public	16.8760	6.69038	5	5.000
2.00	Foreign	51.9820	16.81132	5	5.000
	Institution	6.2260	2.36224	5	5.000
	Promoter	31.7620	17.30739	5	5.000
	Public	8.6520	6.36984	5	5.000
3.00	Foreign	14.1040	6.27452	5	5.000
	Institution	16.2520	11.93781	5	5.000
	Promoter	47.6640	14.54545	5	5.000
	Public	19.8420	5.15487	5	5.000
4.00	Foreign	7.1260	6.78008	5	5.000
	Institution	5.5080	4.82046	5	5.000
	Promoter	81.0860	11.14817	5	5.000
	Public	2.0480	.52247	5	5.000
Total	Foreign	22.1440	20.81256	20	20.000
	Institution	12.0120	9.82465	20	20.000
	Promoter	49.7195	23.21743	20	20.000
	Public	11.8545	8.66306	20	20.000

Table-3
Classification of Shareholders

	Co_Name	code	Total Foreign Investment	Total Institutional Institutions	Total Promoters Investment	Total Public Investment
1	Hindalco Inds.	1	31.43	17.52	26.79	18.06
2	Ispat Inds.	1	0.28	35.7	51.52	10.57
3	Jindal Stainless	1	16	14.61	40.58	19.67
4	Mahendra Seamless	1	6.23	11.45	46.06	10.06
5	Tata Steel	1	22.88	21.03	26.88	26.02
6	HCL Technologies	2	26.38	7.54	54.78	8.48
7	Infosys Tech.	2	53.9	7.17	19.41	17.82
8	Satyam Computer	2	73.52	7.44	14.02	4.06
9	Patni Computer	2	51.45	2.02	44.68	1.58
10	Hexaware	2	54.66	6.96	25.92	11.32
11	Hind. Lever	3	13.88	15.47	51.45	17.85
12	ITC	3	24.79	36.92	23	13.52
13	Bata India	3	12.63	7.13	51.02	24.49
14	Nestle India	3	9.03	10.12	61.85	17.55
15	Colgate Palmoliv	3	10.19	11.62	51	25.8
16	Indian Oil	4	1.76	4	82.03	2.81
17	Neyveli Lignite	4	0.26	4.49	93.56	1.36
18	NTPC	4	6.88	1.2	89.5	2.08
19	ONGC	4	9.49	4.04	74.14	1.87
20	BPCL	4	17.24	13.81	66.2	2.12

Table 4
Relative Percentage of Share holding and its Motive

Shareholders Sectors		Foreign Investors	Institutional Investors	Promoters	Public
Metals	Motive	Portfolio	Strategic	Strategic	Portfolio
	Degree of Shareholdings	Low	High	Low	High
Information Technology	Motive	Portfolio & Strategic	Portfolio	Strategic	Portfolio
	Degree of Shareholdings	Very high	Very low	Very low	Low
FMCG	Motive	Strategic	Portfolio	Strategic	Portfolio
	Degree of Shareholdings	Low	High	Average	High
Energy	Motive	Portfolio	Portfolio	Strategic	Portfolio
	Degree of Shareholdings	Very low	Very low	Very high	Very low

Average, low and high have been used based on the total sectoral mean values. 5percent above or below the mean is considered as average. Above 5percent of the mean is considered as high and below 5percent of the mean is considered as low. Above 10 percent of the mean is considered as very high and below 10 percent of the mean is considered as very low.

Table 5
Eigenvalues of Ownership Structure

Function	Eigenvalue	% of Variance	Cumulative %	Canonical Correlation
1	6.673 [a]	69.8	69.8	.933
2	2.506 [a]	26.2	96.0	.845
3	.385 [a]	4.0	100.0	.527

a. First 3 canonical discriminant functions were used in the analysis.

Table -6
Wilks' Lambda of Ownership Structure

Test of Function(s)	Wilks' Lambda	Chi-square	df	Sig.
1 through 3	.027	54.272	12	.000
2 through 3	.206	23.707	6	.001
3	.722	4.889	2	.087

Table -7
Classification on the Basis of Ownership Structure
Classification Results [b]

			Predicted Group Membership				
		Code	1.00		3.00	4.00	Total
Original Count		1.00	5	0	0	0	5
		2.00	0	4	0	1	5
		3.00	1	0	4	0	5
		4.00	0	0	0	5	5
	%	1.00	100.0	.0	.0	.0	100.0
		2.00	.0	80.0	.0	20.0	100.0
		3.00	20.0	.0	80.0	.0	100.0
		4.00	.0	.0	.0	100.0	100.0

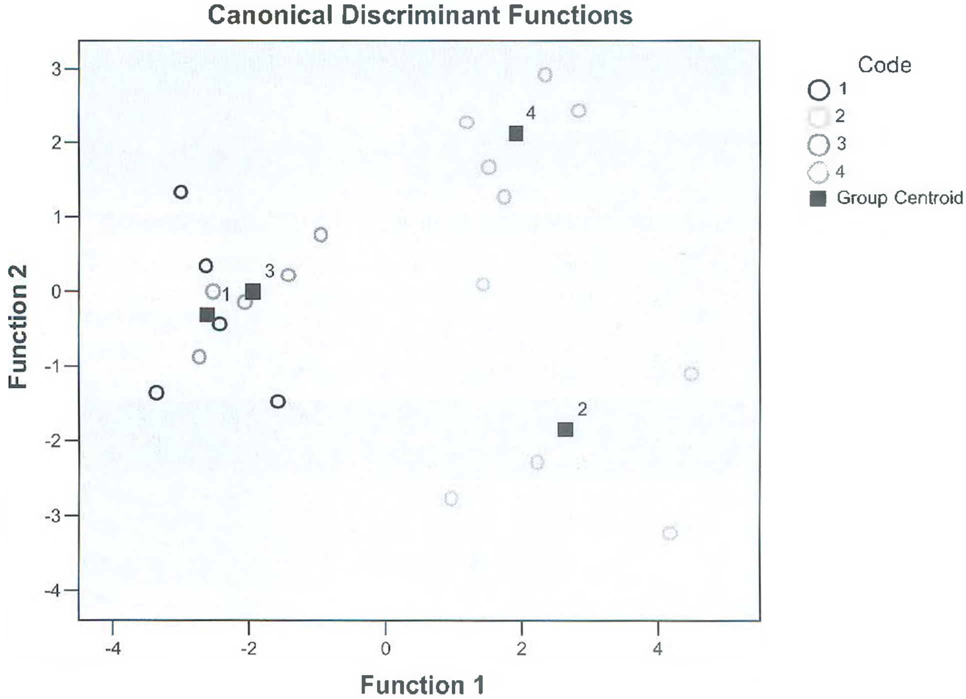
b. 90.0% of original grouped cases correctly classified.

Table 8
Standardized Canonical Discriminant Function Coefficient of Ownership Structure*

	Function		
	1	2	3
Foreign	1.698	-.357	1.626
Institution	-.019	.184	.903
Promoter	1.536	.669	2.199
Public	-.345	-.157	1.216

* The discriminant function coefficients are the multipliers of the variables, when the units are in the standardized units of measurements

Diagram 1
Centroids of the Groups*



* The Centroids are the mean values for the discriminant scores for each group

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