INSTITUTIONAL INVESTORS AS MONITORS IN EMERGING ECONOMY FIRMS: THE CASE OF INTERNATIONALIZATION

A THESIS
SUBMITTED IN PARTIAL FULFILLMENT OF THE

REQUIRMENTS FOR

THE FELLOW PROGRAMME IN MANAGEMENT

BY

Vidya Sukumara Panicker

INDIAN INSTITUTE OF MANAGEMENT

KOZHIKODE

NOVEMBER 2016

ABSTRACT

Extant literature acknowledges the increasing involvement of institutional investors in strategic decisions of a firm in developed as well as emerging economies. Based on the classification of institutional investors into pressure-resistant and pressure-sensitive kinds, studies on developed economies identify that pressure-sensitive institutions, owing to their existing business relations with a firm, are poor monitors of a firm. On the other hand, pressure-resistant institutions have the option of responding to inappropriate firm decision by voicing their opinions or exiting the firm.

We argue that, owing to several reasons, these relations need not hold in emerging economy firms. Firstly, different kind of agency issues exist in an emerging economy, where the possibility of expropriation of minority shareholders by promoters results in principal-principal agency issues. In such a setting, an institutional shareholder could also be a minority shareholder. Secondly, institutional shareholders in an emerging economy can monitor the actions of the promoter through both market and non-market actions. For example, banks (Pressure-Sensitive Institutional Investors) can monitor the actions through nominee directors on boards. Additionally, the absence of formal institutional infrastructure (imperfect institutions and institutional voids) in these countries helps certain kinds of institutional investors (such as domestic banks and local mutual funds) gather better information than foreign institutions through informal-reciprocal relations. Further, the risk propensity, time frame of investment and expected returns from the portfolio firms differ among of institutional investors, and hence their preference for these mechanisms also vary. While studies have pointed out that institutional investors have a positive influence on internationalization decisions of firms, they have not distinguished between various kinds of institutional investors.

Our research, therefore, intents to understand differences in monitoring mechanisms of different categories of institutional investors in the governance of emerging economy firms. Additionally, we identify the interactive influence of different corporate governance mechanisms (such as independence of board, promoter ownership) on the relation between different types of institutional investors and the strategic decisions of a firm.

In this study, we chose internationalization as an important strategic decision. We believe this would help us understand the monitoring capability of different categories of institutional investors in emerging economy firms. This is due to the importance of internationalization as a strategy for firms seeking growth to escape the limitations of emerging economies, and due to the significance that institutional investors attach to this strategy as a means of diversifying their portfolios. We expect some level of generalizability in our results, which would enable us to extend the behavior of institutional investors across similar strategic choices.

Our sample consists of 30385 firm year observations spread over a 10-year period (2005-2014), for 4531 unique firms. Since our data consists of many firms not pursuing internationalization as a strategy, we tested our hypotheses using Tobit Random effects model. We find that all three categories of institutional investors act as monitors of the firms. However, their preferences for internationalization strategy are different. While foreign institutional investors and pressure-resistant domestic institutional investors support firm internationalization as a strategy, pressure-sensitive domestic institutional investors dissuade the firm from overseas expansion. Also, these investors have different preferences for ownership and board characteristics of a firm. Further, foreign institutional investors prefer promoter owned firms that would protect them against country-level risks whereas domestic investors are cautious of promoter-owned firms due their inability to monitor these firms. The preference for type of board members also depends on the time frame of investment of institutions. Relatively long term investors such as foreign institutions prefer non-independent members on board whereas short term investors such as Pressure-Resistant Domestic institutions seek the support of independent board members in monitoring and for ensuring faster returns from internationalization. We also found differences in investment preferences between different types of institutional investors based on business group affiliation of firms, as well as on the industry to which a firm belongs.

Our work is relevant from a theoretical, managerial and investor perspective. We add to the existing agency theory by highlighting how alternate monitoring mechanisms aid certain category of institutional investors in alleviating principal-principal agency problem, in the absence of standard institutions. By understanding the alignment between different corporate governance mechanisms, we also assess the contextual nature of the relationship between institutional investors and firm strategies. For a manager, the knowledge of preferences of different types of institutional investors is important since institutional investors are a group whose interests cannot be ignored and in a firm, where multiple categories of institutional investors with differing interests co-exist, it may be important for managers to prioritize their preferences. The stock market responds to the investment preferences of large investors, and hence for an individual investor and for professional investors, the stance that large institutional investors takes in the investment decisions of a firm might be of interest in choosing their own investments.