

CORPORATE CONTESTABILITY AND CORPORATE EXPROPRIATION

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Abstract

This paper presents evidence on the role of ownership in dealing with corporate expropriation of listed companies in Malaysia. From the perspective of expropriation, a single controlling shareholder is always associated with such behavior due to their power and control at the expense of minority shareholder. However, subsequent individual or coalition of large shareholders can be an important corporate governance tool by providing effective monitoring that would lessen the possibility of expropriation by the controlling shareholder. Relating to that, this study evaluates the role of controlling and large shareholders in dealing with corporate expropriation. It is found that there is a negative relationship between single controlling shareholders and dividend payout ratio indicating that firms with only controlling shareholder will pay a lower dividend due to possible expropriation through profit diversion by controlling shareholder. Using Herfindahl Index as a proxy for ownership contestability, the presence of large shareholders along with controlling shareholder has a positive relationship with dividend payout implying that increased contestability helps to curb the power of controlling shareholder to expropriate fund for their own benefit. In accordance with agency theory, the outcome suggests that large shareholders play a monitoring role in minimizing the Type II agency problem. It is also verifying the argument made based on the Catering Theory of Dividend that the presence of large shareholder brings benefit to all shareholders as they are able to reduce profit diversion by demanding for higher dividend.

Keywords: Ownership Structure, Corporate Governance, Payout Policy

JEL Classification: G32, G34, G35

1. INTRODUCTION

The issues of expropriation by controlling and large shareholders is extensively debated as observed in Pagano & Roell (1998), Bennedsen & Wolfenzon (2000), Gomes & Noveas (2001), Gutierrez & Tribo (2003); and Maury and Pajustee (2005). This phenomenon normally occurs when the party who hold a large amount of stock in the firm is also the one who have significant control of the firm. It exists when the controlling shareholders have both the ability and incentive to deflect fund for their own benefit. The form of expropriation of wealth by the controlling shareholders is one of the important manifestations of Type II agency problem.

According to Bursa Malaysia, the controlling shareholder refers to a shareholder who holds at least 33% of the outstanding shares and will have adequate controlling right on the management or to control the composition of a majority of the board of directors of such company. The largest shareholder or group of large shareholders who own a minimum of 33% will become controlling shareholder that could have a significant influence on corporate decisions. Malaysian public listed companies (PLCs) are classified as having highly concentrated ownership structure (Claessens, Djankov & Lang, 2000). In addition, they also point out that roughly 41% of Malaysian PLCs held by single large shareholders. Basically, what has been

proven by previous studies concluded that Malaysian PLCs are dominated by controlling or large shareholders in a highly concentrated ownership structure (Abdul Samad, 2002; Mohd Sehat & Abdul Rahman, 2005; Zuha et al., 2009). The presence of several large shareholders or single controlling shareholder and accompanied by other large shareholders who controlled the firm is also identified by previous studies as a multiple shareholders structure (Gutierrez & Tribo, 2003; Maury, 2004; Laeven & Levine, 2008; Attig et al., 2009; Isakov & Woisskoff., 2010 and Neves, 2014).

Although numerous studies have been conducted to examine the various issues of ownership structure, hardly any of them focused on the impact of corporate contestability and expropriation. This is quite surprising considering the fact that an ownership is a key mechanism in corporate governance structure. In firms with highly concentrated ownership structure, controlling shareholder has significant power and incentive to expropriate corporate resource (Bennedsen & Wolfenzon, 2000; Claessens, Djankov & Lang, 2000; La Porta, Lopez and Schleiffer, 1999). In this situation, the presence of several large shareholders and coalition among large shareholders can be formed which may resulted to an increase pressure to the controlling shareholders thus creating corporate contestability. Therefore, it is possible to curb the power of controlling shareholder to

expropriate. This study is motivated by the issue of ownership structure focusing on contestability between controlling and large shareholders that could have significant impact on the issue of expropriation in the firm.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Agency Theory

The original concept of agency problem was initiated by Berle & Means (1932). The authors addressed the concept of agency theory which was applied in the large corporation. It became popular among researchers during 1960's and early 1970's which address the problem of risk sharing between two parties that have different perception on risk (Eisenhardt, 1988). Agency theory has been widely used in the fields of economics, finance, marketing, political science, organization behavior and sociology.

According to Berle & Means (1932), agency theory discusses the agency relationship between principal and agent. The principal authorized the agent to represent him/her with certain pre-determined conditions. Due to differences in the perception of risk, there will be differences in action, decision making and goal of both parties. Agency theory describes two problems regarding agency relationship. Firstly, the agency problem that arises when the principal has to incur cost to monitor the agent so that the agent acts according to the requirements set forth by the principal. The second problem is related to risk sharing which occurs when the agent and the principal have difference perception of risk.

The basic form of a firm comprises of three distinct groups, namely shareholders who control the firm regarding its direction, policies and activities; board of directors who elected by shareholders and top management who are appointed by the board of director. In general agency problem is a common phenomenon in any firm when there is a separation of ownership and management. Divergence of interest between managers and shareholders forms the basis for the Type I agency theory which is usually associated with the dispersed ownership structure. The separation of ownership and control is more rampant in a firm with dispersed shareholding because the firm's shares are owned by a large number of shareholders, each with a very small percentage of shareholding. According to Jensen & Meckling (1976), potential agency problem arises because managers owned less than one hundred percent share of the firm. As a result, the shareholders will appoint a manager to manage the firm on their behalf because they themselves are not able to sit on the top management. Such situation provides an avenue for the possible expropriation of wealth by managers at the expense of shareholders (Berle & Mean, 1932).

Jensen & Meckling (1976) state that agency problem in Type I agency theory can be minimized with ownership concentration, whereby firm's shares are owned by a small number of shareholders. However, a highly concentrated ownership structure will lead to a new conflict of interest between large

shareholders and small shareholders due to expropriation of wealth by large shareholders at the expense of small shareholders. This is known as Type II agency theory. Large shareholders are only concerned with their own benefit and disregard the interest of other shareholders. According to Hu & Izumida, 2008, the effect of concentrated ownership is in term of monitoring role and the cost of expropriation by large shareholders. In a study by Pagano & Roell (1995), it is reported that large shareholder will partially internalize the benefit to pay-off their active monitoring effort.

2.2. Catering Theory of Dividend

Baker and Wurgler (2004a) is a precursor of the catering theory of dividend. There are three basic elements in this theory: First, it posits a source of uninformed investor demand for firms that pays cash dividend; second, limit on arbitrage allow this demand to affect current share price; third, manager rationally weight the short run benefits of catering to the current mispricing against the long run cost and then make the dividend payment decision. Baker and Wurgler develop a simple model with catering view of dividends that focus on empirical work in which the propensity to pay dividends depends on dividend premium or discount in stock prices. In general, the author revealed that managers at certain level would cater for investor demand. The result shows that it is aligned with what has been predicted by the catering theory's main prediction. According to this theory dividend payment decision is made when there is a demand by investors. This theory suggests that manager makes dividend payments because investors will put a premium on the firm's share price which pays dividends. Furthermore, this study conclude that firms' that do not pay dividend will begin to pay dividend when there is a high demand and will inclined not to pay dividend when there is a low demand from investor. Thus, they confirm that this catering theory of dividend is a better theory that can explain the propensity to pay dividends compared to other theories of dividends.

In light of the above, the catering dividend theory emphasizes that the dividend payment is based on demand pressure by shareholder. As such, the presence of large shareholder in the firm will monitor and pressure the controlling shareholder who controls the firm to pay higher dividend to avoid any possibility of expropriation of wealth by the controlling shareholder in the firm. In addition, the presence of more than one large shareholders and role played by them to contest for control in the firm will bring benefit to all shareholders where they can reduce profit diversion by demand for higher dividend to lessen the probability of expropriation.

Based on the previous studies, the issue in multiple large shareholders centered on misalignment of interest between the large shareholders and the minority shareholders or between the controlling shareholders and the other large shareholders (Morck et. al, 2000; Bebchuk et. al, 2000; La Porta et al. 2000; Holderness et al., 1988; Shleifer & Vishny 1997). As discussed earlier, the impact of contestability on expropriation can be divided into two broad categories: (1) Firm with controlling shareholder without large shareholder

and (2) Firm with controlling shareholders, but has large shareholder. The category of ownership structure is basically derived from Zwiebel (1995) that also considers contestability in the firm.

2.3. Firm with Single Controlling Shareholder (SCS)

The controlling shareholders are able to influence the firm policies (Bethel et al., 1998; Agrawal & Nasser, 2011) and approaches toward corporate policies are said to be different with the presence of them in the firm (Cronqvist & Fahlenbranch, 2007; Holderness et al., 1988). Effective control by controlling shareholder allow them to influence the decisions as regards to how firm are run and the way corporate policies are developed and then run through in the firms. However, firm with single controlling shareholder will have problem in terms of profit diversion (Maury & Pajustee, 2005) where their presence will lead to a lower dividend payment by the firm due to expropriation on other shareholder for its private benefit (Lacave and Urtiga, 2014; 2003; Khan, 2006). It is also supported by Harada and Nguyen (2006) that a lower dividend in firms with dominant shareholders is due to expropriation on minority shareholders by dominant shareholders. The behavior of controlling shareholders that has greater power on management to partially internalizing private benefit is for the reason to pay-off their monitoring efforts in the firm (Pagano & Roell, 1995; Maury & Pajustee, 2005; Attig et al., 2008; Agrawal & Nasser, 2011).

Firm with controlling shareholders will ensure that every decision taken by the management will benefit them. In this respect, the controlling shareholders will ensure that they are the only person who will lead the firm and no coalition of large shareholders exists (Pagano & Roell, 1998). Therefore, it can be argued that firms with only controlling shareholder will pay a lower dividend due to the possible expropriation and profit diversion. In the absence of contestability by large shareholder and with only a single controlling shareholder, the following hypothesis is developed:

H1: The presence of only controlling shareholder has a negative relationship with dividend payout.

2.4. Firm with Single Controlling Shareholder (SCS) and Large Shareholders (LS)

The role played by large shareholder is very important in order to minimize the Type II agency problem. The monitoring role played by large shareholder will ensure that the decision made by the management will benefit all shareholders. Large shareholders use their power and incentive to alleviate expropriation by controlling shareholder that benefits the other shareholders (Pagano & Roel, 1998; La Porta et al., 1999; Gomes & Noveas, 2000; Mitton, 2002; Attiq et al., 2009). Earlier studies documented that the presence of more than one large shareholder enhance the value of the firm (Pagano & Roell, 1998; Bennedsen & Wolfenzon, 2000; Maury & Pajuste, 2005; Laeven & Levine, 2008), it leads to minimize expropriation of wealth (Pagano & Roel, 1998; La Porta et al., 1999; Gomes & Noveas, 2000; Gutierrez & Tribo, 2003; Maury & Pajustee, 2005; Attig et al., 2008; Zhang, 2015) and it will

significantly reduce agency cost (Isakov & Weisskopf, 2009; Zhang, 2015).

In addition, monitoring role played by large shareholders serve as an alternative mechanism in corporate governance (Gomes & Noveas, 2000) while sharing control by large shareholders has becoming a new corporate mechanism (La Porta et al., 1999). It is due to the efficient monitoring role played by large shareholder to monitor controlling shareholders, hence reduce the probability of expropriation. It is evidenced that the presence of large shareholders affect dividend payout where the presence of large shareholders will likely resulted the firm to pay a higher dividend (Zhang, 2015; Neves, 2014).

Moreover, large shareholders will form a coalition in order to help the firm to avoid expropriation by the controlling shareholder (Pagano & Roell, 1998; Bennedsen & Wolfenzon, 2000; Gomes & Noveas, 2005; Maury & Pajuste, 2005). Therefore, the presence of large shareholder is important due to their role in ensuring that controlling shareholders will not dominate corporate decisions (Bennedsen & Wolfenzon, 2000). Eventually, the possibility of expropriation by controlling shareholder could be alleviated.

Largest shareholder mistreats their power to expropriate other shareholders (La porta et al., 2000) by reducing dividend payment to shareholder in the systems where expropriation is possible. According to Facio et al., 2001, rational shareholder who could anticipate expropriation will demand higher dividends from firms that are more inclined to expropriate them. In this regard, it seems that the presence of large shareholder will benefit all shareholders in terms of policy formulation. This is due to the monitoring role played by them in monitoring the controlling shareholder that determines the dividend policy. Therefore, the presence of large shareholder will give them more power to pressure the controlling shareholders according to catering theory of dividend.

In light of the above, firms with controlling shareholders and accompanied by large shareholders would initiate the setting of contestability, especially when there is a coalition of large shareholders to challenge the power of controlling shareholder. Thus, the large shareholders may pressure the controlling shareholder for high dividend payment from firm that is more likely to be expropriated by the controlling shareholders. Based on the above argument, the hypothesis is formed as follow:

H2: The presence of large shareholders and controlling shareholder has a positive relationship with dividend payout.

3. METHODOLOGY

3.1. Data Collection

This study covers non-financial firms listed on the Main Market (focuses on firms listed on the Main Board previously) of Bursa Malaysia. In addition, this sample excludes all finance-related companies, banks, insurance, unit trusts and utilities companies due to their differences in regulatory requirements, financial reporting standards and compliances (Trojanowski & Renneboog 2005; Yatim et al., 2006;

Cronqvist & Fahlenbrach, 2009). Moreover, companies that are listed under distressed companies (PN4 Companies) are also excluded from the sample.

The data of this study which consist of data for ownership structure are obtained from the company annual report. The website of Bursa Malaysia and OSIRIS financial database become the main source for data related to this study. The individual company annual reports are downloaded from the Bursa Malaysia website and supported by OSIRIS financial database.

3.2. Variables

3.2.1. Dependent Variable

This study intends to determine the impact of contestability in multiple shareholder structure on corporate expropriation. There are several past studies that have employed dividend payout as a measure of expropriation such as Facio et al. (2001), Thomsen (2005), Cronqvist & Fahlenbrach (2007) and Ghachem (2008). Consistent with the earlier research, this study defines corporate expropriation based on Dividend/Earnings ratio where earnings are measured on after taxes and interest but before extraordinary items.

3.2.2. Independent Variables

Controlling Shareholders

The cut-off point in determining controlling shareholders in this study is based on the definition of Bursa Malaysia Main Market Listing Requirements which states that "a person or a group of persons who are together entitled to control at least 33% of company's voting shares will be classified as the controlling shareholders of a firm".

Large Shareholders

Large shareholders in this study can be defined as a person or group of persons who owned at least 10% and greater but less than the controlling shareholders. The 10% cut off point is considered as large shareholders according to most of the previous studies related to multiple large shareholders structure i.e. Gutierrez & Tribo (2003), Maury & Pajuste (2005), Laeven et al. (2008) and Attig et al. (2009).

Corporate Contestability

Herfindahl index (HI_differences)

Herfindahl Index is the combine share of equity held by large shareholder used by several previous studies. This study also follow Maury and Pajuste (2005), Attiq et al. (2008) and Bo and Wang (2010) who used proxies for contestability power using the Hefindahl index (HI_differences).

$$HI_differences = \sum \{(Top1 - Large2)^2 + (Large2 - Large3)^2 + (Large3 - Large4)^2 + (Large4 - large5)^2\} \quad (1)$$

HI is used to capture on the distribution of shares held by investor and to describe the power held by these shareholders. According to Edwards & Hubbard (2000), the higher the value of HI, the more unequal are ownership shares and will have an

incentive to influence corporate managers. Furthermore, the higher the value of HI difference means that there is a lower contestability of the power of the controlling shareholder.

3.3. Control Variables

Firm Growth (GWT)

The firm's growth can be considered as one of the important factors that may influence corporate financial policies. As highlighted by Brailsford et al. (2002), growth is an indicator of the firm's success, thus high growth firm will be expected to pay high dividend to its shareholders due to better earnings. Therefore, it is important to control the different growth prospect of the firm. In this study, the annual percentage change in total asset is employed as a proxy for the firm growth.

Profitability (PFT)

According to Pandey (2002), firm's earning is an important determinant in dividend payout in Malaysia. In addition, Aivazian et al. (2003) find that profitability has a significant effect on dividend payout. Sulong and Mat Nor (2008) argue that dividend would be paid based on the firm's level of profitability. A number of previous study have also examined the effect of profitability on the firm's corporate financial policies i.e. Friend and Lang (1998), Brailsford et al (2002), and Sulong and Mat Nor (2009). This study employs operating income to total asset as a proxy for profitability as used by Moh'd, Perry and Rimbery (1998) and Brailsford et al (2002).

Firm Size (FS)

In this study, firm size is employed to control for size effect. It is because of the possibility that the size of the firm will affect the dividend policy. Sulong and Mat Nor (2008) argue that larger companies have better growth opportunities and access to financing opportunities, less information asymmetry due to availability of information, wider share spread and ownership profile. According to Chu (2010), ownership structure formation is affected by the size of the firm. The author argued that a large size firm with many shareholders in dispersed ownership structure was better in its risk sharing. Moreover, a large firm enjoyed economies of scale and scope, and incurred a larger scale of debt capital.

Pandey (2002) reported that firm size has a positive relationship with debt ratio in Malaysia due to the fact that large firms have lower bankruptcy risk and transaction cost. Moreover, a number of previous studies also supported a similar argument by Pandey (2002) that larger firms have lower risk of bankruptcy and higher level of debt (Friend & Lang, 1988; Agrawal & Nagarajan, 1990). In addition, Frank and Goyal (2003) point out that large firm increased its debt in order to finance dividend payment. Logarithm of corporation's total assets is employed to proxy the firm's size effect.

3.4 Model Specification

This model intends to test whether the presence contestability in firms has significant impact on corporate expropriation proxy by dividend payout made by firms. Using panel regression method, the model specifications are presented as follows:

$$DIVE_{it} = \beta_0 + \beta_1 SCS_{it} + \beta_2 GWT_{it} + \beta_3 PFT_{it} + \beta_4 LFS_{it} + \varepsilon_{it} \quad (2)$$

$$DIVE_{it} = \beta_0 + \beta_1 HI_{it} + \beta_2 GWT_{it} + \beta_3 PFT_{it} + \beta_4 LFS_{it} + \varepsilon_{it} \quad (3)$$

where:
 DIVE_{it} - Dividend Payout Ratio measured by Dividend to Earnings ratio
 β₀ - Constant term or intercept
 ε_{it} - Error term.
 SCS - Total Shareholding of Controlling Shareholder
 LFS - Total shareholding of Large Shareholder
 HI - Herfindahl Index differences as a measure of Ownership Contestability
 GWT - Annual percentage change in total asset
 PFT - Operating income to total asset
 FS - Log of firm's total asset

Model 2 is formed to identify the impact of single controlling shareholder without large shareholder while model 3 includes contestability of ownership structure with single controlling

shareholder and other large shareholder on the dividend payout ratio.

4. RESULTS AND DISCUSSION

4.1. Descriptive Statistics

The descriptive statistics for single controlling shareholder and large shareholders together with other variables are presented in Table 1 and 2.

Table 1. Descriptive Statistic (Single Controlling Shareholder)

Variables	Mean	Med.	Max.	Min.	Std. Dev.	Obs.
DIVE	0.300	0.202	1.726	0.000	0.343	107
SCS	0.497	0.522	0.754	0.010	0.176	107
GWT	0.082	0.035	1.748	-0.707	0.248	107
PFT	0.056	0.057	0.234	-0.172	0.066	107
LFS	12.752	13.078	14.743	11.154	0.803	107

Source: Authors calculations based on data from OSIRIS database.

On average, public listed companies in Malaysia have a dividend payout ratio of around 30-34 percent. The ownership of single controlling shareholders ranges from 52.5 to 75.4 percent surpassing the minimum of 33 percent level defined by Bursa Malaysia.

Table 2. Descriptive Statistic (Single Controlling and Large Shareholders)

Variables	Mean	Med.	Max.	Min.	Std. Dev.	Prob.	Obs.
DIVE	0.342	0.246	1.787	0.000	0.373	0.000	313
HI	12.081	9.434	46.628	0.000	10.887	0.000	313
GWT	0.079	0.054	2.089	-0.413	0.189	0.000	313
PFT	0.090	0.072	0.642	-0.334	0.128	0.000	313
LFS	14.018	13.897	18.298	10.826	1.596	0.000	313

Source: Authors calculations based on data from OSIRIS database.

It is also noted that the average Herfindahl Index (HI) differences is at 12.08 while the highest is recorded at 46.63. This indicates the presence of contestability by large shareholders only single controlling shareholders. Furthermore, combining firms with single controlling shareholders and large shareholders resulted to an average growth and profit at 8.2 and 5.6 percent respectively.

4.2. Regression Results

4.2.1. Single Controlling Shareholders and Expropriation

The result for regression analysis of controlling shareholders and corporate expropriation is presented in table 3. Based on the regression result, it is found that controlling shareholder is negatively and statistically significant (at 1% level) in influencing dividend payout. The result is consistent with Harada and Nguyen (2006) and Lacave and Urtiga (2014). Therefore, their presence increases the potential of corporate expropriation by controlling shareholder. All the control variables- profitability (PFT), growth of the firm (GWT) and firm size (LFS) in Model 1 are insignificant in explaining dividend

payment. In summary, the result in Model 1 provides evidence to support hypothesis H1. Therefore, the hypothesis that there is a negative relationship between the presence of only controlling shareholder and dividend payout is supported.

4.2.2. Contestability and Corporate Expropriation

On the other hand, the hypothesis that there is a positive relationship between the presence of ownership contestability and dividend payout is also accepted. The regression result in Table 3 also implies that there is a statistically positive relationship (at 5% level) between Herfindahl index and dividend payout signifying that the presence of large shareholder has an adverse effect of the contestability power of controlling shareholder. This may be associated with higher dividend which may translate into lower level corporate expropriation. This result is consistent with the arguments that the presence of large shareholders lead to minimize expropriation of wealth as observed in Pagano & Roel, 1998; La Porta et al., 1999; Gomes & Novas, 2000; Giterrez & Tribo, 2003; Maury & Pajustee, 2002 & 2005; Attig et al., 2008; Zhang, 2015. Unlike the earlier result, dividend payout is significantly

influenced by growth of the firm (GWT) and firm size (LFS) (at 1% level).

Table 3. Regression Result

Independent variable	Model 1 (Obs 107)	Model 2 (Obs 313)
	REM	FEM
Constant	0.068	-2.389
SCS	-0.250***	
HI		0.005**
PFT	0.034	-0.109
GWT	-0.033	-0.314***
LFS	0.028	0.192***
R-squared	0.018	0.730
Adjusted R-squared	-0.019	0.627
F-statistic	0.485	7.112
Hausman Test	1.169	44.121***
Durbin-Watson stat	1.292	2.951

5. CONCLUSION

The objective of this paper is to seek evidence on the relationship between ownership contestability as the independent variable and corporate expropriation proxy by dividend payout as the dependent variable. The relationships between the variables are based on the Agency Theory and Catering Theory of Dividend, where the investigation is conducted on the setting of whether the influence of different degree of ownership will have effects on corporate expropriation. The findings have provided strong evidence to support the argument that ownership contestability has influenced corporate expropriation of public listed companies in Malaysia. In accordance with agency theory, the outcome suggests that large shareholders play a monitoring role in minimizing the Type II agency problem. It is also verifying the argument made based on the Catering Theory of Dividend that the presence of large shareholder brings benefit to all shareholders as they are able to reduce profit diversion by demanding for higher dividend which eventually lessen the probability of expropriation. The outcome contributes towards a better understanding on the monitoring role of corporate ownership as corporate governance mechanism in alleviating corporate expropriation in Malaysia. Future research may consider other measurement of dividend such as dividend to cash flow ratio and dividend to sales ratio as a proxy for expropriation. In addition, Shapley Value is also recommended as an alternative measure of contestability.

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