

# **Largest Blockholding and Firm Performance: Evidence from an Emerging Economy**

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## **Abstract**

This study aims at examining the relationship between largest blockholding and firm economic performance in Bangladesh, an emerging economy. It is found that there is a significant positive relationship between the largest blockholding and firm performance under both the accounting and market based performance measures. This study reveals that, largest blockholding, by narrowing the gap between ownership and control, allows the blockholder to add value to the firm.

**Keywords:** Agency Theory, Bangladesh, Corporate Governance, Emerging Economy, Ownership, Performance.

## **1. Introduction**

Due to separation of ownership and control in large corporations, there is a problem of aligning the interest of dispersed shareholders with that of management leading to so called agency problem (see Jensen and Meckling, 1976) also known as principal-agent (traditional) agency problem (Majumdar and Chhibber, 1999; Dharwadkar *et al*, 2000). A number of control mechanisms are suggested as part of checks and balances to reduce the principal-agent (or traditional) agency conflict and to achieve the firm's objectives in a cost effective way. These include the external control mechanisms, such as market for corporate control or takeovers and internal control mechanisms, such as the presence of large shareholders (Demsetz and Lehn, 1985), monitoring by board (Zahra and Pearce II, 1989) and contracting (Godfrey *et al*, 2006). As noted, the large shareholding is an important internal corporate governance mechanism among many other that can prevent the managers from self-opportunistic behavior and can improve the firm efficiency. Such ownership narrows the gap between the controllers' (management) of the corporation with that of owners (shareholders). It helps in exercising the high degree of corporate control through exercising voting rights or representing in the board of directors (Prowse, 1994; Asian Development Bank, 2000; Coulton and Taylor, 2004). As the large shareholding is associated with the cost of non-diversifying that may lead to huge loss, it provides the investors with both the incentive and the ability to monitor and control the management (Prowse, 1994). Therefore, such shareholders always tend to closely control the managers in the interest of themselves, which may in turn increase the firm performance.

This study aims at investigating if the ownership by largest bockholder may influence the firm economic performance in Bangladesh, an emerging economy. The choice of Bangladesh is notable as over the past decades an overwhelming proportion of corporate governance literature has concentrated

on developed economies with sophisticated financial and legal systems (Ararat and Yurtoglu, 2006) and where there are many institutional similarities. There is a dearth of research and less concentration is given on corporate governance research in less developed and emerging economies (Gibson, 2003; Denis and McConnel, 2003; Ararat and Yurtoglu, 2006; Uddin and Choudhury, 2008). Needless to say there is a dearth of research on corporate governance practices in Bangladesh even though there is an increased interest on corporate governance practices by international donor agencies, such as Asian Development Bank (ADB), International Monetary Fund (IMF), World Bank and other international donor agencies (see Uddin and Choudhury, 2008; Siddiqui, 2010). The 'Global Corporate Governance Forum', an IFC multi-donor trust fund facility, argues that corporate governance is a powerful tool to battle against poverty (World Bank, 2007). In the context of Bangladesh it is so warrant that the World Bank has imposed conditions requiring the improvement of corporate governance practices in Bangladesh in order to get financial assistance (Solaiman, 2006).

This paper is structured in several sections. Section 2 presents the corporate governance in Bangladesh. Section 3 presents the earlier studies on ownership structure and firm performance. Section 4 develops the hypotheses. Section 5 presents the research method. Section 6 presents the empirical results. The final section makes the discussion and draws a conclusion.

## 2. Corporate Governance in Bangladesh

Unlike the corporations in Anglo-American countries, the corporate control mechanisms in Bangladesh are mostly insider oriented, such as ownership structure as the core investors own the significant stakes of shares within a single firm which is also known as *ownership control* approach and, in general, are the board of directors (Rashid and Lodh, 2008). There is a high degree of ownership concentration by founding family members leading to a high degree of ownership control. The presence of pyramidal or cross shareholding structure is not very common in Bangladesh; therefore, individual shareholdings are quite large.

Due to highly concentrated ownership, lack of takeover regulations, a non-efficient market<sup>1</sup>, and due to huge transaction costs associated with the takeover process, some of the important external control mechanisms such as a market for corporate control or takeovers are largely absent in Bangladesh corporate sector (see for example, Franks and Mayer, 1990; Sarkar, *et al*, 1998; Asian Development Bank, 2000). Unlike the firms in Anglo-American countries, external board members (outside directors), financial analysts and financial press and media have a little role in monitoring and disciplining the firm management (see for example, Othman and Zeghal, 2006; Rashid *et al*, 2010). Therefore, boards and management are not fearful of being criticized. Finally, the role of other intermediaries, such as investment banks, financial analysts, credit rating agencies are less central in Bangladesh corporate sector.

A notable intuitional difference in Bangladesh corporate sector from that of developed economy is that, due to diffuse share ownership, firms in developed economy appoints professional managers; many of them do not have ownership stakes within the firm. However, executives in Bangladesh are the family owners; many of them have large stake of ownership control or they are the representatives of the family owners. Sobhan and Werner (2003) noted that, in about 73% of the non-bank listed companies, the boards are heavily dominated by the sponsor-shareholders who generally belong to one family-the father as the chairman and the son as the CEO. These owners have huge incentives and ability to monitor, such monitoring mechanism in Bangladesh reduces the need for a performance related pay (see for example, Banghøj *et al*, 2010). Due to this, along with the absence of a liquid capital market, executive compensation in the form of stock options is absent in Bangladesh corporate sector.

In early 2006, the regulatory body 'Securities and Exchange Commission Bangladesh' (SECB) announced the 'Corporate Governance Notification'. Among many other requirements, it requires the listed firms in Bangladesh to have Anglo-American type outside independent directors in their boards, to have a board size of 5 to 20 directors and an Anglo-American type audit committee to oversee the

audit functions. The non-compliance requires an explanation. This notification can so far be considered as the code of corporate governance best practices in the context of Bangladesh.

The key agency conflict in the context of Bangladesh can be described as 'principal-principal' agency conflict. That is there is no real effective separation of ownership and control in the context of Bangladesh. The majority inside owners, who also sit in the board and management, tend to use inside information for personal gain or to diverge assets from minority shareholders which was seen during the event of stock market collapse in 1996<sup>2</sup>. It is very hard for average non-controlling shareholders to achieve necessary votes to pose a threat to the poorly performed company management as there is no guideline regarding the 'ultimate controlling share ownership' in the Bangladesh Companies Act 1994.

### **3. Earlier Studies on Ownership Structure and Firm Performance**

The evidence of ownership structure as the dominant corporate control mechanism came to light following the work of Demsetz (1983), where the ownership structure is described as “an endogenous outcome of competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organization of the firm” (p 384). There is a host of studies on corporate ownership structure and firm performance. Despite this plethora of studies, the study on largest blockholding and firm performance is relatively sparse.

Lins (2003) found that the firm with a managerial control in the range of 5%-20% is associated with lower firm value, when the management group is also a largest blockholder. Managerial control in the range of 5%-20% does not affect firm value in the presence of non-managerial blockholders. Holderness and Sheehan (1988) on 114 NYSE and AMEX listed companies reveal that Tobin's Q is higher with majority corporate ownership and Tobin's Q is lower with individual majority ownership, Barclay and Holderness (1991) on 97 NYSE and AMEX listed companies reveal that blockholding leads to a higher stock price, Shome and Singh (1995) on 92 U. S. firms reveal that external blockholders increase the Accounting return and market to book ratio. Ang *et al* (2000) on 1,708 small U.S. corporations from the NSSBF reveal that agency cost reduces with management ownership. Earnhart, and Lízal (2002) on 10,102 firms of Czech Republic during the period 1993-1998 reveal that ownership structure increases the environmental performance. Gugler *et al* (2003) on more than 19,000 companies from 61 countries reveal that ownership structure improves the firm performance as measured by ROI within the countries with English origin legal system dominating capital market improves performance. Claessens, Djankov and Pohl (1996) on 706 Firms in Czech Republic for the period of 1992-1993 reveal that ownership structure increases firm value as measured by Tobin's Q. Khanna and Palepu (1999) and Sarkar and Sarkar (2000) on Indian firms investigated whether the blockholding in the form of banks and/or lending institutions improve firm performance. Khanna and Palepu (1999) reveal that the blockholding by domestic financial institutions are ineffective monitors; there are low firm performance for blockholding by domestic institutional investors and high performance for blockholding by foreign institutional investors. However, the study by Sarkar and Sarkar (2000) reveals that the blockholding by institutional investors have no influence on firm value.

The earlier studies can be criticized on the premise that most of the earlier studies have been conducted within the context of developed or moderately developed economies, where there are many institutional similarities. This study extends the literature on ownership structure and firm performance in the context of an emerging economy.

### **4. Research Hypotheses**

Blockholding is a form of concentrated ownership in reducing the principal-agent conflicts or principal-principal conflict. Blockholding is not just the concentrated ownership; with the specific skills, wealth and expertise, blockholders have strong incentive to monitor the management (Barclay and Holderness, 1991; Gibson, 2003). Firms monitored by outside blockholders are substitute for incentive pay for executives (Kraft and Niederprüm, 1999). Blockholders may influence the

management which increases the overall shareholder value in the form of 'shared benefit of control' (Denis and McConnell, 2003). It leads to the following hypothesis:

**Hypothesis 1:** *There is a positive relationship between blockholding and firm performance.*

## **5. Research Method**

### **5.1. Sample Selection**

Based on the availability of company annual reports, this study considers 94 non-financial firms listed on the Dhaka Stock Exchange for the period of 2000-2009, representing 39.57% of the total listed companies as of 31<sup>st</sup> December 2009. These firms also represent 63.70% of the total non-financial companies listed and almost 55% of the market capitalization of total non-financial companies as of that date. The sample consists of variety of industries as per 'Standard Industrial Classification Codes' (SIC). Depending on the company's annual reports, a total of 844 observations could be made (94 firms in year 2000-2006, 92 firms in 2007, 82 firms in 2008 and 12 firms in 2009).

The audited financial report was the basis for obtaining the company's accounting information, such as EBIT, total assets, total liabilities and equities, preferred stock. The data were manually collected from company annual reports. Market value of the closing (year end) share price was collected from Dhaka Stock Exchange web page ([www.dsebd.org](http://www.dsebd.org)), from the 'Monthly Review' of Dhaka Stock Exchange. The monthly market price of shares was collected from *DataStream* database. The ownership data were obtained from notes to the financial statement, 'Corporate Governance Compliance Report' of the respective company and from the 'Monthly Review' of Dhaka Stock Exchange.

### **5.2. Variable Definitions**

#### **5.2.1. Dependent Variables**

The dependent variable in this study is firm performance under different performance measures. Two performance measures are considered in this study; such as Return on Assets (ROA) as accounting based and Tobin's Q as market based performance measure. Consistent with Core *et al*, 1999, Rashid and Lodh (2008), Rashid (2010), Rashid *et al* (2010), Return on Assets (ROA) is calculated as the ratio of Earnings before Interest and Taxes (EBIT) and the book value of average net total assets (average net asset at the end of the year). Tobin's Q, is the ratio of the market value of the firm to the replacement cost of their average total assets.

#### **5.2.2. Independent Variables**

Independent variable in this study is the largest blockholder (LBOWN). It is the percentage of shares owned by single largest blockholder. This single largest blockholder may be an insider or a financial institution.

#### **5.2.3. Control Variables**

This study considers a number of control variables. These are board composition, board size, board leadership structure, debt ratio, firm age, firm size, growth and risk. It can be argued that board has huge role in monitoring the management and disciplining the firm. A variable board composition (BDCOMP) is used as the percentage of outside independent directors to total directors in the board. Board size (BDSIZE) is the natural logarithm of total number of board members in a board. CEO-duality (CEOD) is a binary, which is equal to be one (1) if the post of CEO and Chairperson is hold by same person, otherwise zero (0). Leverage may increase the firm's return on stock by minimizing its financing cost. Due to Jensen (1989) free cash flow theory, companies with high leverage ratio has an interest payment commitment and therefore are less able to keep funds. Debt ratio (DR) is measured as Total Debt to Total Assets, and calculated by scaling the total debt by average total assets. Liquidity may influence firm performance. Although excess liquidity may reflect the superior skills (Majumdar and Chhibber, 1999, p 296), it may negatively influence firm performance as excess liquidity may lead

to firm's assets tied up in non-revenue generating assets. A control variable liquidity (LIQ) is considered as current ratio. Firm age may influence the performance; the older firms are likely to be more efficient than younger firms (Ang *et al*, 2000). A variable 'firm age' (AGE) is defined as the natural logarithm of the number of years firm have been listed on the stock exchange. The firm size is an important variable influencing the firm performance (Demsetz and Lehn, 1985; Short and Keasey, 1999); as the large firms have more capacity to generate internal funds (Short and Keasey, 1999; Majumdar and Chhibber, 1999); large firms may also have problems of coordination, which may negatively influence its performance (Williamson, 1967). This study considers the natural logarithm of average total net assets as 'firm size' (SIZE). Consistent with past studies (such as, McConnell and Servaes, 1990; Morck *et al*, 1988; Short and Keasey, 1999), this study considers growth (GROWTH) as the percentage of annual change in sales, which may also influence firm performance. Risk (RISK) is included as a control variable that may also influence firm performance and is measured as the natural logarithm of the standard deviation of stock returns over the year (12 months).

### 5.3. Regression Model Specification

In order to examine the relationship between the ownership structure and firm performance, the following model is developed,

$$Y_{it} = \alpha + \beta_1 \text{LBOWN}_{i,t} + \beta_2 \text{BDCOMP}_{i,t} + \beta_3 \text{BDSIZE}_{i,t} + \beta_4 \text{CEOD}_{i,t} + \beta_5 \text{DR}_{i,t} + \beta_6 \text{LIQ}_{i,t} + \beta_7 \text{AGE}_{i,t} + \beta_8 \text{SIZE}_{i,t} + \beta_9 \text{GROWTH}_{i,t} + \beta_{10} \text{RISK}_{i,t} + \epsilon_{i,t}$$

Where,  $Y_{i,t}$  is alternatively  $\text{ROA}_{i,t}$  and Tobin's  $Q_{i,t}$  for  $i$ th firm at time  $t$ .  $\text{LBOWN}_{i,t}$  is the percent of shares owned by largest block holders for  $i$ th firm at time  $t$ .  $\text{BDCOMP}_{i,t}$  is the percent of outside independent directors to total directors for  $i$ th firm at time  $t$ .  $\text{BDSIZE}_{i,t}$  is the board size (representing the total number of directors) for  $i$ th firm at time  $t$ ,  $\text{DR}_{i,t}$  is the debt ratio for  $i$ th firm at time  $t$ .  $\text{LIQ}_{i,t}$  is the firm liquidity for  $i$ th firm at time  $t$ .  $\text{AGE}_{i,t}$  is the firm age for  $i$ th firm at time  $t$ .  $\text{SIZE}_{i,t}$  is the firm size for  $i$ th firm at time  $t$ .  $\text{GROWTH}_{i,t}$  is the firm growth in sales for  $i$ th firm at time  $t$ .  $\text{RISK}_{i,t}$  is the natural logarithm of stock returns standard deviation for  $i$ th firm at time  $t$ .  $\alpha$  is the intercept,  $\beta$  is the regression coefficient and  $\epsilon$  is the error term.

### 5.4. Descriptive Statistics

Descriptive statistics of the variables are presented in table 1. The descriptive statistics include mean, median, minimum, maximum, standard deviation and Jarque-Bera statistics for normality test. The descriptive statistics reveals that average firm performance in terms of ROA is 5.8 percent which is ranging from negative 149.4 percent to 34.1 percent; average firm performance in terms of Tobin's Q is 117 percent which is ranging from 17 percent to 826 percent. Average largest blockholding is 28.7 percent which is ranging from 1 percent to 83.6 percent.

**Table 1:** Descriptive statistics of the variables (N=844)

	Mean	Median	Minimum	Maximum	Std. Deviation	Jarque-Bera	Probability
Return on Assets (ROA)	0.058	0.062	-1.494	0.341	0.097	214,864.200	0.000
Tobin's Q	1.173	0.993	0.172	8.258	0.693	15,495.110	0.000
Largest Block holding (LBOWN)	0.287	0.255	0.010	0.836	0.192	204.466	0.000
Board Composition (BDCOMP)	0.038	0.00	0.000	0.333	0.070	420.635	0.000
Board Size (Log)	1.778	1.792	1.099	2.485	0.310	8.476	0.014
CEOD	0.467	0.000	0.000	1.000	0.499	140.510	0.000
Debt Ratio	0.743	0.644	0.020	7.115	0.570	38,540.900	0.000
Liquidity	1.484	1.131	0.021	31.245	1.947	550,944.100	0.000
Firm Age (Log)	2.641	2.708	0.693	3.466	0.439	55.957	0.000
Firm Size (LogTA)	5.987	6.042	2.443	9.857	1.475	2.269	0.322
GROWTH	0.231	0.063	-1.000	4.597	3.651	21,614,636.000	0.000
RISK	2.314	2.177	-2.262	6.780	1.556	4.655	0.098

Average board composition in the form of representation of outside independent director is 3.8 percent which is ranging from 0 to 33.3 percent. Average board size is 5.9 which is ranging from 3 directors to 12 directors. There is a 46.7 percent incidence of CEO duality. Average debt ratio is 74.3

percent implying that 74.3 percent of the firm assets are financed by debt. Average current ratio is 1.48; average firm age (in the form of listing at the stock exchange) is 14 years which is ranging from 2 years to 32 years. Average firm size in the form of total assets is Taka 398.21 million which is ranging from Taka 11.47 million to Taka 19148.50 million. Average firm growth is 23.1 percent which is ranging from negative 100 percent to 459.7 percent. Average firm risk is 231 percent.

To perform the statistical analysis, it is necessary to meet the assumptions of statistical analysis, such as normality, heteroscedasticity and multicollinearity. The assumption of normality is confirmed through a Normal Q-Q Plot, the Residual Test/Histogram-Normality Test as well both the 'Kolmogorov-Smirnov' and 'Shapiro-Wilk'. No multicollinearity problem is seen in this study as the correlation matrix of the explanatory variables (not shown here) shows that there is no strong correlation among the variables as correlation coefficients are very small (less than 0.75 or negative) and Variance Inflation Factor (VIF) is less than 2. The Breusch-Pagan-Godfrey test suggests that there is a presence of heteroscedasticity in the model, which is corrected by using correction technique for unknown heteroskedasticity of White (1980).

### 6. Empirical Results

The regression coefficients of the relationship between the blockholding and firm performance under different performance measures are presented in table 2 (panel A). The regression coefficients suggest that there is a significant positive relationship between largest blockholding and firm performance under both accounting (ROA) and market based (Tobin's Q) performance measures. Board composition in the form of representation of outside independent directors has no significant explanatory power in influencing firm performance under both the performance measures. Board size has significant positive explanatory power in influencing firm performance under both the performance measures. CEO duality has a significant negative explanatory power in influencing firm performance under market based performance measure. Debt ratio, liquidity, age have significant positive explanatory powers in influencing firm performance under market based performance measure. Firm size, growth and risk have significant positive explanatory power in influencing firm performance under both the accounting and market based performance measures.

It is argued that, the relationship between the ownership structure and firm performance is spurious because the relationship between these variables is industry-specific and no control has been included in the regressions for this possibility (Short and Keasey, 1999, p 95). Consistent with this argument and following Demsetz and Lehn (1985), McConnell and Servaes (1995), Short and Keasey (1999), further analysis is conducted to determine the robustness of the results by controlling the above regression model for industry and time effect. This is done by adding 'INDUSTRY Dummies' for two-digit industrial classification (SIC) codes for the sector to which the firm belongs and 'TIME Dummies' for the year in which the observation is made. The following regression equation is arrived at:

$$Y_{it} = \alpha + \beta_1 LBOWN_{i,t} + \beta_2 BDCOMP_{i,t} + \beta_3 BDSIZE_{i,t} + \beta_4 CEOD_{i,t} + \beta_5 DR_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 AGE_{i,t} + \beta_8 SIZE_{i,t} + \beta_9 GROWTH_{i,t} + \beta_{10} RISK_{i,t} + \Omega YEAR + \gamma INDUSTRY + \epsilon_{i,t}$$

**Table 2:** Relationship between the largest blockholding and firm performance  
 This table presents the summary results of the largest blockholding and firm performance under different performance measures.

	Dependent Variables			
	Panel A (Before controlling for Industry and Time)		Panel B (After controlling for Industry and Time)	
	ROA	Tobin's Q	ROA	Tobin's Q
Intercept	-0.001 (-0.031)	-0.770 *** (-6.503)	-0.045 (-0.726)	-0.348 (-1.454)
LBOWN	0.109 *** (6.774)	0.761 *** (6.789)	0.107 *** (5.901)	0.649 *** (6.565)

**Table 2:** Relationship between the largest blockholding and firm performance - continued

BDCOMP	-0.050 (-1.222)	-0.076 (-0.340)	0.035 (0.596)	0.167 (0.684)
BDSIZE	0.037 ** (2.385)	0.459 *** (6.948)	0.039 ** (2.290)	0.347 *** (5.089)
CEOD	0.000 (-0.018)	-0.086 ** (-2.943)	0.008 (0.885)	-0.082 ** (-3.039)
Debt Ratio	-0.055 ** (-2.530)	0.951 *** (22.481)	-0.060 ** (-2.272)	0.963 *** (23.524)
LIQ	-0.001 (-0.517)	0.018 ** (2.269)	-0.002 (-0.902)	0.021 * (1.834)
AGE	-0.008 (-1.314)	0.142 *** (4.782)	-0.001 (-0.117)	0.105 *** (3.332)
SIZE	0.005 ** (2.250)	0.031 ** (2.991)	0.005 ** (2.450)	0.019 * (1.743)
GROWTH	0.038 *** (3.838)	0.079 ** (2.263)	0.032 *** (3.817)	0.023 (0.949)
RISK	0.017 *** (10.696)	0.090 *** (8.025)	0.018 *** (9.996)	0.088 *** (7.196)
F Statistics	47.677 ***	175.495 ***	16.523 ***	59.890 ***
Adjusted R <sup>2</sup>	0.357	0.675	0.412	0.727

The *t*-tests are presented in the parentheses. \*  $p < 0.10$ ; \*\*  $p < 0.010$ ; \*\*\*  $p < 0.001$ .

The regression coefficients shown in table 2 (panel B) were not altered materially, except the firm growth under market based performance measure changed from significant to non-significant.

## 7. Discussions and Conclusion

This study investigates the relationship between largest blockholding and firm performance in Bangladesh. It is found that there is a significant positive relationship between largest blockholding and firm performance under all the performance measures. The significant positive relationship between largest blockholding and firm performance primarily supports the Jensen (1993) 'convergence of interest' hypothesis; that is, the controlling shareholding may align the interest of managers with that of shareholders and thereby enhance firm performance.

The theoretical implication of this study is that, this study supports the agency theory. This is because, the separation of ownership and control leads to the problem of aligning the interest of owners with managers that may be detrimental firm economic performance. It is to be noted that, largest blockholders, by narrowing the gap between ownership and control, could significantly influence the firm economic performance; thus, separation of ownership and control may be detrimental to firm performance.

The practitioner/policy implication of this study is that legislative guideline for controlling share ownership may be required. It will to pose a threat to the poorly performed company management. This study also noted that, representation of outside independent directors in the board does not add any value to the firms in Bangladesh. While outsider representation in the board works well in many emerging economies (see for example, Tian and Lau, 2001; Luan and Tang, 2007), it has no role in the context of Bangladesh. Therefore, it may be imperative to direct the firms in Bangladesh to appoint 'true' outside independent directors, who will be able to add value to the corporate boards in Bangladesh.

This study may have some limitations. For example, the data were mainly collected from the annual reports of the companies. As accounting standards are very poor in developing countries, the annual report may not truly represent a company's state of affairs and performance. Further, the data were collected from a large number of observations of different corporate entities, ignoring the underlying differences in organizations and that no two organizations (even in the same industry) are

the same (Deegan, 2006). The extreme value of some observed variables such as EBIT may be skewed by the accumulated profits of a few firms for certain years and may severely impact the outcome of this study.

#### Notes:

1. The stock market in Bangladesh is considered to be non-efficient, as there is an information asymmetry between insiders and outsiders and irrational behaviors of insiders. Insiders tend to use sensitive information for private gain, which is seen during stock market turmoil in 1996 (also see note 2).
2. There was an unusual growth of capital market at Dhaka and Chittagong Stock Exchange during 1996 due to a speculative bubble. It is alleged that, it started following the market manipulation primarily by foreign institutional investors with the help of local company directors and the local brokers-members syndicate. The price jump continued until the bubble burst in November 1996.

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