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Impact of Family Ownership Concentration on the Firm's Performance (Evidence from Pakistani Capital Market)

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Abstract

This study evaluates the impact of family ownership on the firm's performance during 2004 and 2009 considering a sample of 29 manufacturing firms listed at KSE-100 index in the Pakistani capital market. The dependent variable is performance which is measured by Return on Asset (ROA), Return on Equity (ROE) and Tobin's Q of the sample firm and the independent variable is family ownership. Linear regression model is used for estimation along correlation analysis. The study reported positive relation between the ownership variable and performance variables. The results indicate negative association between the ownership variable and firm's dividend payment, concluding that family control firms prefer to retain earning and investment opportunities rather to distribute the earnings. The empirical analysis reveal that the overall better governance practices have positive affect on financial decisions. However, the firms with more family ownership do not adopt good practices and disclose less.

Keywords: Family ownership, return on asset, return on equity, Tobin's Q, agency theory, entrenchment theory

Introduction

In the emerged markets the subject of corporate governance is a hot issue for discussion, because globalization of the market place has made the world market place accessible to corporate governance of countries. This leads the intensified competition in the domestic front with the advent of multinational firms. In this scenario quality of governance has become a critical success factor for survival and a source of competitive advantage. It has also become a major factor influencing the ability of a company to raise funds from capital market.

La Portal et al (2000) define the corporate governance as "corporate governance is to a certain extent a set of mechanisms through which the outside investors protect themselves against the expropriation by the insiders".

The corporate governance structure is composed of a variety of elements, including the roles of management, ownership, and the board of directors or manager stock holders that manager performance. Good corporate structure encourages companies to generate value, in term of innovation, development, and exploration and provide accountability to control system corresponding with the risks involved.

The code of corporate governance introduced by SECP in early 2002 is the major step in the corporate governance reforms in Pakistan. The code includes many rules and regulations and recommendations in line with international practices. The major areas of enforcement include reforms of board of directors in order to make it accountable to all shareholders and better disclosure including improved internal and external audits for listed companies. However, the code's limited provisions on director's independence remain voluntary and provide no guidance on internal controls, risk management and board compensation policies.

In Pakistani capital market culture 59 percent of the firms are family owned. The major shares of these companies are blocked by the owners and the managers of these firms. Besides this these firms have pyramid structure and cross holding ownership structure which leads to agency conflict and the outsiders, especially in case of business groups face difficult in to understanding the ownership structure of these companies.

This paper investigates the relationship between performance and family share ownership firms. Family firms are fundamental feature of the Pakistan's corporate sector. These family firms are more or less valuable than non-family firms, it is an open discussion… The major question is that family management creates or destroys value. The agency theory presumed that the agency problem can be reduced or even eliminated by the family management and predict positive effect on the firm's value.

The firms in the selected sample having more than 25% family share are treated as family managed firms.

Family owned companies are typically managed by owners themselves. In case of state owned enterprises and multinationals there is often a direct relationship between state/foreign owners and the management, again bypassing the boards. Many important corporate decisions are not made on boards' Annual General Meetings (AGMs) level. The code explicitly mentions director's duties to act with objective and independent judgment and in the best interest of company. In business groups boards are dominated by executives and non-executives members of controlling family and by proxy directors appointed to act on their behalf. Inter-locking directorships are often used to retain majority control. Family dominated boards are less able to protect minority shareholder's right and risk a loss of competitiveness as other boards become more professional.

Objective of the study

The main focus of this study is to examine the relationship between Family Ownership and firm's performance for publicly listed KSE firms. Therefore this attempted to identify the relationship between ownership concentration and the firm's performance in our sample of KSE firms. In Pakistani capital market, traditionally low dispersion of ownership, the primary tool to solve agency problem are the legal protection of minority investors, the use of boards as monitors of senior management. In contrast to development markets in Pakistan corporate governance is characterized by lesser reliance on capital market and outside investors, but strong reliance on large insider investors and financial institutions to achieve efficiency in the corporate sector.

Primarily, this study explores that how much firm performance is affected by the family concentrated ownership. Secondly, this paper adds the literature about the determinants of family ownership concentration in manufacturing firms listed at Karachi Stock Exchange (KSE). Finally it contributes the literature that how much family concentered firms effect the corporate financial decisions.

Significance of the Study

This study helps the investors to understand the ownership pattern practices in the capital market of Pakistan. It also helps the manager to solve the agency conflict with the shareholder, having to take sound decision about their corporate policies namely their dividend and debt decisions. This study assists the investors to take decisions about their ownership pattern and the market value of their stocks in the capital market (KSE).

Literature review

This section includes the review of the precedent studies in the area of ownership structure and firm's performance. The association between ownership structure and firm's performance has been a subject of important and ongoing debate in the corporate finance literature and on the basis of these studies valuable facts, statistics and results have been accomplished.

Klein, Shapiro and Young (2005) documented that due to difference in the ownership concentration across countries the relationships in governance-performance also vary. Because difference in the general and economic environment (e.g. Level of competition in product and capital markets) may produce different performance in different countries. In the same pattern Family firms may differ with many dimensions that impact performance such as the ownership structure, firm's culture, managerial philosophy and experience have great influence on the firm decision making process and performance.

Villalonga and Amit (2004) presumed that the family concentrated firms create value only when it is associated with family management and control. Family management adds value as long as the founder serves as the CEO of the family firm or as its Chairman with a non-family CEO. When descendants of the founder serve as CEO, firm value destroyed. Family control in excess of ownership is often displayed in custom of multiple share classes, pyramids, cross-holding, or voting agreements. These strategies reduce the shareholder values.

The literature has provided mix result about the relationship between the family concentration and performance. Demsetz and Lehn (1985) provide the evidence that managerial cost reduced by the family concentrated firms, while the same findings were contradicted with the study of Fame and Jensen (1985). They argued that family ownership caused agency cost, which leads suboptimal investment decisions, high managerial compensation and employment of competent family managers.

Morck et al. (2000) contribute to the academic literature that firms have undiversified share holding pattern (i.e. family concentered) forgo maximum profits, due to the difficulty of their financial preference with the outside holders. The family concentrated firms limit the executive management position to the family members. So these suffer to obtain talent and qualified capable employee from the labor pool.

McConaughty et al. (1998) and Aaderson and Reeb (2003) suggest that family control firms should enhance the firms value. Due to their large wealth investment, interested in reducing the agency conflict and in managing firm's resources in well manner to create firm's value. Secondly, in

family concentrated firms, the owners have long-term relation with the firm and have long term prospective more conductive in taking value creating decisions. Demsetz and Lehn (1985) found that firm's value is closely related with high family owned firms, because the family appointed persons closely monitor managers and compact the free ride problem inherent with small.

Maury (2006) finds out that in the Western European Countries family control increase firm profitability, whereas legal environment protect minority shareholders against family opportunism. Ben-Amar & Andre (2005) find that a large proportion of Canadian public companies have controlling shareholders (families) that often exercise control over voting rights while holding a small fraction of cash flow rights. This separation of ownership from control rights is achieved through the concurrent use odd dual class voting shares and stock pyramids; While Canada is believed to offer good protection to minority shareholders, dominant shareholders are nevertheless able to obtain private benefit. The study concluded that in an environment with good legal and extra institutions protection minority shareholders where firms need to maintain good relationship with the investment community, the dominant shareholders can add value by the competencies and well played monitoring role.

Methodological framework and data

In the literature of economics and corporate finance, the relationship between ownership concentrations and firm's performance is a hot debate. Large empirical research done using different methodologies has focused on the relationship between ownership concentration and firm's performance and provides mixed evidence. The literature provide both empirically and theoretical the association between concentrated ownership and firms performance positive, negative, mixed and no statistical relationship. This is due to the tradeoff between the agency frame work and entrenchment effect.

The entrenchment theory can be defining "The possible outcome of the decisions of manager (family) firms. Managers of the firms can identify and invest in the positive NPV projects than the family managers of the firms. But the family managers prefer to invest in projects which benefit themselves and might not maximize the earning per share (EPS) of the firm. The entrenchment theory is defined by the Weisbach (1988) "the problem of entrenchment occurs when the managers gain maximum authority (high power), start using the firms resources for their personal benefits rather in the interest of the shareholders. The entrenchment theory suggests the negative relationship between managerial ownership and the firm's performance by arguing that managerial ownership above certain threshold will destroy the firm's value due to the conflict between large block holders.

Jensen and Meckling (1976) conclude that agency cost and managerial ownership are negatively related and have positive relationship between managerial ownership and firm's performance. The convergence –of- interest hypothesis suggest a positive relationship between managerial ownership and firms performance , due to the large equity share of the managers should be associated with high market valuations due to lower agency cost.

Higher family ownership in the firms motivates the family managers to perform well due to the incentive alignment. A manager owning the large frication of the shares in the firm bears the consequences of managerial action that either create or destroy the performance. As consequences with managers shareholders are likely to work hard and create better investment decisions and high managerial ownership firms should better performance. On the basis of agency theory explanation, this study presumed following hypothesis for the Pakistani capital market.

H_1: There is a positive relationship between managerial ownership and firm's performance

Methodology

In the literature of finance, the issue of managerial ownership and firms financial policies is debatable from last many years. Some of the researchers used the Logit approach to solve this issue. While Amitabh (1999) elaborate this problem by using the simultaneous regression frame work.

Short and Keasey (1999) investigate the association between ownership structure and performance of firms Taking 225 UK firms listed on London Stock Exchange for the period of 1988-92. The variable of ownership has been taken as, shares held by the directors, held by institutions with more than 5% stocks, and external ownership in percentage. Performance is measured through return on equity and Tobin's Q and the evidence suggests that there is positive significant effect of director ownership and cubic ownership but have significant negative effect of squared ownership the polynomials reach its maximum at 16% and its minimum at 42% ownership.

Santor & King (2008) study how family ownership affects the performance and capital structure of 613 Canadian firm's period 1998-2005. They adopt the panel data regression approach and report different results from the US economy based results. This is due to the difference of the legal environment and market conditions. They measure performance with ROA and Tobin's Q as dependent variable while independent variable is the percentage family ownership concentration. They used explanatory variables size, sales growth, industry dummy, firm age and documented positive relationship between both performance variables and family ownership.

To test the above mentioned hypothesis performance measures are used: return on asset (ROA), return on equity (ROE) and Tobin Q. The performance measures are regressed on family ownership variables along set explanatory variables. This leads to the estimation of following equations

$$ROA_{it} = \alpha_0 + \alpha_{it}FO_1 + \alpha_2 DIV_{it} + \alpha_3 LEV_{it} + \alpha_4 G_{it} + \alpha_5 NE_{it} + \alpha_6 SIZE_{it} + \varepsilon_{it}$$

$$ROE_{it} = \alpha_0 + \alpha_{it}FO_1 + \alpha_2 DIV_{it} + \alpha_3 LEV_{it} + \alpha_4 G_{it} + \alpha_5 NE_{it} + \alpha_6 SIZE_{it} + \varepsilon_{it}$$

$$Q_{it} = \alpha_0 + \alpha_{it}FO_1 + \alpha_2 DIV_{it} + \alpha_3 LEV_{it} + \alpha_4 G_{it} + \alpha_5 NE_{it} + \alpha_6 SIZE_{it} + \varepsilon_{it}$$

Return on asset (ROA), return on equity (ROE) and Tobin's Q (Q) is dependent variable. FO is the percentage of family ownership is the independent variable while the control variables are dividend (DIV), leverage (LEV), sales growth (G), Net income (NE) and the size of the firm (SIZE) where ε is the error term.

In this study, the estimation procedure for the analysis of hypothesis is regression frame work, pooled time series cross sectional analysis, ordinary least square method (OLS) and pooled sample regression model is used.

Definition of variables

Variables		**Explanatory Variables**
Family Ownership	FO	%age family shareholding in the firm i at time t, i-e the shares held by the directors and spouses and other family personals.
Dividend	DIV	Variable used to measure dividend paid to outside shareholders, so the interdependence between dividend and leverage strictly affect principal repented by the outside shareholders (Crutchy and Hansen, 1984).
Leverage	LEV	Long term debt divided by total long term debt plus market value of the common stock outsiders.
Size	SIZE	Natural log (total assets). This variable is expected to have a positive coefficient as large more diversified firms are likely to have a lower a lower bankruptcy and can sustain a higher level of debt (Scott and Martin 1975, Ferri and Jones 1979).
Growth	G	Growth in this study has used as proxy to investment opportunity and obtain by book to equity value of the market. Book to market value of equity is mostly used by financial researchers. Net income used as explanatory variable and can be obtained by dividing net income over net sales. The same variable used by the Amitabh (1999) to find impact of insider holding on the financial policy of US banking Industry.
Net Income	NE	Net income used as explanatory variable and can be obtained by dividing net income over net sales. The same variable used by the Amitabh (1999) to find impact of insider holding on the financial policy of US banking Industry
Return on Asset	ROA	we take return on the assets as the ratio of return to total assets, where return is define as the difference between operating revenues and expenditures before tax and interest payment, and the total asset includes fixed asset, investment and current assets. ROA = Profit before Depreciation, interest and Tax (PBDIT)/ total assets.
Return on Equity	ROE	Return on equity capital as the ratio of return to equity capital. Equity capital is the total outstanding paid up equity capital of the firm as at the end of the accounting period. Return on equity can be calculated by the following approach. ROE = PBIT/ EQUITY
Tobin's Q	Q	Proxy for Tobin's Average Q is defining as the ratio of the value of the firm divided by the replacement value of the firm. Here we take the market value of common equity plus total borrowing and for the replacement cost. The Tobin's Q can be calculated by the following method. Q = (Total Borrowings + Market Value Equity)/ Total assets

Data and sample selection

To assess the effect of family ownership on the firm's performance, in emerging economy, we focus attention on Pakistani corporate sector. The Data set includes KSE 100 index non-financial firms. KSE 100 consists of 100 firms of financial and non-financial companies. There are 67 non-financial public limited companies listed KSE 100 index. Due to inconsistency of data and major merger and acquisition in the financial sector, our samples do not include the financial sector. Initially we start with 67 listed form different sectors and time under consideration was 2004-2009. But due to unavailability of published reports of some firms we exclude those firms from our sample. At the end we got sample of 29 firms representing of KSE 100 index. As we got most of our variables from balance sheet analysis of listed firms published by the state bank of Pakistan, the ownership variables are calculated from the annual reports of the selected companies. According to the rules and regulation Security Exchange Commission of Pakistan (SECP) are bounded to publish ownership pattern

in their annual reports. The first problem was the authenticity of the data, as the sampled firms are not using International financial standards (IFRS)

Empirical results

Descriptive statistics

As our sample consists of 29 manufacturing firms listed at KSE-100 index. Table 4.1 explains the characteristics of the sample firm.

Table 4.1: Sample distribution by industries

Sectors	No. of companies selected	%
Textile & Fabrics	8	27.5%
Cement	2	6.8%
Steal	2	6.8%
Sugar	3	10.3%
Other	14	48.2%
Total	29	100%

Source: Balance sheet Analysis of Joint Stock Companies

The textile sector and the cement sector of the Pakistan are family concentrated firms. The textile and cement sector contribute 27.5% and 6 .8% of the sample, while some firms have been selected across different sectors, which are 48.2% of the selected sample. The data for this study covered the time period from 2004-2009. Table 4.2 presents the descriptive measure of the variable for yearly.

The mean value of family ownership 57.16 percent (take the percentage share capture by family members) is shows that the ownership has remained constant over the period of time. These evidences support that in Pakistan major entities are family oriented and encourage holding maxim share with them. The standard deviation value is 16.46 recommend the maximum and minimum fluctuation in the mean value.

Table 4.2: Descriptive statistics of variables from 2004-2009

	FO		DIV		LEV		Growth		SIZE		NE	
	Mean	SD	Mean	SD	Mean	SD	Mean	SD	Mean	SD	Mean	SD
2004	57.16	16.08	146.50	451.94	4.69	1.82	3.10	26.29	81.17	1.50	77.68	16.47
2005	56.44	16.38	148.85	500.04	4.80	1.25	34.24	74.10	81.30	1.56	77.52	11.81
2006	56.83	16.50	166.80	628.99	5.02	1.22	8.66	27.24	81.43	1.50	81.51	10.81
2007	56.91	16.46	317.53	976.88	4.92	1.05	31.61	40.75	81.64	1.50	81.31	20.71
2008	56.86	16.10	351.18	1044.11	4.89	1.07	8.84	40.24	81.87	1.56	81.73	19.75
2009	57.74	17.74	226.17	702.05	4.81	0.99	23.42	44.63	81.99	1.50	80.06	12.52

Table 4.3: Descriptive Statistics of Performance Variables from 2004-2009

	ROE		ROA		Q	
	Mean	SD	Mean	SD	Mean	SD
2004	83.46	25.81	6.41	13.06	0.63	0.20
2005	83.29	41.89	7.04	14.20	0.65	0.23
2006	88.72	30.55	6.73	11.53	0.61	0.17
2007	96.73	22.94	9.42	12.00	0.60	0.17
2008	97.91	23.94	10.11	12.94	0.59	0.20
2009	97.87	24.01	9.48	11.85	0.59	0.18

The above table presents the summary statics of the measures of performance used in the study. The performance has explained by the three variables:

Return on Asset, Return on equity and Tobin's ratio. The average value of the ROA is 6.4% to 9.4%. The deviation in the mean value is 0.63% and 0.59% respectively throughout study year. The return on equity has average value 25.81% in 2004 and25.58% respectively. Similarly the return on equity has average value 97.87 % in 2009 and the SD 24.01%. This shows that firms in the sample efficiently utilize their equity. Table 4.4 provides summary statistics of the Total assets, Debt-to-equity ratio (Leverage) sales growth and percentage shareholding of family sampled firms for the period of 2004 to 2009.

Table 4.4: Descriptive Statistics of the Variables in a Pooled Sample

	FO	DIV	LEV	G	NE	SIZE	ROA	ROE	Q
Mean	78.50	56.99	226.17	4.86	18.94	5.88	7.53	17.67	8.20
Median	78.50	52.23	1.95	4.94	13.15	6.95	7.58	14.30	6.15
Maximum	156	97.10	4934.70	11.72	294.30	37.10	10.35	96.15	38.30
Minimum	1	29.54	0.00	1.65	-90.20	-81.50	4.51	-163	-27.9
Std. Dev.	45.18	16.29	743.65	1.25	46.24	15.68	1.52	29.25	12.51
Skewness	0.0	0.64	4.66	0.64	1.99	-1.95	0.09	-1.45	0.28
Jarque-Bera	9.36	14.11	3798.28	198.85	635.95	484.78	6.42	552.72	2.12
Probability	0.01	0.00	0.00	0.00	0.00	0.00	0.04	0.00	0.35
Observations	156	156	156	156	156	156	156	156	156

The results reported in Table 4.4 show that the mean value of the percentage family ownership is 78.50% and median is also 78.50%. These are closely related which each other and confirm that data of this variable is normal, and the standard deviation is 45.18 % which shows minimum deviation in the mean value.

The average value of the ROA is 7.53% and the media value is 7.58 %. This is closely related to the average value of the ROA so it is concluded that large number of the firm in our sample has 10.35% on the return asset.

The return on equity has average value 17.67% and the median 14.30% these values are also closely related to each other. Similarly Tobin's Q has mean value 8.20% and the median 6.15%.

Correlation analysis

The correlation matrix defines the relationship between the explanatory variables and also with the dependent variable. It is also used as a tool to identify multicolinarity between the explanatory variables. The matrix indicated positive relationship between the family ownership variable and the three performance variable. The correlation value is 0.12, 0.24 and 0.15 with ROA, ROE and Q respectively. The relationship is week positive.

Table 4.5: Correlation Matrixes

	FO	DIV	LEV	G	NE	SIZE	ROA	ROE	Q
FO	1								
DIV	0.0024	1							
LEV	0.09	0.00	1						
G	0.01	0.10	-0.03	1					
NE	0.09	0.18	-0.06	0.05	1				
SIZE	0.10	-0.12	0.07	0.11	-0.06	1			
ROA	0.12	0.11	0.42	0.22	-0.02	0.00	1		
ROE	0.24	-0.08	0.20	-0.06	0.09	0.21	0.12	1	
Q	0.15	-0.07	0.06	0.04	0.11	0.17	0.06	0.31	1

The matrix also document positive relationship between the family ownership and the size of the firm, indicate that the family owned are more interested in the expansion rather to distribute the corporate earnings. There is a positive relation between the dividend and family ownership, but this relationship is vary week, having no major influence.

Regression results

This study has three dependent variables ROA, ROE and Tobin's respectively and the independent variable is Family ownership (FO). The performance variables are regressed on the FO and other explanatory variables Dividend (DIV) leverage (LEV), Growth (G) and Net income (NE). The combined results of the regressions are reported in the table 4.6

In model 1 when regress the dependent ROA on the FO with the other control variables, reported positive coefficient of 5.30. It can be concluded that the family control have high rate of return on their investment. But this is significant at the 10% significance level. All the explanatory variables show positive association with the ROA. The Growth variable indicate positive and high statistically significant with the ROA. The R2 is 0.24; its mean the dependent variable is explain 24% by the explanatory variables.

There is positive and highly significant relationship between ROE and the FO reported by the model 2 of this study. The coefficient value is 1.52 and T-statistics value is 2.50.The analysis also report negative relation between the ROE and the Dividend, have coefficient is -0.12 (t-value -0.192). This relationship is weakened statistically insignificant.

Table 4.6: Impact of family ownership on the performance variables

Variable	Model 1 ROA	Model 2 ROE	Model 3 Q
C	5.30* (9.06)	18.4*** (1.52)	(5.94)*** (1.10)
FO	0.0031*** (1.29)	0.125* (2.50)	0.032*** (1.46)
DIV	0.0082*** (1.20)	-0.12 (-0.91)	-0.05 (-0.87)
LEV	0.00085 (5.82)*	0.006* (2.19)	0.0006 (0.51)
G	0.28 (3.23)*	-1.66 (-0.91)	0.27 (0.34)
NE	0.0011 (0.502)	0.07*** (1.43)	0.033*** (1.51)
SIZE	0.0051 (0.72)	(0.33)* 2.30	(0.11)** 1.84
R^2	0.24	0.13	0.64
DW	1.95	1.69	1.51
Observations	156	156	156

Note: The * indicates significant at 1%, ** indicates significant at 5% and *** indicates significant at 10%. The Dependent variables are ROA, ROE and Q and the independent variable is family ownership.

The overall regression model presents that the ROE is 13 % (R2=0.13) explain by the independent variables. The value of Durbin-Watson is 1.69 which is close to the 2 and provided that there is no autocorrelation in our data.

The third model of the study also report positive relation performance variable and ownership variable. As the Q is market base value of firm. In the literature its relationship with ownership is ambiguous. The literature documented both positive and negative sign for this variable. The study also finds negative and statistically insignificant relation between dividend and Tobin's. The overall regression model indicates that there is (R2=0.64) 64% in dependent variable by the explanatory variables.

Conclusion

This study examined the link between the performances of the firm with the family ownership for the period of 2004-2009 of the manufacturing firms listed at KSE 100 index. The sample of this study consists of 29 manufacturing firms. The study has conducted by keeping focus on a Pakistani capital market. Where the investors have less protection and the corporate governance is not much mature. Beside most of the list firm are family owned firms and the owners of these firms take operation according their own philosophy. However this study tries to find out the possible effect of the performance by the family controls.

The empirical results show positive effect of family ownership on the firm's performance in the Pakistani capital market. Where major firm's family owned and high management also appointed by these owners. These family mangers take decisions for the benefits of the owners instead of the shareholders.

The study has also observed positive and significant relation between the family ownership variable and size of the firms suggesting that the family control firms prefer to invest in the projects rather to distribute earnings among shareholders. This paper also finds negative relation between ownership variable and Dividend. Hence it also support that the family control firms have conservative approach in dividend payments. The same results was documented by Reeb (2003) and Santor (2008) on the US and Canadian economy.

Limitation of the study

There are many gaps in this paper for the future researchers. Due to the time constraint unavailability of data, the study is conducted on just 29 manufacturing firms. The new researchers must increase the sample size and estimation technique and introduced new variables. The most important gap in this study is that it does not define the determents family ownership. The coming researches can work on this area. The future researcher also includes corporate governance structure in Pakistan with family ownership to introduce new dimension in financial decision making.

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