Ishtiaq AHMAD
Syed Zaheer ABBAS KAZMI
Faculty of Economics and Business, University of Debrecen
Faculty of Management Sciences, NUML, Islamabad Pakistan

A FINANCIAL PERFORMANCE COMPARISON OF GROUP AND NON-GROUP FIRMS IN TEXTILE SECTOR OF PAKISTAN

Empirical
Study

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Abstract

Pakistan is a developing economy and business groups are key players of the Pakistan's economy. Previous research evidence shows that in the emerging economies group affiliation creates value for the firms. This study is intended to empirically investigate to know that whether group affiliated (GA) firms perform financially better than non-group affiliated firms or not? GA firms in emerging economies can have better financial performance by sharing tangible and intangible resources at group level. The financial ratio is used to compare performance of affiliated and non-group affiliated firms by using the data of 70 textile firms listed at Karachi Stock Exchange(now Pakistan Stock Exchange) covering a period from 2008 to 2012. Based on mean values of return on assets (ROA), results of the study show that GA firms have higher financial performance than non-group affiliated firms in each year and over all five years.

INTRODUCTION

Business groups are recognized as the backbone of Pakistan economy. The business groups in Pakistan are defined by Securities and Exchange Commission of Pakistan (SECP). As per this definition, group means a holding company and its subsidiaries. Khanna & Rivkin, (2001) and Leff (1978) defined a business group as family dominated ownership of several legally independent companies. Business groups are playing very active role in Pakistan's economy.

It is clear that business groups are largely available and playing prominent function in every emerging economy, however, the effect of their performance on the affiliated firms is less acknowledged. The role of business groups can be positive or negative for member firms; they can improve their financial performance or harm it. Earlier studies conducted in developing economies like India, Chile, Korea and Turkey show that affiliation with group improves financial performance of the affiliated firms. There are several reasons for this positive impact of group affiliation on the performance. Political affiliation of the board members, history and experience of the owners in conducting the business, deep understanding of the country's economic and business dynamics, diversification in the group, strong network & relationship, interdependent resource sharing, strong capital base and better relationship with financial institutions are among the main factors for positive perfromance impact of groups on the affiliated companies. In general, developing economies are comprised by weak institutional control and poor functioning capital markets. This phenomenon motivates the study of business groups in Pakistan. Do business groups in Pakistan improve the financial performance of their member firms or not?

Pakistani public limited firms present an ideal reason to study the financial performance of GA and non-group affiliated firms because of an emerging economy, especially co-existence of non-group firms and GA firms, both contributing significantly to Pakistan economy. In Pakistan, group firms are only member of one group; one firm can not become a member of two groups, thus, determination of member firm group afilliation is certain.

Increasing growth and globalization has brought many challenges for business groups. Through resource sharing business groups may well allow their member firms to attract more industries and foreign markets to expand internationally and achieve economies of scale as compared to non-group affiliated firms.

In comparision to developing economies, the studies conducted in developed economies related to business group's performance, the results are in contradiction with developing economies. Caves and Uekusa (1976) have explored that Keiretsu member firms experienced lower profits (average ROA) than non-group firms. Nakatani (1984) also found that profitability (ROA) for Keiretsu affiliated firms is lower than non-group affiliated firms.

Khanna and Palepu (2000) stated that sound diversification of group produces positive returns for member firms. The diversification of group is just like portfolio, investment in different industries, at the same time receiving positive and negative returns. When positive returns are more than of negative returns, the groups are in better position. The maximum return is associated with diversification level, after maturity it returns negatively.

Ghani et al. (2011) have compared the financial performance of GA and non-group affiliated firms. They described that GA firms have large size and enjoying superior operational profits. Overall, the GA firms are better than non-group affiliated firms because of better liquidity position, constant sales growth and lower financial leverage. In addition, non-group affiliated firms are less profitable as compare to GA firms. Ikram and Naqvi (2005) examined the behavior of big business groups in Pakistan.They reported that business groups are mainly engaged in cross-shareholdings. In group, financially strong firms are capable to meet the financing needs of weaker firms. Generally, this kind of financing is not available for non-affiliated firms; therefore, non-group firms have to rely on external source of funds. This internal financing for group firms works as insurance mechanism; that makes them financially strong and enables them to enjoy higher operating profits.

The studies conducted on business groups are based on many different themes, for instance why business groups are dominating in developing economies and disappearing in developed economies, and performance comparison of non-group affiliated firms and GA firms. In many studies, while comparing the financial performance of groups and stand-alone firms, the results are mixed. In developing economies group firms are dominating non-group firms but in developed economies the situation is different. This rationale is based on the concept that affiliated firms have more advantages than non-affiliated firms.

LITERATURE REVIEW

While comparative studies of financial performance between GA and non-group affiliated firms are well researched, results are not similar. In Korea and Japan, business groups are termed as Chaebols and Keiretsu respectively, in both economies they have been considered as signs of

economic growth. Lee et al. (2010) stated that in early research work on Japanese business groups, mainly Hoshi et al. (1990), Hoshi et al. (1991) and Ferris et al. (1995) affiliation with group is considered valuable, it helps in avoidance of agency problems, reduction in bankruptcy and monitoring costs and favor for better liquidity position. Lee et al. (2010) also reported that later studies on Japanese Keiretsu like Morck and Nakamura (1999) and Kang and Stulz (2000) explored that GA firms have to bear significant costs, when there is an affiliated bank in the group.

Soo et al. (2010) report that the presence and performance of business groups has obtained much attention in business and economic studies. Goto (1982) reported that the presence of business groups in developing economies is due to imperfect market conditions. The level of market imperfections is playing a defining role of business groups; higher degree of imperfect markets leads to strong role of business groups. After these studies, there was a flow of literature in this area, more important Khanna and Yafeh, (2007), and others e.g. Khanna (2000), Khanna and Palepu (1997), Guillen (2000) and Granovetter (1994). The fact is recognized that business groups are prevailing in both developing and developed economies but with some differences.

Lee et al. (2010) have also compared the results of Korean business groups; they have different results similar to Japanese Keiretsu, even though Korean structures of ownership are quite different from Japanese Keiretsu. Korean groups comprise large corporate grouping companies that are controlled by the families and have their investment in different sectors. Early study by Chang and Choi (1988) acknowledged that non-chaebol companies have lower profitability than chaebols. In contrast, later studies in 1990s, Chang and Hong (2000) related chaebol companies showed poor efficiency.

Choi and Cowing (1999) and Joh (2003) have compared the financial performance of GA and non-group firms and verified that relative economic efficiency of chaebol firms is lower. Ferris et al. (2003) investigated that chaebol firms suffer value loss due to group affiliation as compared to stand-alone firms.

Keister (1998) observed that group affiliation favors in increasing productivity and improves financial performance of Chinese firms and more importantly the existence of financial intermediaries in group related to insurance, banking and leasing helps in enhancing output and providing stability of liquidity position. It is also explored that concentrated groups outperform diversified groups.
Gopalan et al. (2007) studied that interdependence has greater value in business groups. Due to sharing of resources business groups are stronger as compared to stand-alone firms. In India, investors and creditors are well informed with the degree of financial resources that are shared between and among the GA firms. In group, financially sound firms especially have a potential to generate funds at a reasonable cost which can meet the financing needs of other affiliated firms those who are not capable of borrowing and issuing of equity. Therefore, stronger firms in a group provides rescue to weaker firms; due to this weaker firms will get strength by investing in profitable opportunities and capable to avoid bankruptcy, by doing this the financial performance of individual affiliated firm will lead to the overall performance of group.

Chu (2004) observed that group size matters for financial performance of affiliated firms. Firms affiliated with large size groups have higher financial performance as compared to those affiliated with medium and small size groups.

OVERVIEW OF THE TEXTILE SECTOR IN PAKISTAN

The financial performance comparison between GA and non-group affiliated firms of the textile sector in Pakistan has been focused here in this study. It is one of the vitally important sectors in Pakistan economy. It is the prime source of GDP growth, employment opportunities, exports and investment. As per the Economic survey of Pakistan (2011-2012), textile industry contibuted 52% of the total exports which amount to 12.36 billion USD. The textile industry employs 40% of the Pakistan's total labour force and it contributes 8.5% to the GDP. Importance and vitality of the textile sector convinced for the study to be focused on it.

The table -1 and figure -1 show annual percentage sales and profitability growth in the textile sector of Pakistan. It can be seen that the year 2009 is depressing, textile industry was in many problems. The global economic crisis badly affected the world's economy. Domestically, the rise in utilities cost mainly power and gas has badly affected the production and export performance of textile industry. Resultantly, competing countries made distress sales to maintain their market share. This situation badly affected Pakistan's textile industry as well.

Pakistan's textile industry has great potential for performing better equally in export and efficient production because of its inherent competitiveness in the international markets for traditional goods. However, to maintain this position to increase market share and progress toward high value added goods, a large investment is needed for state of the art technology that helps in minimizing cost per unit. The textile sector should focus more on

workers training, labour productivity, product diversification, R&D and more importantly the branding of products.

Locally textile industry is in trouble due to acute shortage of electricity, gas and unfortunate prevailing law and order situation in Pakistan. The announced and unannounced load shedding besides increasing rates of per unit of electricity and gas have created many problems especially to meet the international export commitments. Due to this exports are mainly comprised of raw materials to global textile buyers and then importing expensive finished goods back to local market. The utilization capacity in textile sector is 60 percent only. The encouraging initiatives for textile sector like American textile buyers are building their links again with Pakistan's textile and clothing manufacturers. These incentives would enable textile sector to increase exports

METHODOLOGY

4.1 Sample Selection

The sample of 350 observations of 70 Pakistan listed Textile firms from 2008 to 2012 has been collected. Out of 70 sample firms 35 are classified as GA and remaining 35 are non-group affiliated firms. The sample is primarily determined by the availability of annual data for both GA and non-group affiliated firms in the textile sector. One key document "Financial Statement Analysis of Non-Financial Sector" is used to access the financial data. This data is administered and published by State Bank of Pakistan (SBP) the central benk.

4.2 Hypothesis and Variable

In this study, the profitability of firms is used as a determinant of financial performance. It is difficult to identify a single indicator for the financial performance of GA firms. Some argued that growth is a prominent factor than profitability in group firms. Chang and Hong (2000) studied that GA firm's practiced growth at group level but they pursue profitability at individual level. There are number of factors that are affecting the performance of GA firms however, mainly the resource sharing between the groups is important factor. However, at individual level group firms try to maximize their profits. Since the data covers 5 years, both for non-group and group firms. Therefore, it is reasonably expected to compare the financial performance of group and non-group firms.

The financial performance at firm level is measured by Return on Assets (ROA). The ROA is calculated as "net income plus after tax interest cost divided by total assets". It is a well-known measure to compare the firm's performance.

Return on Assets (ROAs) = Net Profit + Interest $(1 - t) \div$ Total Assets

- **H1**: There is a significant difference of financial performance of group firms and non-group firms in Pakistan.

Independent Sample T-test is applied to compare the financial performance of two groups. This test is used to compare the values of means from two samples, it is tested whether samples from populations have different means or not? Firms are separated into group and non-group sample firms. Different sources are used to identify the business groups in Pakistan and to verify a firm's affiliation with a group. These sources are: companioes' annual reports, group web sites and individual company web sites.

RESULTS

Table-2 shows the findings of this study. Based on the results it is concluded that during the five years period 2008-2012 group firms on average perform financially better than non-group firms.

The mean financial performance (ROA) of GA firms (*M= 4.0531, SD = 6.68*) is significantly higher, $t(68) = 2.823$, two tailed *p=.006, than that of non-affiliated* (*M= -.1938, SD = 5.88*). The overall financial performance of group firms over the five years is statically better than non-group firms.

Table-3 shows year wise financial performance comparison of GA and non-affiliated firms. In year 2008, the mean financial performance (ROA) of GA firms (*M= .5169, SD = 5.191*) is statistically different, $t(68) = 2.394$, *than that of non-affiliated firms (M= -.2.3820, SD =4.936).* In the year 2009, the mean financial performance of GA firms is statistically different but performs negatively than non-affiliated firms. Overall, year 2009 was a declining period; textile industry was facing many problems. The global economic crisis badly affected the world's economy. The effect of globalization was clear on both demand and supply sides of the trade equation. Domestically, the rise in utilities cost mainly power and gas has badly affected the production and export performance of textile industry.

In year 2010, 2011 and 2012 the mean financial performance (ROA) of GA firms is significantly higher than non-affiliated firms. There are certain reasons for superior performance of GA firms; at group level, sharing resources is a common practice in form of borrowing and lending and buying and selling. Intra-group resource sharing is powerful source of growth and profitability, which is lacking in non-group firms. This is how GA firms are subsidizing each other. The stronger firms are providing resources to weaker firms. Nevertheless, business groups have very strong financial

background since independence of Pakistan 1947. Generally, in every group there is a bank, which is helpful in debt and equity financing, also supports in providing guarantees.

CONCLUSION

The financial performance is measured in terms of profitability of firms. The results show that overall financial performance of GA firms is relatively higher than non-affiliated firms.

The GA firms are financially strong because of (i) strong historical asset growth (ii) more capable to invest in capital intensive projects (iii) having bank in a group (easy loans and guarantees) (iv) intra-group resource sharing (internal buying and selling) (v) strong political connections.

Because of the unavailibilty of decades long data from reliable sources, this study is limited to a period of five years only. Other sectors of the economy could not be covered because of time and resources limitations.

Future studies can be conducted by analysing the other sectors of economy. Having a bank or finacial institution in the group and its comparision with a group not having the same is also important for future research. Political affiliation of the board members or owners of the group and non group companies in Pakistan is vital for researching in the future.

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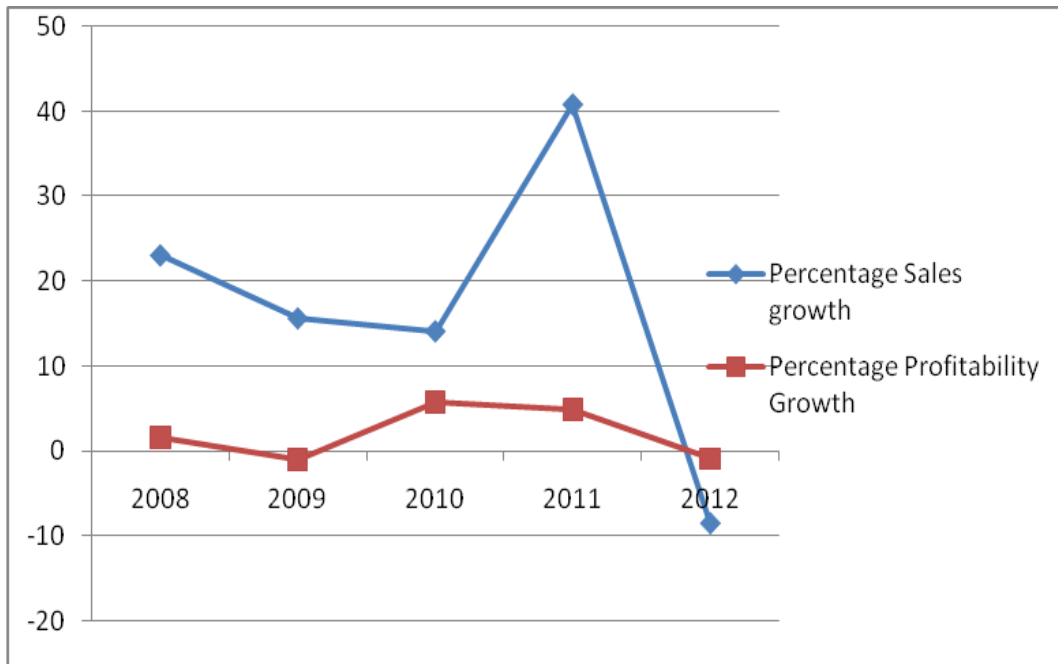
ANNEXES

Figure1. Percentage Sales and Profitability Growth of Textile Sector over 5-years
Source: State Bank of Pakistan

Table 1: Percentage sales and Profitability Growth of Textile Sector

Year	Percentage Sales Growth	Percentage Profitability Growth
2008	23.065	1.66
2009	15.638	-0.98
2010	14.115	5.81
2011	40.845	4.88
2012	-8.503	-0.84

Source: State Bank of Pakistan

Table 2: Group Statistics-Independent Sample T-test

Variable-Financial Performance (ROA)	N	Mean	Std. Deviation	T-value
GA Firms	35	4.0531	6.681	2.823**
Unaffiliated Firms	35	-.1938	5.880	

Table 3: Group Statistics Yearly-Intendependent Sample T-test

Variable-Financial Performance (ROA)	N	Mean	Std. Deviation	T-value
2008	35	.5169	5.191	2.394*
		-2.3820	4.936	
2009	35	-3.7180	8.766	-1.179
		.1006	17.031	
2010	35	8.3386	8.324	3.687***
		1.4243	7.335	
2011	35	11.0186	11.620	3.991***
		.7511	9.831	
2012	35	4.1094	8.175	2.500*
		-.8629	8.461	

Note: ***, ** and * denote significance at the 1, 5 and 10 percent level.