

A Study of the Relationship Between Institutional Investors and Corporate Value: Empirical Evidence of Iran

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Abstract: Institutional investors have substantially grown globally, matured markets in last two decades parallel with the increase in their impact. They seek to own large proportions of equities; as a result they have become influential on the performance of companies in which they invest. The aim of the present study is to create the instances which are related to the controlling role of the institutional investors in listed companies on Tehran Stock Exchange during 2001-2008. The results show that the growth and institutional investors' level variables are the most important factors which have the positive effect on the corporate value. On other hand, the institutional investors' concentration, debt and size variables are the most important factors, which have the negative effect on the corporate value. There is a meaningful negative relationship between the institutional investors' concentration and corporate value, i.e. the institutional investors' concentration decrease the company's value.

Key words: Institutional investors • Institutional investors' concentration • Companies' value

INTRODUCTION

Institutional investors have emerged as an integral force in the equity market and they are pushing companies to take long-term decisions that account for the welfare of communities- corporate social responsibility in the broader sense where they operate [1]. One potential motivation is that institutional investors are interested in the long-term cash flows of their investments which are increasingly linked to good corporate performance [2]. Institutional investors can be defined as economic entities with large amount of capital to invest; they include mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds [3]. Their potential influence as large shareholders was traced back to 1930 in the separation of owners from control of business to be in the hand of directors when was first introduced by [4]. This separation of ownership was behind the agency problem, when managers (agents) might look for their own interest rather than on behalf the interest of shareholders. The traditional view that the distribution of a firm's share ownership has no influence on the value of the firm has been challenged by a view that can be traced back to Berle and Means [4].

The efficient monitoring hypothesis contends that the larger the shareholding of the institutional shareholder the more efficient the monitoring exerted by that shareholder and the higher the likelihood of dissident success. On the other hand the strategic alignment and conflict of- interest hypotheses state that large institutional shareholders maintain strategic alliances with the incumbent management and will be swayed in their voting behaviour by their existing relationship with the management, implying a lower likelihood of dissident success in proxy contests. Hence the first hypothesis (efficient monitoring) predicts a positive relation whereas the remaining two hypotheses (conflict-of-interest and strategic alignment) predict a negative relation between corporate value and institutional shareholding. Thus, the few studies that exist provide mixed evidence on the effect of institutional shareholding on the value of the firm.

It is possible that institutional investors (similar to corporate insiders) will decrease firm value once their shareholdings exceed a certain level. That is, active monitoring may improve firm value (convergence-of-interest hypothesis) only up to a certain level of shareholding. At higher levels of share ownership, institutional institutions may encourage sub-optimal

decisions that could be harmful to the firm (entrenchment hypothesis). The mixture of these two hypotheses leads to the prediction of a non-linear relation between the shareholding by institutions and the value of the firm. Whether such a non-linear relation exists for institutions has not been investigated in prior studies.

Another concern is whether all institutional investors have incentives for actively monitoring management. The premise of the current study is that institutional investors have different motivations. Some institutional investors may be transient and interested only in short-term profits as argued. These fund managers have a short-term focus because their own performance is evaluated based on the short-term returns they generate. These investors usually have no incentive for gaining representation on the board of directors of firms in which they acquire blocks of stock. On the other hand those investors with board representation (active investors) have chosen to exercise efficient monitoring and therefore their shareholding is more likely to be related to the value of the firm. This leads to the prediction that corporate value is unrelated to the extent of shareholdings of transient (or passive) institutional investors and any non-linear relationship (if any) between corporate value and investor shareholding should only be visible for active institutional investor shareholdings.

One of the main groups who use the financial forms is stockholders. Considering that the institutional investors have the considerable ownership of the companies, so they can influence on the investment companies and they can affect their methods. Most of the theorists believe that any kinds of the ownership can effect on companies value.

The ways for controlling the managers' functions, the effective factors on their functions and the methods for measuring the effectiveness of any kinds of the ownership on the company's value are the matters which stockholders and managers are interested in. Generally, it is supposed that the availability of the institutional investors may lead to the change of the company behavior. It originates from the controlling actions that these investors do and these controlling institutional owners is not usually clear.

Theoretically, the institutions may have motivations for active controlling on management, but still there are lots of scientists which believe that institutions don't control the company effectively, because they don't have enough experience or they may behave conservatively with managers.

The purpose of the current study is to investigate relationship between institutional investors and corporate value.

The Determinants of Growth, Size and Debt

Growth: Agency problems are likely to be more severe for growing firms, because they are more flexible in their choice of future investments. Thus, the expected growth rate should be negatively related to long-term leverage.

Moreover, firms with high-growth opportunities provide a positive signal about the firm's future performance. Hence institutional investors prefer to invest in high-growth firms rather than lower ones. In addition, Hovakimian *et al.* [5] suggest that high growth firms may bring more capital gains to institutional investors than lower growth ones. This is because institutional investors, as taxpayers, would prefer to invest in capital-gain stocks to delay tax payments and to avoid double taxation. Thus, a firm's growth opportunities are considered to be a positive signal for institutional investors. The study uses percentage of variation assets of firm in year t into year $t-1$.

Size: There is considerable evidence that the size of a firm plays an important role in the capital structure decision. Large firms tend to be more diversified and less prone to bankruptcy. Therefore, a positive relationship is expected between a firm's size and its leverage [6].

Institutional investors prefer to invest in large firms in the belief that they have a low risk of bankruptcy. This is because large firms have the required resources and ability to minimize the risk of their stock investment. Therefore they are less subject to financial distress and bankruptcy risk [7]. The natural logarithm of total assets is used as a proxy for firm size ($\ln \text{SIZE}$).

Debt and Business Risk (BR): The results indicate that there is strong evidence of a negative relationship between BR and the debt ratio. Debt financing involves a commitment to periodic payment. Firms with a high debt ratio tend to face high financial distress costs. Thus, firms with volatile incomes are likely to be less leveraged. In addition, there is evidence of a negative relationship between institutional ownership and the BR of the firm. Institutional investors tend to invest in low BR firms, because firms with higher volatility in their returns are likely to have a higher probability of default and to become bankrupt.

Objectives of the Study: Prior studies examining the relationship between the shareholdings by institutional investors and firm value have produced mixed results. These studies have assumed that a linear relationship exists between corporate value and institutional shareholdings. The purpose of this study is to further investigate the nature of this relationship between institutional investors and corporate value in TSE.

Literature Review: Institutional investors as corporate monitors were a focus of many studies and researches.

Millstein and MacAvoy [8] found that corporations with active and independent boards appear to have performed much better in the 1990s than those with passive, non-independent boards in a study covered large US listed companies.

Conversely, the work of Dalton, *et al.* [9] concluded that no such relation between board composition and firms' performance and that there was no relationship between leadership structure (CEO/Chairman) and firm performance. Despite that evidence seems to appear quite mixed, there is a common perception that corporate governance can make a difference to the bottom line.

Gompers *et al.* [10] investigated the ways in which shareholder rights vary across firms. They found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures and made fewer corporate acquisitions. Deutsche Bank, (2004) studied the impact of corporate governance on portfolio management and concluded that corporate governance standards are an important for equity risk. Mallin and Runall [11] pointed that shareholders' activism is an important issue for deriving good corporate governance and without this there is less accountability and transparency and hence management get more opportunities to work for their interest rather than owners' interest (value maximization).

In a study by Moradi [12]; dealt with the controlling role of the institutional investors in Tehran Stock Exchange and discovered that if the institutional ownership effects on the quality of the reported profit or not. The results of this research show a positive relation between the institutional shows a positive relation between the institutional investors and the profit s quality.

Shleifer and Vishny [13] argue that the presence of large institutional investors will have a positive effect on the market value of the firm because of the more effective monitoring. Barclay and Holderness [14]

provide evidence of positive excess returns around the announcement date when institutional investors acquire large equity positions. The prediction that large institutional investors have a positive influence on the value of the firm arises from the assumption that these investors have an incentive to and can efficiently monitor insiders. This efficient monitoring reduces the likelihood that insiders will make sub-optimal decisions.

Pound [15], however, presents three alternative hypotheses with respect to the relation between shareholding by institutional investors and corporate value. He examines proxy contests in which dissident shareholders own far less than controlling interests in their firms and hence need to borrow voting rights of other shareholders to impose particular policy or personnel changes. In doing so, Pound [15] investigates the role that large informed institutional shareholders play and whether they have economic incentives to make the voting process efficient.

Returns associated with the announcement of majority block trades. McConnell and Servaes [16] support this view empirically with the finding of a significant relation between Tobin's Q and the fraction of shares held by corporate insiders. While evidence exists showing a positive relationship between share ownership by insiders and corporate value, there is empirical evidence to suggest that this relationship is non-linear in nature.

Research Methodology: Type of this study is descriptive and applicable. In order to, testing hypotheses we used the regression model as follow:

$$VALUE_{it} = \alpha + \beta_1 INOWN_{it} + \beta_2 CONC_{it} + \beta_3 SIZE_{it} + \beta_4 DEBT_{it} + \beta_5 GROWTH_{it} + \varepsilon_{it}$$

In this model, $VALUE_{it}$ stand for dependent variable (company's value), B_i stand for the model parameters, $INOWN_{it}$ is institutional investors, $CONC_{it}$ is a concentration' owner, $SIZE_{it}$ is a size of corporate, $DEBT_{it}$ is a debt ratio, $GROWTH_{it}$ is a growth ratio, all of them are dependent variable is remaining part.

The regression variable coefficients are tested by the student T test statistic. For meaningful testing for the model of R^2 which is resulted from the regression model is high, the mentioned model will be more pleasant.

Research Hypotheses: Considering the available theories, we can propose two theories for the research:

- There is a positive relationship between the level of the institutional investors and the corporate value.
- There is a negative, meaningful relationship between the institutional investor's concentration and the corporate value.

Data Collection: In this research, the statistical society covers all listed companies on TSE. The time period of this research is from 2001 to 2008.

The Focus Will Be on Companies Which:

- Are listed in TSE until 2001.
- Presented in TSE from 2001 to 2008.
- Their financial year leads to end of fiscal year.
- The company doesn't change the fiscal year from 2001 to 2008.
- The company is not one of the financial group companies.
- The company doesn't have functional stop from 2001 to 2008.
- The company must have at least 30 days active every year.

Considering the above situation, we examined 71 companies.

The essential data for variables are extracted from the financial reports which are published in TSE by the companies. We can reach to these data by audit report, the website of TSE too.

The acquired information is base for measuring dependent and independent variable.

Research Variables:

- Company's value: The company's value is designed by dividing the market's value of stockholders owners on the book's value of stockholders owners.
- The rate of institutional investors: The rate of common stock which the institutional investors have.
- Institutional ownership concentration: It is estimated by Herfindal Herishman index.
- Size: natural logarithm of the company's properties.
- Leverage: It is calculated by dividing the long - Term debts on company's properties.
- Growth: The variation percent in all the company's property at the end of the year in comparison with the last year.

Statistical Results: For creating a logic relation between the acquired instances of descriptive statistics and multi - variable regression test, we used the 95 percent reliance level. The information which relate to descriptive statistics and deduce statistics, are as follows.

Descriptive Statistics: Descriptive statistics are reported in below Table. The mean shareholding by institutional (INOWN) is 64.12 per cent and ranges from 0 per cent to 99 per cent. The mean institutional investors' concentration (CONC) is 23.70 per cent in the full sample and ranges from 0 per cent to 76 per cent. The mean size of firms (SIZE) is 27.14 and ranges from 24.25 to 31.93. The mean firms leverage (DEBT) is 7.22 per cent and ranges from 0 per cent to 67 per cent. The mean growth of firms (GROWTH) is 23.72 per cent and ranges from -0.27 to 2.80. The mean value of firms (Value) is 2.8778 and ranges from -0.39 per cent to 26.32 percent. The results are presented in Table 1.

Empirical Results: In this part, the results of multi regression model test are shown by collective information. The results of multi regression are presented in Table 2.

Test show that the model is generally meaningful in 95 percent reliance model. The acquired R^2 shows that about 20.9 percent of the company's value's variations are explained by Institutional Investors, Concentration, Size, Debt and Growth variable.

The T statistics and coefficient which are related to institutional investors show that there is a direct and meaningful relation between the institutional investor's level and company's value in 95 percent reliance level.

Summary and Overall Conclusion: Considering the explained cases, in relation to the results of the statistical tests, we can conclude that the first assumption of research which said "there is a positive, meaningful relationship between the level of the institutional investors and the company's value in listed companies on TSE" is accepted. So, the effective control Theory is confirmed. The second theory of a research which said "there is a negative, meaningful relation between the institutional investor's concentration and the company's value in the accepted companies in Tehran's stock exchange" is accepted, too. On the whole, the profit theory is confirmed.

Table 1: Descriptive information of the study

Index Variable	Observed	Minimum	Maximum	Mean	SD
INOWN	426	0.00	0.99	0.6412	0.2653
CONC	426	0.00	0.76	0.2370	0.1613
SIZE	426	24.25	31.93	27.1453	1.4465
DEBT	426	0.00	0.67	0.0722	0.0885
GROWTH	426	-0.27	2.80	0.2372	0.3031
VALUE	426	-0.39	26.32	2.8778	2.7391

Table 2: The results of multi regression test

TABLE 2: The results of multivariate regression			
$VALUE_{it} = 10.2669 + 3.742GROWTH_{it} - 3.736DEBT_{it} + 3.159INOWN_{it} - .342SIZE_{it} - 3.145CONC_{it}$			
Variables	Parameters	T	Significant
Constant	10.269	4.358	0.000
Institutional Investors	3.742	4.359	0.000
Concentration	-3.736	-2.815	0.005
Size	3.159	-3.756	0.000
Debt	-0.342	-2.720	0.007
Growth	-3.145	9.273	0.000
F: 22.141		R ² :.209	

We can understand that the controlling role of institutional investors in the companies' ownership structure increases the companies' value. The concentration of this ownership can decrease the company's value by profits convergence suggestions for future researches.

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