# CORPORATE GOVERNANCE, OWNERSHIP CONCENTRATION AND FIRM PERFORMANCE IN A DEVELOPING FINANCIAL MARKET

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**Abstract**

This paper seeks to examine the role of blockholders (majority shareholders) in affecting the value of a firm (BVF) in the developing (Malaysian) financial market characterized by the existence of additional imperfections in this market. The data is collected by using stratified random sampling for the firms listed in the Kuala Lumpur Securities Exchange for the years 2000-2003 to perform multiple regression analysis. The results of the study suggest that blockholders play a negative role in affecting the firms' value explaining market operations in the selected market, and contradicting the foundation of the developing market and convergence of interest hypothesis. In addition, the bigger board, liquid market, correct valuation of securities and effective utilization of assets improve shareholders' value in the selected financial market. This paper contributes to the literature by performing a comprehensive study on the poorly researched topic of the BVF relationship. Furthermore, a correct proxy to value a firm is used and additional tests for robustness are performed to provide valid results on this relationship. Finally, the role of additional imperfections and implications of different management theories in explaining the BVF relationship is also provided in this study. The results provide new insights and highlight the importance of corporate governance provisions relevant for the firms of the developing market. The results of the study can be used by the regulatory regime to make effective corporate governance policies.

**Keywords:** Ownership concentration, Board size, Corporate governance, Firm performance, Malaysia

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## 1. Introduction

Studies on the role of majority shareholders in affecting the value of a firm in a developing financial market provide us with either *inconclusive* or *diverging results*. Recent studies conducted in the developing financial market are by Claessens and Djankov (1998), Himmelberg et al. (1999), Morck et al. (2000), Nagar et al. (2000), Demsetz and Villalonga (2001) and Wiwattanakantang (2001). These studies support the incentive or convergence of interest hypothesis, as Wiwattanakantang (2001), Lins (2003) and Suto (2003) find a positive role of blockholders in affecting the value of a firm in Malaysia. They further argue that these blockholders reduce the divergence of interest between managers and the owners (shareholders). Kaplan and Minton (1994) and Yafeh and Yosha (1995) suggest that concentrated shareholding disciplines management, improving the performance of a firm. Similarly, Khanna and Palepu (1999) in their studies on Indian firms and Lefort and Walker (2000) on the firms listed in Chile, support a positive role of conglomerates (business group) in affecting shareholders' value. These conglomerates deal with the market imperfections in developing markets in a better manner improving shareholders' value in these markets.

On the contrary, literature on the role of blockholders in affecting the value of a firm (BVF relationship) also suggests a negative relationship between shareholders' value and the level of blockholding, supporting the divergence of interest hypothesis (Tam and Tan, 2007; Young et al., 2008). The literature further suggests that principal-principal conflict arises due to a divergence of interest between the majority and minority shareholders in the financial market. Similarly, Bebchuk et al. (2004) and Colombo and Stanca (2006) argue that managers, with the help of majority shareholders, are involved in under and over investment of the free cash flow, deteriorating the value of a firm in the developing financial market. The studies conducted by Lefort and Walker (2001) in Chile and Klapper and Love (2003) in different emerging markets find that concentrated shareholding leads to the divergence between cash

flow and voting rights harming the value for shareholders in these financial markets.

In addition to the *diverging views* related to the role of majority shareholders in affecting the value of a firm, the existing literature including a recent paper by Tam and Tan (2007) on Malaysian firms *lacks* the following.

- an analysis of blockholders and the value of a firm relationship by constructing a *comprehensive conceptual framework* (incorporating additional factors affecting the BVF relationship) in the developing market;
- tests about the relationship of blockholders and the *correct proxy* to value a firm in the developing financial market;
- *interpretation* of results about the blockholders and the value of a firm relationship by taking into account the *major hypotheses* (convergence of interests and entrenchment hypothesis) present in the literature; and
- performance of *additional test of robustness* to detect and address the *two-way* relationship between concentrated shareholding and the value of a firm (endogeneity test) in the developing financial market.

The paper addresses the abovementioned gap in the literature and *extends* a recent study by Tam and Tan (2007) by using sophisticated econometric software, *correct proxy* to value a firm, interpretation of result about BVF relationship by taking into account the *major hypotheses* in the literature and by performing an additional test of *robustness* (endogeneity test) in a developing financial market. Utilizing data for 60 companies listed in the Kuala-Lumpur Securities Exchange for years 2000-2003, this paper shows that majority shareholders deteriorate the value of a firm in the developing financial market *contradicting* the foundation of the hybrid system and *convergence* of interest hypothesis (stewardship theory). Furthermore, the results about the role of control variables (board size, CEO duality, price to book value ratio, return on total assets and market capitalization) in affecting shareholders' value suggest that a bigger board, correctly priced securities, optimal utilization of assets and liquid market, improve shareholders' value in the selected market. Following the introduction, the rest of the paper is structured as follows. Section 2 presents the literature review and the hypothesis relevant for the study. Section 3 explains the methodology for the study. Section 4 presents the econometric results of the model. Similarly, Section 5 explains the results for the BVF relationship model. Finally, Section 6 concludes this study.

## 2. Critical Literature Review and Hypothesis Development

Corporate governance is related to the protection of the rights of a shareholder in the economy. For a survey of corporate governance issues see Heinrich (1999), Vives (2000) and Bhagat and Jefferis (2002). Good corporate governance also deals with defending the interests of all the stakeholders (managers, suppliers, debtors, creditors and employees) in the market (Gompers et al., 2003). Corporate governance provisions improve shareholders' value as the rights of shareholders (principal) are safeguarded (Black, 2001). Additional imperfections (inflation, political instability and weak regulatory framework) in a developing financial market also play an important role in affecting the relationship between corporate governance and the value of a firm.

The Malaysian market follows a hybrid system of corporate governance. The characteristics of this system include concentrated shareholding, weak regulatory regime, higher debt, less diversified portfolios, illiquid market and lower level of transparency (Wei, 2003 cited in Rashid and Islam, 2008). Furthermore, in comparison with the financial systems of developed countries such as U.K and U.S.A, there are higher levels of market imperfections due to the existence of a weak corporate law in Malaysia. This makes it qualify as a developing market.

There are two types of corporate governance instruments in financial markets. These include external and internal corporate governance mechanisms (Nam and Nam, 2004; Bebchuk et al., 2004). The external corporate governance instruments in the market incorporate the role of regulatory authority, the role of judiciary and the role of majority shareholders. The regulatory authorities in the market include the securities and investment commission and the reserve bank. The regulatory and judicial authorities play an important role in disciplining firms in the market (Black, 2001). The external governance mechanism is weak in developing financial markets which results in non protection of the rights of shareholders (Nenova, 2003). There is a higher responsibility on majority shareholders to monitor the affairs of a firm in a developing financial market compared to the regulatory authorities due to a greater role designated to them.

The internal corporate governance instruments in the financial market include board size, CEO, CEO duality, chairman, majority shareholders and an independent auditor (Bebchuk et al., 2004). The external corporate governance instruments can improve the value of a firm by disciplining the internal corporate governance mechanism in the market. The abovementioned internal corporate governance instruments can also improve shareholders' value by making democratic decisions, ultimately reducing the agency cost in a market (see Shleifer and Vishny (1986), Kaplan and Minton (1994), La Porta et al. (1997), Durnev and Kim (2002), Dittmar, Mahrt-Smith and Servaes (2003) and Nenova (2003)).

There are two theories on the role of agent (managers) in affecting the rights of the principal (shareholders). The first theory is based on the convergence of interests between the principal (shareholders) and the agent (managers) and is known as the stewardship theory. This theory suggests that the interests of the agent (management) coincide with those of the principal (shareholders). The convergence of interests between the management and shareholders leads to lowering the agency cost and improving the firm's performance in a market. On the contrary, the second theory is based on the divergence of interests between the principal (shareholders) and agent (managers) and is known as the agency theory. This divergence leads to a higher agency cost between these two parties deteriorating the value of a firm in the market.

Grossman and Hart (1982) argue that majority shareholders reduce the free riding in a firm improving shareholders' value in the market. Free riding occurs when a few shareholders share the profitability of a firm without paying any monitoring cost. Similarly, Suto (2003) and Lins (2003) suggest that concentrated shareholding improves the value of a firm by reducing conflicts between managers and shareholders (equityholders) in the market.

Anderson and Reeb (2003) recommend that firms owned by the founding family perform better compared to the non-family-owned firms. It is further argued that blockholders play a critical role in monitoring and displaying leadership qualities which results in the protection of the rights of minority shareholders in a market. The blockholders, having lack of affiliations with the management, also affect the firm's performance positively and counter-balance the opportunistic role of managers in a firm. This safeguards the interests of shareholders and results in improving the firm's performance in a market.

Majority shareholders, as external monitors, improve the value of a firm by making the decisions related to defending the rights of shareholders (Kaplan and Minton, 1994). Furthermore, these blockholders remove the underperforming management in a developing financial market reducing the agency cost of the firm. Yafeh and Yosha (1995) support the similar results and endorse that external corporate governance instruments (majority shareholders) discipline the internal corporate governance instruments (board) by reducing the unhealthy conflicts among the board members.

In addition to the role of majority shareholders in isolation, their role in affecting the value of a firm in combination with the other instruments is also important (Heinrich, 2002). The combination of instruments which improves the value of a firm by reducing the opportunity cost created by each instrument is Edgeworth complements. The adverse effect by the excessive use of a single corporate governance instrument is nullified by the use of a second instrument in a financial market. The Edgeworth combination of instruments in the developing market includes higher debt, concentrated shareholding, illiquid financial market, weak regulatory authority, undiversified portfolios and effective role played by majority shareholders in the market. The combination of the abovementioned instruments comprises the foundation of the developing market.

This foundation suggests that existence of concentrated shareholding creates value due to a better maintenance of agency cost between blockholders and minority shareholders (Berglof, 1997). Blockholders also improve the firms' value in the presence of higher debt and weak regulatory authorities as they (blockholders) act as an effective monitor reducing the agency cost of debt from the developing market. The healthy role by these blockholders enables investors to earn higher returns by holding concentrated portfolios in this market.

The abovementioned discussion suggests that majority shareholders encourage the managers to safeguard the interests of all the shareholders reducing the principal (shareholders) and agent (managers) conflicts in a market. The positive role by the blockholders in the developing financial market is also supported by the foundation of the hybrid system. This leads to the relevance of the stewardship theory in the developing market.

On the contrary, Pinkowitz et al. (2003) argue that majority shareholders exploit minority shareholders and deteriorate firms' performance in developing financial markets. Minority shareholders are also not allowed to use their votes to discipline the autocratic (value destroying) management in these markets. Furthermore, regulatory authorities do not reduce the gap of information asymmetry between majority and minority shareholders in the developing financial market.

The managers in developing markets generally accrue private benefits and harm shareholders' interests by tunneling (misusing and stealing the resources of a firm). Tunneling can take two forms: under and over investment of the free cash flow (Colombo and Stanca, 2006). Under investment occurs when the management of a firm does not derive benefits from the positive net present value projects. Shareholders' value is harmed in this case because the managers do not perform their fiduciaries as the creditors share the part of profits from the successful investments made by the firm.

The second form of tunneling in the financial market takes place due to the over investment of the free cash flow. According to Jensen (1986), over investment takes place when the size of a firm is increased beyond the optimal level by investing in unhealthy projects due to the private interests of the management. Over investment also includes empire-building by the management of a firm. The managers do not pay dividends to the shareholders and utilize the free cash flow for their own private benefits, such

as buying luxurious apartments and private jets and making heavy innovations of their offices (Rashid and Islam, 2008).

One of the factors that drives over investment of the free cash flow is the over confidence of managers. The managers over estimate the future profitability of a firm and invest in negative net present value projects. The phenomenon (over investment) also takes place due to an error of judgment by the managers of a firm in making the correct financial decisions. These decisions do not improve shareholders' value in the financial market.

The regulatory authorities in developing financial markets do not reduce the divergence between majority and minority shareholders (Klapper and Love, 2003). Due to a weak corporate law, the rights of minority shareholders are not protected in the developing financial market. The independent auditors cannot reduce the gap of information asymmetry between majority and minority shareholders. The ratio of outside (independent) and inside directors is also not maintained properly by the external regulatory regime which has resulted in the deteriorating value of a firm in this market.

In addition to the poor role of the regulatory authority, the judiciary in the developing market is also corrupt and biased (Ahunwan, 2003). The judges do not have proper qualifications to understand the nature of corporate crimes in the market. The judiciary establishes illegal connections with politicians and government officials in the country. Furthermore, the government in developing financial markets, neither finances courts optimally, nor provides judges with the proper libraries, guidance sessions and requisite infrastructure. The lack of these facilities makes the decision-making system in the courts slow and irritating (Ararat and Ugur, 2003). This results in the deteriorating performance of a firm as corporate disputes are not resolved in a timely and effective manner in the market.

There are additional imperfections in the developing financial market which affect shareholders' value. These include non-existence of a financial system, high inflation, political instability, lack of transparency, inconsistent accounting standards, weak regulatory framework, cross and pyramidal shareholding, poorly regulated banking system and lower level of literacy in this market (Pereiro, 2002). The relationship among the players in the developed market is based on trust and related ethical norms, which also adds to the imperfections in the contracting system making the financial system more risky (Vives, 2000; Dallas, 2004).

Due to these imperfections, shareholders in developing financial market pay a higher level of monitoring cost (cost incurred in monitoring the management), residual cost (cost related to appointing the independent board) and finally the bonding cost (cost related to the operations of an independent auditor) (Matos, 2001). These costs diminish the value of shareholders in the developing market. The additional imperfections in the developing market also affect the majority shareholders and the value of a firm relationship adversely deteriorating the value of a firm. We support the agency theory and argue that managers (agent) and majority shareholders (principal) do not look after the interests of the minority shareholders (principal) in a developing financial market. This discussion leads to the following hypothesis.

$H_1$: Concentrated shareholding deteriorates the value of a firm in a developing financial market.

The control variables in the current study are important instruments which add robustness to the model for blockholders and the value of a firm relationship. Majority shareholders in the financial market can also complement the role of these variables and improve the value of shareholders. The first instrument (control variable) used in this study is the role of board size in affecting shareholders' value. The board is an important corporate governance provision in affecting the value of a firm (Rashid and Islam, 2008). It performs important regulatory duties such as keeping an eye on the management of a firm and providing accurate financial information to the investors. The board members should neither harm the rights of shareholders nor deteriorate their value (Tomasic et al., 2003).

The size of a board is also an important determinant to improve the value of a firm. There are two theories related to the role of board size in affecting the firms' performance in financial markets. The first is the agency theory and suggests that a bigger board makes irrational decisions affecting shareholders' value in a negative manner (Yermack, 1996). The members of the bigger board are not united, which results in a slow and costly decision making process in the board. Furthermore, there is a free rider problem in a bigger board when some of the board members do not perform their duties of monitoring, instead they depend on their peer members to improve the firm's performance (Loderer and Peyer, 2002).

The next theory explaining the relationship between the board size and the value of a firm is the stewardship theory. This theory suggests that a bigger board leads to better decisions due to higher level of expertise (conceptual, technical and dispute resolution skills) improving the value of a firm. The higher number of board members leads to intense brainstorming by these members. This results in the healthy divergences among the board members, improving the value for shareholders in the financial market (Zahra and Pearce, 1989).

The second control variable used in this study is related to the role of leadership structure in affecting shareholders' value. Leadership structure is an imperative component of corporate governance in the

financial market. There are two main types of leadership structures which include dual and non-dual leadership mechanisms (Lam and Lee, 2008). The dual structure of leadership pertains to the mechanism in which the CEO also holds the position of chairman of the board. On the contrary, the non-dual structure refers to the holding of the two positions by separate individuals (Brickley et al., 1997; Kyereboah-Coleman and Biekpe, 2005).

The theory explaining the relationship between concentrated shareholders, CEO duality and the firm's performance in a developing financial market is agency theory. This theory suggests that a single person occupying both of these important positions is contrary to corporate governance principles. This type of leadership structure deteriorates the firm's performance as the independent decision making of the board member is harmed. Majority shareholders in the presence of dual leadership structure in a developing financial market harm the value of a firm as the performance of the CEO is not monitored properly. The CEO in this market is generally involved in tunneling (expropriation of minority shareholders' assets) deteriorating the value of a firm.

Similar to the role of the instruments mentioned above, market capitalization (MC), price to book value (PBVR) and return on total assets (ROTA) affect the value of a firm in a developing financial market. Higher market capitalization improves the value of a firm by making the market liquid which leads to ease in buying and selling of the shares. Similarly, correct valuation of securities improves shareholders' value by reducing the information asymmetry in the market. This results in improved investors' confidence and a higher firm value. Finally, optimal utilization of assets reduces the level of tunneling (misuse of the corporate resources) in the financial market improving the firms' performance.

**Figure 1.** Conceptual Framework for the Study

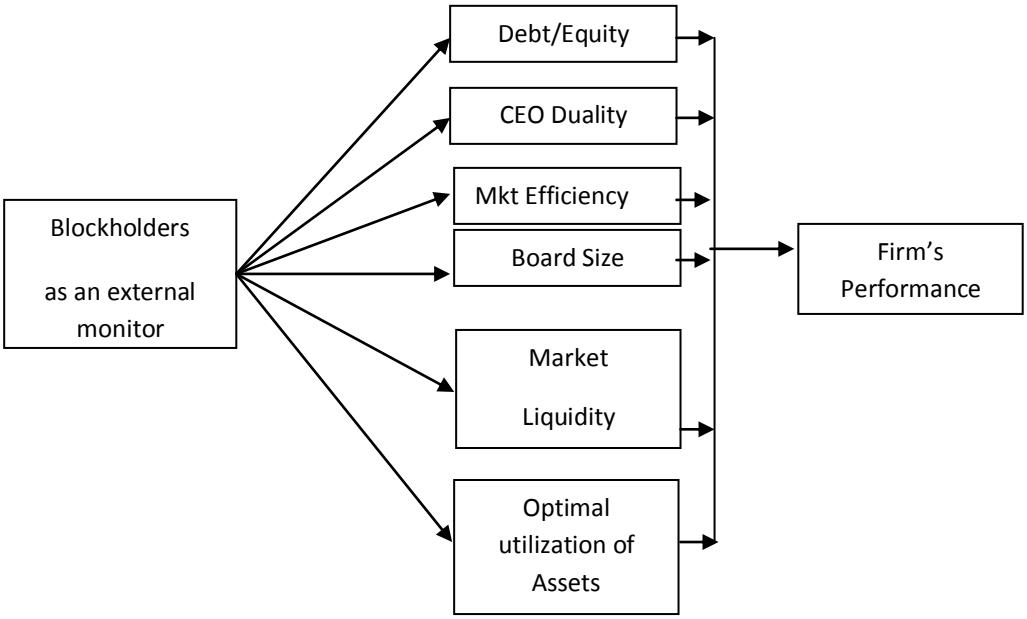

Figure 1 shows that blockholders in the developing financial market can improve the value of a firm by altering debt and equity structure, ultimately reducing the free cash flow problem in a firm. The efficient role of blockholders shields the rights of shareholders as the agency cost between the management and the creditor is handled effectively in the market. Similarly, majority shareholders can discipline the independent CEO in a dual leadership structure and force him to create value for shareholders in the developing financial market. In the case of a non-dual leadership structure, blockholders as monitors can also discipline the chairman and CEO, either by coercive actions or by aligning their interests, ultimately leading to the improvement in the value of a firm.

An effective role by the majority shareholders can decrease the agency cost among the board members reducing the free rider problem in the board. This reduces the agency cost and enhances the decision-making process of the board, improving the value of a firm. Similarly, the blockholders can encourage the market forces to represent the true prices of the shares and make the market liquid. Finally, these blockholders can also play a role in utilizing the assets of the firms optimally.

## 3. Methodology

The data relevant for the study is collected for sixty companies listed in Kuala-Lumpur Securities Exchange selected on a random basis. The data collection method consists of stratified random sampling where the properties of listed companies are generalized by analyzing the characteristics of sample companies. The two types of variables used in this study include internal corporate governance instruments (mechanism) and control variables. The internal corporate governance mechanism includes the role of concentrated shareholding in affecting the value of a firm. Similarly, the control variables consist of board size, CEO duality, market capitalization, return on total assets and price to book value ratio. The data for internal corporate governance instruments is collected by using OSIRIS database and is crossed checked against the websites of the listed companies. The data for control variables is collected from the books of the Securities Exchange and other published sources.

### *3.1 Variables of the Study*

The variables used in this study are presented in Table 1 and their methodology of construction is as follows. The dependent variable in the model for blockholders and the value of a firm relationship is the firm's value (Tobin's Q as a proxy) (Bhagat and Jefferis, 2002). This proxy is calculated by adding market capitalization and total assets. The added amount is then subtracted from shareholders' funds. The obtained value is lastly divided by total assets to get the final value for the proxy of firm's performance. The final value is a better proxy for the Tobin's Q, as the replacement value of institutional debt is not used in the formula for calculating the respective value in the developing financial market.

**Table 1.** Variables Used for the Study of a Developing Market (Malaysia)

| Variables | Proxied by | Symbol | Expected sign |
|---|---|---|---|
| Dependent Variable | | | |
| Value of a Firm Tobin's Q | Mkt Cap + TA – Sh F/TA | TQ | |
| Independent Variables | | | |
| Return on Total Assets | Return generated by the assets of a firm | Rota | Positive + |
| Size | Number of directors in the board | Log Size | Negative - |
| Duality | Dummy variable: Can take values of 0 and 1 | Duality | Negative - |
| Agency Cost | Ownership concentration in a firm | Ac | Negative - |
| Market Capitalization | Market capitalization of a firm | Log Mc | Positive + |
| Price to Book Value Ratio | Price to book value ratio of a firm | Pb | Positive + |

Notes: Mkt Cap = Market capitalization.
TA = Total assets.
Sh F = Shareholders' fund.

As discussed in the previous section, this study is based on the role of concentrated shareholding in affecting the value of a firm in the market. The ownership concentration is measured by capturing the highest level of ownership in a firm. The actual level of ownership is a better measure compared to the dummy variable based on the cut off points (20% ownership), as used by Gompers et al. (2003).

As mentioned in Section 2, the control variables in this study include board size, CEO duality, market capitalization, price to book value ratio and return on total assets. Board size is calculated by counting the number of directors on the board (Kyereboah-Coleman and Biekpe, 2005). A negative relationship between board size and the value of a firm is expected as higher strength in the board leads to the

deteriorating performance of a firm in the developing financial market.

The next variable used in this study is the CEO duality. The variable is measured by using the dummy variable (Lam and Lee, 2008). The value of the variable is 0 when both the roles of CEO and the chairman are performed by two different individuals. On the contrary, value of the variable is 1 when the roles of CEO and the chairman are performed by a single person. We expect CEO non-duality to improve the value of a firm as it supports corporate governance principles in the market (Chen et al., 2005).

The other control variables in the current study include market capitalization, price to book value ratio and return on total assets. These variables are extracted directly from the balance sheets of the listed firms and are expected to have a positive relationship with a firm's performance as market liquidity, correct information about the prices of securities and optimal utilization of assets improve the value of shareholders in the developing financial market.

*3.2 Econometric Model*

The functional form of the model relevant for blockholders and the value of a firm (BVF) relationship is as follows:

Tobin's Q = f (Log Size, Ac, Duality, Pb, Rota, Log Mc)……

The equation (1) represents the relationship between ownership concentration, control variables and the value of a firm. The general representation of the model is as follows:

$$Y_t = C + \beta_{1t} \log X_{1t} + \beta_{2t} X_{2t} + \beta_{3t} X_{3t} + \beta_{4t} X_{4t} + \beta_{5t} X_{5t} + \beta_{6t} \log X_{6t} + U_t \quad (1)$$

where: $Y_t$ (regressand) = dependent variable;

C = intercept;

$\beta_t$ ($\beta_1$ - $\beta_6$) = slope of the independent variables;

$X_t$ (regressor) = independent variables;

t = periods;

$U_t$ = error term;

$\beta_1$ = coefficient of board size;

$\beta_2$ = coefficient of agency cost;

$\beta_3$ = coefficient of CEO duality;

$\beta_4$ = coefficient of price to book value ratio;

$\beta_5$ = coefficient of return on total assets; and

$\beta_6$ = coefficient of market capitalization.

The sign of $\beta_1$ is expected to be negative as the literature suggests a negative relationship between the value of a firm and a bigger board. The sign of $\beta_2$ is also expected to be negative as the study is based on the entrenchment hypothesis. This hypothesis suggests that the majority shareholders harm the value of a firm in the developing financial market. Similarly, $\beta_3$ being the coefficient of CEO duality is expected to have a negative relationship with the value of a firm. In contrast, $\beta_4$, $\beta_5$ and $\beta_6$ are expected to be positive as price to book value ratio, return on total assets and market capitalization are expected to have a positive relationship with the value of a firm in the developing financial market.

## 4. Econometric Results

The current section explains the results of the model relevant for the study. The model for the study is selected on the basis of high R squared, strong diagnostics and the best functional forms of the independent variables. To ensure the validity of the hypothesis relevant for the study, several remedial measures were taken. The variance of the error terms of the model was unequal which showed the presence of a heteroscedasticity problem. White diagonal treatment was applied to the model which resulted in the correction of the variance of error term and achievement of a robust econometric result.

The test to detect multicollinearity in the model for the BVF relationship is also performed. The values of the variance inflation factors for the variables of the model range from 1.02 to 1.13, endorsing the validity of the regression results (Gujarati, 2003).

The results of the study are presented in Table 2 and show that the value for the R squared in the model is 0.75. The result shows that 75% (value for the R squared) of the variation in the Tobin's Q is explained by the independent variables of the model. The mean value of the dependent variable (Tobin's Q) is 1.03 which shows that firms in the developing market are healthy and create value for shareholders. Finally, value of the F statistic is 116.68 and is significant, confirming the validity of the results of the model.

The econometric results for the BVF relationship model are as follows:

TQ = -0.01 + 0.18 Size - 0.19 Ac + 0.05 Duality + 43.44 Pb + 1.09 Rota + 0.03 Mc…. (2)

(-0.09) (3.51)** (-2.15)** (1.59) (5.43)** (1.76)* (2.44)**

$R^2$ = 0.75

**Table 2.** Results of the Model Relevant for the Developing Financial Market

| Variables | Malaysian Model |
|---|---|
| Constant | -0.01<br>(-0.09) |
| Log Board Size | 0.18<br>(3.51)** |
| Log Market Capitalization | 0.03<br>(2.44)** |
| CEO Duality | 0.05<br>(1.59) |
| Price to Book Value Ratio | 43.44<br>(5.43)** |
| Return on Total Assets | 1.09<br>(1.76)* |
| Agency Cost | -0.19<br>(-2.15)** |
| R-squared | 0.75 |
| Mean Dependent Variable | 1.03 |
| F-statistic | (116.68)** |

Notes: The values of the coefficients are in the first row.
T statistics are in parenthesis.
Total number of observation for BVF relationship model = 240.
* Represents the significance of a variable at 10% significance level.
** Represents the significance of a variable at 5% significance level.
Source. Authors' estimate.

The values of the coefficients are in the first row. The values of the t-statistics are in the parenthesis below. The single asterisk (*) and double asterisk (**) in the equation above represent the significance of a variable at 10% and 5% level of significance respectively.

## 5. Explanation of Results

The detrimental role of majority shareholders in the developing financial market is endorsed at a 5% significance level with the value of a coefficient of the variable (Ac) as -0.19. The result suggests that majority shareholders (blockholders) deteriorate the value of a firm in the developing financial market. The blockholders are involved in under and over investment of the free cash flow in this market. The regulatory regime and judiciary also make biased decisions harming the interests of minority shareholders. The pyramidal, cross-shareholding and additional imperfections limit the role of the regulatory authority in reducing principal and agent conflicts in the developing financial market.

The result *contradicts* the *convergence of interest* hypothesis and the *foundation* of the developing financial market, which suggests that a majority and minority shareholders mix in the hybrid system, improves shareholders' value due to a better management of conflicts between both. Majority shareholders as a monitor create their own type of agency cost and do not reduce the free rider problem in the developing financial market. This leads to the *acceptance* of the *entrenchment hypothesis* ($H_1$) in the developing financial market supporting the findings of Bebchuk et al. (2004), Colombo and Stanca (2006), Tam and Tan (2007) and Young et al., (2008). The debt in this case can be used as a powerful tool to decrease the agency cost between managers and shareholders improving the value of the firm (Jensen, 1986).

The result of the next variable (the role of board size) affecting a firm's performance shows that bigger boards in the developing market add value as there are functional (healthy) conflicts among the board members (Pfeffer, 1972; Zahra and Pearce, 1989). There is a lack of free riding among the board members, reducing the agency cost in a firm. Furthermore, there are higher level of conceptual, technical and problem solving skills which improve shareholders' value in the developing market.

The third variable used in this study is the role of CEO duality in affecting the value of a firm. There is a lack of a relationship between the dual leadership structure and the value of a firm in the developing financial market.

The result relevant to the role of return on total assets (ROTA) in affecting the value of a firm shows a positive relationship between both the variables as

ROTA is statistically significant at a 10% level with the value of coefficient as 1.09. The efficiency of assets in creating returns is endorsed as these assets are utilized optimally, which resulted in value creation for shareholders in the developing market.

The result of the relationship between the price to book value ratio and firms' performance shows that correct valuation of securities improves the value of a firm at a 5% significance level with the value of coefficient as 43.44. The result shows that due to higher investor's confidence in the developing market, the shares are priced greater compared to their book value. The firm can issue new shares on higher prices which will improve the value of a firm in this market.

The result of the final control variable (market capitalization) used in the study shows that higher liquidity improves the firm's performance in the selected market. The result is consistent with corporate governance principles in the developing financial market.

The robustness tests in this study are performed to check the validity of the results relevant to the BVF relationship model. These tests include test for incremental regression and endogeneity test. The details of these tests are as follows.

**Table 3.** Results of Incremental Regression Removing Price to Book Value Ratio

| Models | Malaysia |
|---|---|
| R-squared (original) | 0.75 |
| R-squared (after the removal) | 0.06 |

### *5.1 Incremental Regression*

The incremental regression is performed to analyze the importance of individual corporate governance instruments in affecting the value of a firm. This test was performed by removing these individual instruments and analyzing the change in the value for the R squared. Among all the variables removed, the price to book value ratio has affected the explanatory power of the independent variables in explaining the change in the dependent variable to a highest degree as the value for the R squared has decreased from 75% to 6%. The result endorses the importance of investors' confidence and market efficiency as depicted in the regression results. The result is presented in Table 3.

### *5.2 Endogeneity Test*

The literature on the BVF relationship suggests that shareholders concentration (blockholders) can improve firm's performance by monitoring the firm properly. Similarly, improved value of a firm can also lead to a higher level of shareholding by investors in the financial market. This two way relationship in the literature on the BVF relationship is endogeneous which leads to the lack of robustness of the regression results (Bhagat and Jefferis, 2002).

The endogeneity in the current study is tested by following the two step process as present in the literature on the BVF relationship. In the first step, the shareholders concentration is used as a dependent variable and its relationship with all other independent variables of the study is tested, calculating the error term (residual) of the model. In the second step, the error term is used as an independent variable and its relationship with the value of a firm is tested. The result of this test shows an absence of a relationship of the residual with the firm's performance. This implies that there is a lack of a two-way relationship between the firm's value and concentrated shareholding, confirming the robustness of the regression results. The results are presented in Table 4.

### *5.3 Nature of the Relationship among the Variables*

The relationship of the variables such as the price to book value ratio, shareholders concentration and return on total assets (expressed in terms of percentage) is linear with the value of a firm which shows that these variables affect shareholders' value proportionately. On the contrary, the relationship between the dependent variable (Tobin's Q) and the independent variables (board size and market capitalization) is linear with the logarithm of these variables, but is non-linear with the individual variables. This shows that these variables do not affect the value of a firm proportionately (to an equal degree).

**Table 4.** Endogeneity Test for Developing (Malaysia) Financial Market

| Variables | Malaysian Model |
|---|---|
| Constant | -0.01<br>(-0.11) |
| Log Board Size | 0.19<br>(3.61)** |
| Log Market Capitalization | 0.03<br>(2.43)** |
| CEO Duality | 0.05<br>(1.75)* |
| Price to Book Value Ratio | 43.14<br>(5.35)** |
| Return on Total Assets | 1.10<br>(1.76)* |
| Agency Cost | -0.22<br>(-2.44)** |
| Residuals | -0.11<br>(-1.53) |
| R-squared | 0.75 |
| F-statistic | (100.34)** |

Notes: The values of the coefficients are in the first row.
T statistics are in parenthesis.
Total number of observation for BVF relationship model = 240.
* Represents the significance of a variable at 10% significance level.
** Represents the significance of a variable at 5% significance level.
Source. Authors' estimate.

## 6. Conclusion

The current paper has tested the role of majority shareholders' in affecting the firm's performance in the developing financial market (Malaysia). An *integrated model* considering all the important factors in affecting the concentrated shareholding and the value of a firm relationship has been constructed. The results of the model *support* the *entrenchment hypothesis* which suggests that blockholders play a negative role in affecting the value of a firm. The pyramidal and cross-shareholding affect the firm's performance in a negative manner as these complex forms of ownership structures reduce the level of regulatory control in the market. These modes of shareholdings should be *dismantled* so that the external regulatory regime can operate effectively to safeguard the rights of minority shareholders. The results explain *business operations* in the selected market and suggest that regulatory authorities should make required regulations to reduce the intensity of *additional imperfections* and incomplete contracting between minority and majority shareholders in the developing financial market.

The results also show that the incremental addition of board members improves the performance of a firm in the selected market. The firms in a developing market should take advantage of the bigger board size. The democratic provisions such as an efficient utilization of resources, liquid market and the correct valuation of securities *reduce* the *information asymmetry*, endorsing that these corporate governance provisions are important for firms of the developing market. The limitations of the study suggest that the relationship of blockholders and the value of a firm in the insider system of corporate governance can give us a different type of relationship between concentrated shareholding and the performance of a firm with alternate policy implications.

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