



Impact of Ownership Structure on Agency Cost of Debt in India

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Abstract

Using data from Indian listed companies from 2000 to 2014, the relationship between the ownership structure of the firm and the agency cost of debt in the context of an emerging economy is being explored in this paper. We mainly look at family ownership. Family owners and debt holders share similar risk profile and long term orientation towards firms and therefore, expected to have goal alignment between them. However, we hypothesize that debt-holders, in the Indian context, are more concerned with the risk of wealth expropriation by the concentrated family owners rather than the benefits entailed by such an ownership structure. Accordingly, the paper attempts to answer the question: which agency problem namely the management-principal or the principal-principal is given more significance by the debt holders in the Indian context.

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INTRODUCTION

Extant literature has extensively looked at the relationship between ownership structure and agency cost for shareholders.

The agency cost is primarily described in the literature as the result of the agency conflict due to the separation of management and control between the shareholders and the managers (Berle and Means, 1932). Primary agency theory assumes managers to be risk averse and dispersed owner to be risk neutral. This difference in risk choices is expected to create goal misalignment between manager and the owner. Consequently, it is believed that managers destroy shareholders' wealth by taking less risky decisions or they draw private benefits at the expense of shareholders. The cost shareholders have to bear because of this goal misalignment is called agency cost. Following this proposition, many researchers have looked for alternatives to reduce this agency cost. Insider ownership, concentrated ownership, incentive structure for managers, having outside directors on the board are few options that firms use to monitor the management, and/or align its goal with that of shareholders so that the agency cost of equity can be reduced. Literature has also looked at goal misalignment among different shareholders especially, majority and minority shareholders. Minority shareholders are risk neutral while majority shareholders are risk averse and again their goals vary; resultantly, majority shareholders who have controlling stake in the firm are believed to expropriate wealth at the expense of minority shareholders. In fact, firms with majority shareholders are expected to raise equity at higher cost because minority shareholders or investors charge premium anticipating agency conflicts in such firms. Therefore, agency cost of equity is higher in such firms. Demsetz and Lehn (2014) have demonstrated how the ownership structure of a firm evolves to mitigate agency cost and increase value of the firm.

Ang, Cole, and Lin (2000) have examined impact of ownership-management structure of small firms on agency cost of equity. Their findings suggest that agency cost are higher when an outsider manages the firm and when number of non-manager shareholders increase. Agency

costs are lower when there is greater monitoring by bank and these costs are inversely proportional to management's ownership share.

Similar to agency cost of equity, there is agency cost of debt. Here the goal conflict could appear among shareholders and debtholders (Anderson et al., 2003). It is believed that shareholders with dispersed ownership are risk neutral while debt holders are risk averse; again this difference in risk profile could lead to goal misalignment. Further, debt holders have long term association with firm, however, dispersed shareholders or minority shareholders generally have short term engagement with the firm. This further leads to goal misalignment among shareholders and bond holders. Therefore, firms with dispersed shareholding are expected to have agency conflict among debt holder and shareholder because shareholders may end up taking decisions that may expropriate debt-holders wealth. Therefore, agency cost of debt in firms with dispersed shareholding is expected to be high because debt-holders will charge premium for lending money to such firms anticipating such agency conflicts. Anderson et al., (2003) have empirically shown that family firms with majority shareholding face less conflict with debt holders as both have similar risk profile and therefore, agency cost of debt is low in such firms. Further, they conclude that firms with family member as the CEO has higher cost of debt than family firms with an outsider as the CEO. Similarly, firms with outside directors are expected to have lower cost of debt as compared to firms with more number of insider directors. The main explanation behind these results is that majority shareholders can monitor a professional (outside) CEO more closely than the family member CEO; similarly outside directors will be able to monitor the management more easily than the inside directors.

In this paper, we make an attempt to examine impact of ownership structure on agency cost of debt in the Indian context for two reasons: first, there is limited amount of work that has been done in an emerging economy context and therefore, it is interesting to test some of the theories of western context in the Indian context. Second, we also examine the impact of family ownership on the perception of credit worthiness of credit rating agencies

LITERATURE REVIEW

Many researchers have looked at impact of ownership structure on agency cost of debt in European and east Asian countries; further, a lot of emphasis has been given to family ownership. Classens et al (2002) examine the agency cost of debt on East Asian firms while Faccio and Lang (2002) examine this on Western European firms. Similarly, Boubakri and Ghouma (2010) have empirically found support for positive impact of family control and bond yield spreads and a negative impact of family control on bond ratings. These findings are in line with what Aslan and Kumar (2012) have found. These authors also find a positive impact of concentrated ownership on prices of loan among a sample of European and east Asian firms. They have contributed to the literature by also looking at impact of variables like strength of investors' protection rights and governance mechanisms in these countries on ownership structure-agency cost of debt relationship. Their findings are similar to Khan et al. (2012) work where they have found that blocking holding is related to low cost of debt among Pakistani firms. Further, Sa'nchez-Ballesta And Garcí ´ A-Meca (2011) have examined the impact of ownership identity (government or bank) on agency cost of debt and found that government holding leads to lower cost of debt than the bank holding.

This is similar to the finding of Shailer and Wang (2014), who have found a negative relationship between government ownership and cost of debt in a sample of Chinese firms. These results indicate that debt holders perceive government holding in a positive way and feel more secured when government is one of the shareholders in the firm. In addition to this, Shuto and Kitagawa, (2011) have examined Japanese firms and have found relationship between managerial ownership and interest rate spread.

In this paper, the relation between the ownership structure and agency cost of debt and its ultimate reflection in the debt cost is studied in the context of an emerging economy namely, India. The important difference between the two contexts namely developed economy and emerging economy are the differences in the institutional and legal frameworks provided by the two economies. In a weak institutional framework with weak minority and stakeholder protection rights, the probability and extent of expropriation by the concentrated owner may be substantially high. In such a scenario, the paper attempts to understand whether the benefit of

family concentrated ownership as posited by Anderson et al overshadows the agency cost of a higher expropriation possibility of the debt-holders due to the weak rights available with the debt holders.

Accordingly, the paper will attempt to answer the question which agency problem namely the management-principal or the principal-principal is given more significance and thereby has a greater impact on the terms of the contract between the company and its stakeholders in an emerging economy. Also, the paper goes on to demonstrate empirically the impact of the family concentrated ownership on the perception of the credit rating agencies as reflected by the rankings assigned to the debt extended by the firms in the sample.

We argue that although benefits are derived from risk alignment and improved monitoring offered by family owned businesses, in the context of a weak institutional framework the probability of expropriation by the concentrated owners is high. Debt-holders are posited to be more concerned with this risk of expropriation. Therefore we hypothesize that

Hypothesis 1: A positive relation exists between the interest rate and the existence of concentrated family ownership among Indian firms.

Hypothesis 2: A positive relation is expected between the credit rating and the existence of family concentrated ownership.

DATA

For the analysis, information is collected from 2060 companies listed on the two major exchanges of India namely, the NSE (National Stock Exchange) and the BSE (Bombay Stock Exchange) over the duration from 2000 to 2014. The source of data is CMIE Prowess. Prowess provides the information on the interest expense of the company for a year and the long term borrowing in the year. The interest rate has been calculated as the interest expense as a percentage of the long term loan of the company. Also, data is provided for the total equity during the year separately with the proportion held by individual and HUF Indian promoters. Their proportion of the total equity is considered as the proportion of family ownership during

the year. Leverage is taken in terms of the debt equity ratio i.e. the long term loans divided by the total equity. Prowess also provides information on the total assets of the firm in a given year.

The ratings are assigned to the firms on a yearly basis which are categorized by Prowess in 8 categories ranging from “highest safety” to the lowest category “default”. Accordingly, ranks are assigned to the ratings: 1 being the best and 8 being the worst (The ranking of 9 is assigned in case no rating is obtained by the firm as shown by Prowess).

Around 57% of the firms are family owned (Where the proportion held by individual and HUF Indian promoters is greater than or equal to 5%). If 20% or higher proportion is considered, then around 39% of the firms are family owned out of the sample of 2060 firms. The average ownership by the families is approximately 34% and 44% respectively. The average log of assets of the firms is 3.84 and the average leverage is 2.06.

Firms with family ownership greater than 20% of the total firms are allotted categorical variable 1 and the other firms as 0.

METHODOLOGY

Multi variate regression testing is carried out with the following specification:

To test hypothesis 1:

$$\text{Interest rate} = A_0 + A_1 * \text{Family Firm} + A_2 * \text{Industry Dummy}$$

Control variable of industry dummy is incorporated to control for differences in the industries of the respective firms.

To test hypothesis 2:

$$\text{Credit Rating} = A_0 + A_1 * \text{Family Firm}$$

RESULTS

We have done a very preliminary analysis to test our hypothesis.

The empirical findings indicate a positive relation between the interest rate and the presence of family ownership concentration. The intercept is significant at a 0.1% confidence level and the co-efficient of “family firms” is significant at the 10% confidence level. So, we get support for hypothesis 1. Similarly, we get support for hypothesis 2 where coefficient corresponding to family ownership is positive and significant at 1% level.

These results indicate that family ownership increases cost of debt among Indian firms that is contrary to the findings of the existing literature; however family ownership leads to better credit rating.

Since it is a very preliminary analysis, we need to check the robustness of results by controlling for more variables.

We also plan to look at identity of different owners and their shareholding concentration to examine the relationship between ownership structure and agency cost of debt among Indian firms.

CONCLUSION

As discussed earlier, literature has looked at impact of ownership structure on both agency cost of equity as well as agency cost of debt. There is work done on both developed and developing economy contexts; however, there is very limited work on Indian firms. This paper is an attempt to test existing theories in the Indian context. We examine the impact of family ownership on agency cost of debt as well as credit rating of a firm. Interestingly, we find results that are contrary to existing findings in the literature. We find that debt holders charge premium if there is family shareholding in the firm. Family shareholding does reduce primary agency cost by monitoring the management, however in the Indian context where stakeholders rights are not well protected they also view family shareholders as expropriators of debt holders' wealth. Family owners may impose personal decision on the firm that may not be beneficial for the longevity of the firm. To give an example, family owners may give CEO's post to family scion even the scion

is not as capable as an outsider. In this case, family's performance may suffer. Also, family owners may start drawing private benefits from the firm at the expense of debtholders' wealth. Therefore, debtholders seem to perceive this threat more than the benefits of reduction in primary agency cost.

Accordingly the threat of the principal-principal agency cost appears to be perceived by debtholders significantly and thereby overshadows the benefits entailed by the concentrated family ownership structure. This is reflected from the higher debt cost charged in the case of family concentrated ownership. On the other hand, credit rating agencies are assigning more importance to the former agency cost namely the principle-management agency cost and therefore assigning a higher rating for concentrated family owned firms.

However, these are very preliminary results and we need to build on this dataset further and add more control variables to understand the nuances of this relationship more. Our future work will be heading in that direction.

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