

FOREIGN OWNERSHIP AS A CORPORATE GOVERNANCE MECHANISM AFFECTING THE FIRM VALUE

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Abstract

Especially for emerging markets, the role of foreign shareholdings is a highly debated topic. In general, there are two clashing views about foreign ownership of firms in emerging markets. The first view implies that when foreign owners are focused on high gains in the short term, they may not care about corporate governance policy since they keep aloof from monitoring costs. On the contrary, if foreign shareholders have a long-term investment motive, they provide a good monitoring mechanism on the corporate governance policy of the firm as they are independent of the controlling ownership (largest blockholder) and local governments, and international diversification benefit is assumed to provide more stable cash flows decreasing the agency costs.

Building on these two views, this study aims to examine the effect of foreign investors on firm value via increasing corporate governance's disciplining power against entrenchment by the dominant controlling owners. Numerous studies provide evidence about the possible impact of foreign ownership on firm value but channels through which foreign ownership affects corporate governance need to be explored more. These channels could be the increased level of board independence and foreign owners' impact on the firm's dividend and investment policies.

The first expected outcome of the study is that higher foreign ownership leads to the involvement of more unaffiliated outsiders in the form of foreign directors affecting the independence level of the board which will indicate more monitoring power by independent outsiders and good motives for corporate governance which in turn will increase firm's market value. Second, foreign ownership in a firm may motivate more dividend payments to shareholders and prevent the free cash flow problem (classical corporate governance dilemma) by eliminating over-investing and providing efficient allocation of resources in a company if lower growth opportunities exist. Thus, through increased dividends, foreign ownership may discipline the managers. Third, foreign investors are deemed to be involved more in innovation-oriented research and development investments and this may motivate managers to increase capital expenditures when a firm has greater growth opportunities. Through increased research and development investments, focusing on high growth and return opportunities, foreign ownership may have a disciplinary power on managers, reducing agency costs and increasing firm value.

This study examines the effect of foreign ownership on firm value by affecting corporate policies as a corporate governance monitoring mechanism and contributes to the literature on the role of foreign shareholdings which are especially important for emerging markets in three stands: increased level of board independence which serves to eliminate the conflicts of interest among different stakeholders within a company, a dividend policy disciplining the management of free cash flows and an investment policy focusing on more research and development (innovation), enabling high growth opportunities and profitable investments.

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