

Institutional Ownership and Firm Performance - Evidence from Romania

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Abstract

This paper examines the impact of institutional ownership on the firm's financial performance for a sample of 1,432 Romanian companies, in a time frame that range from 2008 to 2015. The effects of institutional ownership on performance is estimated using fixed effects model (FE), random effects model (RE) and a corrective model (PCSE) as methodology. The main results indicate the fact that between institutional ownership and firm performance is an inverse relationship, but the coefficient is insignificant from the statistical point of view. A potential explanation for these results consists in the fact that this category of investors is underdeveloped in the Romanian market and their evolution was not a smooth one but, on the contrary, it was hampered by the effects of the global financial crisis as well as by the national political and economic turmoil.

Key words: institutional ownership, financial performance, corporate governance

J.E.L. classification: G32, G34, L25

1. Introduction

In the last decades, the influence of the ownership structure on the financial performance has been carefully revised by the literature. Thus, in the financial corporate researches, following questions appear: "Who owns the company's capital?", "Which is the relation which is carried out between the shareholders and the managers of the company?" and "If this relation exists, how does it influences the financial performance of the company?". Even though lately the idea regarding the separation of property from control is more pregnant, in practice the managerial interests regarding the company may differ from the interests of those who provide its capital. In an attempt to answer to these questions, the issue of the nature of the relationship between a firm's ownership structure and its financial performance has led to a widespread debate among international researchers.

Based on these considerations, the first part of this paper summarizes the most important studies found in the literature. The paper continues by describing the data and the methodology used to develop the empirical study and the main results obtained. The final part of the paper presents the conclusions and the remarks on the submitted study.

2. Literature review

Over time, institutional investors have become major players in today's financial markets. Although the volume of capital managed by institutional investors has increased exponentially, however, it is unclear whether this development is favorable to the corporate environment. In fact, what has led to the expansion of institutional investment in recent years is largely due to the establishment and development of pension funds (Graves and Waddock, 1990). Thus, in parallel with the increase in the volume of institutional participations in the capital market, the role of institutional investors has changed dramatically from that of the passive investor to the active one.

Traditionally, institutional investors are not directly involved in the decision-making process; instead, if the performance of the company or the market is unsatisfactory, they will follow a "disinvestment policy", which consists in selling the share package (Bathala et al., 1994). With the increase in the volume of capital invested, institutional ownership will opt for "signaling" dissatisfactions about the decision-making process and low performance, to the detriment of a spontaneous decision to disinvest, that would lead to declining stock market shares. Institutional investors, compared to individuals, will be more likely to be involved in the decision-making process due to their significant contribution to the company's capital, thus trying to get managers to manage their long-term interests (Holderness and Sheehan, 1988; Brickley et al., 1988). In other words, institutional ownership will assume responsibility for more effective management monitoring, thus influencing top-level decisions, and therefore performance of the company (Chaganti and Damanpour, 1991). In his paper, Pound (1988) proposes three assumptions about the relationship between institutional ownership and firm performance: (1) effective monitoring hypothesis; (2) conflict of interest hypothesis and (3) strategic alignment hypothesis. The *effective monitoring hypothesis* shows that institutional investors have expertise and can monitor management at a lower cost to individual shareholders. Consequently, this leads to a positive relationship between institutional ownership and firm performance. The *conflict of interest hypothesis* suggests that if institutional investors also have other relationships (such as business relationships) with the company they invest in, they are forced to protect their management. The *strategic alignment hypothesis* asserts that institutional shareholders and company managers consider it advantageous to develop cooperative relationships. In general, the cooperative actions of the two parties could lead to a decrease of firm's performance, to the detriment of higher performance that might result from the involvement and monitoring of the decision-making process by majority shareholders. Therefore, both the conflict-of-interest hypothesis and the strategic alignment hypothesis foresee an inverse relationship between institutional ownership and firm performance.

In view of empirical studies, researchers examining the relationship between institutional ownership and firm performance have achieved mixed results. For instance, by conducting a cross-sectional study on a sample of 1,173 NYSE / AMEX listed companies in 1976 and another sample of 1,093 companies listed in 1986, McConnell and Servaes (1990) achieved a significant positive impact of institutional ownership on the firm performance. The authors argue that such a relationship reveals an effective monitoring undertaken by institutional investors. Only a year later, Chaganti and Damanpour (1991) and Lowenstein (1991) confirm the results of the previous study obtaining a positive correlation established between the two variables. In another research, Clay (2001) performs different econometric models (the ordinary least squares and 2SLS type regression models) over a sample of 8,951 companies between 1988 and 1999, reporting a positive impact of institutional ownership on firm performance. Other recent researches found in the literature that study the link between institutional ownership and firm performance: Harjoto and Jo (2008), Irina and Nadezhda (2009), Nuryanah and Islam (2011), Fazlzadeh et al. (2011), Uwuigbe and Olusanmi (2012), Hussain Tahir et al. (2015), etc.

On the other hand, a limited number of studies reveal an insignificant or even negative relationship between institutional ownership and the various measures of firm performance. Thus, through the results of the studies conducted, Agrawal and Knoeber (1996), Craswell, Taylor and Saywell (1997), Duggal and Millar (1999), Faccio and Lasfer (2000) and Mollah et al. (2012) argue that the institutional shareholder is not a significant determinant of firm performance.

3. Data and methodology

The impact of institutional ownership on the financial performances of the largest active companies from Romania is analysed within a panel data framework. The sample comprised 1,432 Romanian companies, with data for a period of 8 years (2008-2015). The source of data is AMADEUS, platform database of Bureau van Dijk (2017).

The dependent variable describes the financial performance. Past research identified a range of variables as potentially capturing firm performance. However, in this study, firm performance was measured by return on total assets (ROA) which represent the company's profitability related to its

total assets.

In order to capture the potential impact of institutional ownership on financial performance, a dummy variable (INST) was constructed. In line with most of the researchers, it was assigned a value of 1 for companies with an institutional ownership concentration above 20 percent and a value of 0 if the company's shareholding is considered mixed one.

An appropriate set of control variables was introduced in the model, in line with the literature on financial performance determinants: firm age (AGE) defined as the natural logarithm of company age since establishment of the company until the certain year; firm size (SIZE) represents the annual absolute change of natural logarithm of total assets; capital intensity (CAPINT) shows the proportion of fixed assets (tangible assets) over total assets; leverage (LVRG) measures the proportion of funds provided by creditors and stockholders using to finance its assets.

Based on the analysis of the literature on corporate financial performance determinants, it was assumed that firms have their own intrinsic characteristics which could influence the financial performance and, therefore it was estimated a fixed effects (FE) model. It was also estimated a random effects (RE) model which imply a random variation across firms, uncorrelated to the explanatory variables. In order to decide between fixed effects and random effects empirical specifications, a Hausman test was employed which showed that fixed effects estimator should be preferred. Tests results were reported in the lower part of the estimation tables. In addition, it is important to identify the autocorrelation issue before the standard errors of the estimated coefficients to be computed. Wooldridge test for autocorrelation pointed out that first order autocorrelation could not be rejected.

Given the evidence of strong cross-sectional dependence, the presence of heteroscedasticity and autocorrelation, Prais-Winsten PCSE procedure was used as the baseline scenario. The procedure fits linear models when the residuals are not independent and identically distributed, allowing correcting cross-sectional dependence, heteroskedasticity and autocorrelation.

$$Y_{i,t} = \beta_0 + \beta_k X_{i,t} + \varepsilon_{i,t}$$

where Y represents dependent variable (ROA), β_0 represents the constant, β_k represents the estimated coefficients, X represents the independent and the control variables, $\varepsilon_{i,t}$ is the random component of the error, i - the companies, t - the time.

4. Results

The following table presents the results of the regressive analysis of the relationship between the financial performance of companies, the institutional ownership and the control variables:

Table no. 1: Results of regression analysis

VARIABLES	ROA		
	(1) FE	(2) RE	(3) PCSE
INST	0.153 (0.364)	-0.443 (0.332)	-0.255 (0.341)
SIZE	1.005*** (0.167)	-0.677*** (0.106)	-1.525*** (0.167)
AGE	-0.428*** (0.0313)	-0.223*** (0.0226)	-0.151*** (0.0253)
LIQID	-0.149*** (0.0276)	-0.133*** (0.0266)	-0.0646** (0.0295)
DEBT	-26.61*** (0.605)	-23.01*** (0.502)	-19.48*** (1.578)
TANG	-13.81*** (0.724)	-13.24*** (0.537)	-11.14*** (1.116)
Constant	24.93*** (1.438)	35.77*** (1.010)	39.82*** (1.771)
R-squared	0.184	0.175	0.266

F-test all $\alpha_i = 0$	37.79***	
Hausman test		211.07***
Pesaran CD test	81.28***	
Wooldridge (F-test)	222.98***	
Breusch-Pagan LM χ^2		9,809.62***

Source: Author's personal estimations

*, **, *** denote significance at 10%, 5%, 1%

() standard deviation

Analyzing the results synthesized in the table, it can be stated that there is an indirect link between the institutional ownership of companies and their financial performance, but the coefficient is insignificant from a statistical point of view, considering the indicator ROA as financial performance. Such a result was also obtained by Duggal and Millar (1999), Faccio and Lasfer (2000), Demsetz and Villalonga (2001), Thomsen et al. (2006), Elyasiani and Jia (2010), Mollah et al. (2012) etc. thereby rejecting the formulated hypothesis.

In the last decade, institutional investors have begun to appear and develop in Romania, but this market is at an early stage in its development. There are several categories of institutional investors relevant to the Romanian market: the five financial investment companies, pension funds, venture capital funds and mutual funds. Other institutional investors, such as banking institutions or insurance companies, have an insignificant role, due to the low performance of investments made in companies compared with alternative placements. Pension funds, one of the most important institutional investors in European countries, is also at an early stage of development (the basic legislation was adopted only in the early 2000s by Law 411/2004 on privately managed pensions). Regarding the prospects for development and expansion of institutional investors, increasing the investment of pension funds at an increasingly rhythm is an important signal that these investors will play a significant role in the Romanian economy.

In this respect, the lack of significance of the relationship established between institutional investors and the financial performance of companies can be explained by reference to the fact that this category of investors is underdeveloped in the Romanian market (according to the methodology, 8% of the companies considered are represented by institutional shareholders). Moreover, this evolution of the institutional investors' market has not been smooth but has been hampered by the effects of the global financial crisis as well as by the national political and economic turmoil.

Considering the control variables, it can be concluded that they are statistically significant at 1%. Thus, all of the control variables considered adversely affect the firm's financial performance. Overall, the model is statistically significant (F statistic = 0.266, $p < 0.01$). With regard to the explanations of the results, with the increase in market size and accumulation, companies tend to expand and diversify their business by focusing on investment projects that may slow down the growth rate of their performance. The results on asset tangibility confirm those obtained by Güner (2016) indicating that an increase in its rate leads to a decline in financial performance. Finally, a high level of indebtedness will affect the financial performance of companies by increasing the cost of capital but also by price fluctuations on the stock market (Daskalakis & Psillaki, 2008; Vasiliou et al., 2009).

5. Conclusions

The ownership structure can influence the performance of companies in many ways. Differences in shareholder identity, different degrees of concentration, or unequal distribution of resources among shareholders affect their power and ability to control managers. Moreover, the wide range of shareholders and managers' objectives can influence the performance of the company in different ways.

In the literature there are numerous studies conducted on the association between the ownership and the financial performance of the companies. However, the results obtained do not clearly identify the relationship established between these variables. The identified conclusions differ significantly from studies in developed countries to developing countries.

This research contributes to the expansion of the literature on the impact of corporate governance from the perspective of the impact of the institutional ownership on the financial performance of Romanian companies, considering a panel-based approach for 2008-2015.

In conclusion, in the post-communist period, there have been some changes in Romania regarding the corporate environment. Thus, although it is difficult to quantify, through the numerous studies found in the literature, it can be said that the contribution of the different ownership structures to the growth of companies' financial performance. Despite the fact that globalization has expanded considerably, certain factors such as the various degrees of economic development, regional disparities or cultural differences in emerging economies are limiting a global approach, in particular, making comparisons with developed economies. Last but not least, with the familiarization and applicability of corporate governance principles, the corporate environment will be able to support or develop Romania's economy, leading to the opening of new horizons of research in corporate finance.

6. References

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