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Ownership of Blockholders and Agency Cost: Evidence from Pakistan

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Abstract: Purpose of the study is to analyze the effectiveness and efficiency of monitoring power and performance of equity holders, who have ownership in blocks, in minimizing and controlling the agency cost in Pakistani firms. Asset utilization ratio is used as the proxy to measure the agency cost for equity holders. This study has been done by analyzing the financial and ownership data of top 100 (capitalization wise) of Pakistani manufacturing companies by using study window of 2006-2010. By using fix effect and random effect models of GLS regression, study found that agency cost decreases with the increase in the proportion of ownership of blockholders due to their greater monitoring power.
Keywords: Ownership, blockholders, Agency Cost, Pakistan, Asset Turnover.

INTRODUCTION

Jensen and Meckling defined agency problem as the situation in which principal hires agent to perform some task of the principal and delegates his authority to agent [1]. It may happen that agent does not fulfill principal's requirements by not performing the task according to principal's wish. For instance, principal wants that there should be efficient utilization of assets to produce sales to increase principal's wealth. But manager may be lazy or acquires various perquisites for his luxuries. To check such anomalies, principal has to monitor agent for his actions and offer him incentives to consume less perquisites. This monitoring cost is the agency cost of equity because it is related to shareholder- manager (principal-agent) relationship.

Agency problem is the conflict of interest between owners and managers. It arises when mangers overlook the interest of owners and concentrate more on their personal benefits, By this financial performance of the firm is largely affected. Owners of block of equity can play significant role in influencing agency cost. It is because usually they have strong monitoring power. They have influential power in the form of blockholding to restrict the managers to consume firm resources on negative NPV projects and managerial perquisites and managerial discretion. Blockholders are the investors who own blocks of equity (more than 10% shares of total shares outstanding).

Present study uses the asset utilization ratio as proxy of agency cost of equity. Our proxy has been supported by different researchers [4, 18, 12, 19, 20 and 11]. Literature is of the view that asset utilization measures the effectiveness of using firm assets to generate the sales. If asset utilization ratio is higher, it depicts that management of the firm is making best utilization of assets. This means the management interest is matching with the interest of shareholders, it shows reduced agency cost of equity. If asset utilization is low, this shows that mangers are not utilizing assets efficiently, this is due to the reason that mangers are not taking care of the interest of the shareholders. So they are lazy or not capable of which they are being expected by the shareholders. So lower asset turnover ratio shows the increased agency cost of equity (Kim et. al. 2002). Study answers whether assets are efficiently utilized with the increased ownership of blockholders or not.

LITERATURE REVIEW

Researcher confirmed that if firm has higher proportion of outsiders' ownership, then there is lower agency cost [2]. He finds large outside blockholders sign found to be significant. From his regression results, He also finds some evidence that large blocks of stock held by outside investors can reduce agency costs. [3] found that firms in countries with superior investor protection and concentrated ownership hold less cash for their discretionary purposes. [4] found that the outsiders don't reduce agency costs. Furthermore independent outsiders on a board do not appear to protect the firm from agency costs. [5] commented that Nonfounder firms have high agency cost because a high level of blockholder ownership. On the other hand, founding family firms have lower agency cost because they benefit a low level of blockholder ownership. So this study gave idea from different researches that high blockholder ownership reduces the agency cost.

Family firms may experience lower agency costs due to their concentrated equity ownership [6]. By [4], the proportion of the outside blockholders' stake reflects the degree of external monitoring of managerial decisions. They used the equity held by outside blockholders as a proxy of outsiders monitoring ability. [7] studied two main determinants of corporate cash holdings: board size and non-management blockholders ownership. They found that large board and small non-management blockholder ownership face severe agency problem and poor corporate governance. Small, dividend-paying firms; firms with high market to book and ratio of capital expenditures to total assets; and low tangible asset ratios lead to large cash holdings . One weakness of this study is that it uses the data of only one year. [4] found that cash holdings are positively affected by the leverage. Significant negative relationship between bank debt and cash holdings is found. Bank debt is negatively associated with the cash holding, which shows that firm with bank debt hold less cash. [8] worked on the informativeness of accounting earnings in relation to corporate ownership structures, and described that intense ownership create agency problems between owners and shareholders. [9] conducted study on Korean companies and found that blockholders have incentives to actively monitor management. But blockholders are not expert in monitoring in case of Korea, they fail to establish strategically alliance with management. They found information about the firm increases with the holdings of block holders due to the alignment of owner manager interest. This supports the active monitoring role of institutions.

METHODOLOGY

Sample of this study is 100 manufacturing companies listed in Karachi Stock Exchange and study window is 2006-2010. There are total 819 listed companies in Karachi Stock Exchange. In which 353 are financial and 466 are non-financial companies. We ignored 353 financial firms because these firms need special accounting and financial treatment for their analysis. Secondly our proxies of agency costs are not calculated fully from financial sector. Among 466 non financial firms, we selected 100 top capitalized KSE listed firms. By this, sample gets almost 22% (by number of firms) representation of whole population of non-financial companies. Selection criteria of this study are the firms which have highest capitalization. By this, we get representation of almost 17 sectors, thus representation of all manufacturing sectors. Moreover we followed following guidelines while selecting the sample:

1. Firms must remain in business for the whole study period.
2. Should remain enlisted during the entire study period.
3. Should not have merged, due to any reason.
4. Data, including ownership structure, of entire period must be available.
5. For payout policy we included only those firms those pay dividend at least once in five years.

Data for this study have been collected from KSE, Economic Survey of Pakistan, Published financial statements of companies, joint stock balance sheet analysis from SBP, Business recorder newspaper and Annual reports. Study has drawn its results by Generalized least Square Regression GLS.

Model: $ATR_{it}=\beta_0+\beta_1 BLOCK_{it}+\beta_2 DR_{it}+\beta_3 DP_{it}+\beta_4 SIZE_{it}+\beta_5 Q_{it}+\beta_6 YRDUM_{it}+\varepsilon_{it}$

Where

β= regression coefficient
i= index of ith firm
t=time period
ε=error term

Table 1: Definitions of Variables

Variables	Sign	Formula
Asset Turnover Ratio	ATR	Net Income divided by Total Assets
Ownership of Blockholders	BLOCK	Total number of shares held by blockholders divided by total number of shares outstanding. Where blockholders are shareholders having more than 10% ownership in total equity outstanding.
Debt Ratio	DR	Book value of contractual long term debt / Book value of total assets
Size	SIZE	Natural Logarithm of total assets
Debt Ratio	DR	Book value of contractual long term debt / Book value of total assets
Dividend	DIV	Dividend per share divided by earnings per share
Tobin's Q	GROWTH	Ratio of (market value of equity + book value of debt) to Book value of total assets

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Table 2: Descriptive Statistics

Variables	N	Minimum	Maximum	Mean	Standard Dev.
ATR	500	0.000	5.849	1.317	1.006
INST	500	0.008	1.000	0.598	0.309
BLOCK	500	0.000	1.000	0.514	0.303
DR	500	0.000	0.934	0.190	0.177
DP	500	-14.470	22.726	0.467	1.828
SIZE	500	19.055	26.156	22.691	1.487
GROWTH	500	0.038	15.650	1.347	1.648
Valid N (listwise)	500				

RESULTS & DISCUSSIONS

Table 4 gives the detail of descriptive analysis of 100 firms listed at Karachi Stock Exchange (KSE) of Pakistan from the period 2006 to 2010. Table 4.3 shows correlation matrix. Furthermore there is no multicollinearity among variables because all the coefficient of the correlations is less than 0.090.

Table 4: Results of GLS Regression

Variable	Dependent Variable: ATR	
	Fix	**Random**
BLOCK	0.345**	0.016
DR	0.050	-0.564*
DP	0.001	-0.001
SIZE	-0.342*	-0.008
Q	0.1264*	0.105*
YRDUM	-0.250	-0.295*
CONST	9.098	1.424*
R sq	0.396	0.358
Hausman Test	Prob>chi2 = 0.0004	
*significant at 0.01 level , ** significant at 0.05 level		

As Hausman test came out to be significant, so we will follow fix effect model. We found that firm's asset utilization increases with the increase in ownership of blockholders. This means that with the increase in the ownership of blockholding, equity agency cost reduces. Blockholders have incentives to actively monitor agents because they have larger stake in the firm. So if managers don't utilize the assets efficiently in producing sales, then shareholders value will destroy. To stop this phenomenon, blockholders make their monitoring strong, so reduce agency cost of equity. Results tell that Pakistani blockholders have influential monitoring power. When firm is greater subjected to the monitoring of blockholders, then managers make efficient utilization of assets. It mitigates the equity agency cost. This supports the results of [10] who reached to the fact that with monitoring of blockholders agency cost is reduced. [11] who also used efficiency ratio as proxy of equity agency cost, found same findings. Our findings are contrary to the findings of [4] who reported that block owners do not result in achieving higher asset utilization.

Debt ratio (DR) is significantly and positively associated with the asset utilization ratio. As risk of bankruptcy increases with the increase in ratio of debt, it make the manager more conscious about generating more sales by utilizing their assets more efficiently. Debt reduces the free cash flow and debt makes the managers more disciplined in utilizing assets. Managers are afraid that if they don't use firm assets efficiently to produce sale, they wouldn't be able to pay interest on loans after fix period. So they will lose their jobs if firm goes to bankrupt or suffers financial distress. These findings are consistent with researches of [12, 13, 14, 2, and 16]. Dividend Payout Ration (DP) of the firm is negatively and insignificantly associated with the agency cost of equity. We were expecting positive relation between them because dividend is announced when firm gains enough earnings by generating more sales or by utilizing firm assets more efficiently.

Size is significantly associated with the asset turnover and direction of association is negative. This shows that managers of the larger firms are less concerned towards the efficient utilization of assets because lager firms have large amount of cash flows. Larger firms carry more agency cost of equity.

Moreover larger firms are difficult to monitor efficiently by the equityholders because of complexity and informational problems. This result confirms prior studies like [4, 16, 17, and 3]. Results show that Growth and Asset turnover are positively and significantly related with asset turnover ratio. Firms having more growth, have better utilization of its assets. Results are contrary to the finding of [12] who found that high growth firms exhibit lower asset turnover ratio.

CONCLUSION

The purpose of this research is to test the effectiveness of monitoring of blockholders in minimizing the agency cost. We tested this proportion by the data of top 100 capitalized companies of KSE 100 index. We found that asset utilization ratio rises with increase of ownership of blockholders in Pakistani firms, thus lessening the agency cost. Asset utilization ratio also increases with increase in the use of debt and growth opportunities whereas it decreases with size of firm. Our study has significance in the sense that no other study in Pakistan has covered this topic in context of Pakistan. All the researchers have studied the impact of corporate governance on performance, but didn't address agency issue. Study has recommendation for the investor of Pakistan that they may invest without fear in the firms which have ownership of blockholders. The study employs five year data (2006-2010) from Pakistani economy. This period is recognized as unchecked inflation but stable or declining interest rate. The results would likely differ using data from the time of economic stability. For example profitability remained relatively lower in this period. Firms didn't make efficient utilization of assets and did not expand due to terrorists attacks in Pakistan.

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