

# Ownership Structure and Firm Value: An Insider Ownership Effect

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## Abstract

**Purpose:** This study attempts to investigate the effect of insider ownership on firm value.

**Design/methodology/approach:** A sample of 282 non-financial listed companies is used in this empirical study. The study incorporates both cross-sectional and time series data over a period of five years period. These data are combined as pooled data for analysis and modeling using the pooled OLS method. Appropriate methods and procedures are used in selecting variables and measures to offer more insights of the effect of insider ownership on firm value. Dependent variable is the firm performance, and the independent variables were three levels of insider ownership, defined as the percentage of shares owned by directors and there were four control variables; growth, firm size, block holding and leverage.

**Findings:** The results show that managerial ownership and firm value are inversely correlated. Managerial ownership ( $mo$ ) has a significant impact on firm value but a further increase of managerial ownership ( $mo^2$  and  $mo^3$ ) does not have any impact on firm value.

**Originality/value:** Arguments on the effect of managerial ownership on firm performance remains equivocal. This study has put forward for insightful information on the real implication of the increasing insider ownership on firm performance. Excessive managerial ownership does not offer any significant return on firm value.

**Keywords:** Ownership structure, Insider ownership, Firm value

## Introduction

Separation of ownership may have an adverse effect on firm value. Internal control in a company will prevent the agency problem from arising. Insider ownership includes the company's executives, officers, members of board. Hence, the conflict of interest between the shareholders and managers will reduce due to greater insider ownership.

Agency problems may arise when the goals of the principal and agent are different, especially when managers are their per or asymmetric information exists which makes it difficult for the principal to monitor the agent's actions. For example, an agency problem exists when management and stockholders have conflicting ideas on how the company should be run. This could affect the firm performance that cause it is hard to run smoothly for the operation. Demsetz and Lehn, (1985)

found that ownership and performance are endogenously determined by firm specific factors and key variables in the firms contracting environment (Himmelberg *et al.*, 1999). De Miguel (2004) examined several countries with diverse corporate governance systems and concluded that the prevailing governance system has a significant impact on the relationship between the ownership of managers and firm value.

The classic adverse-selection model of predicts that asymmetric information between informed managers and the public market causes underinvestment (Myers and Majluf, 1984). Jensen and Meckling, 1976) argued that there is a positive relation between inside equity holdings and firm value. They propose that inside holdings serve to align managers' interests with those of the stockholders, thus reducing agency costs. Conversely, other studies suggest that higher levels managerial holdings result in additional agency costs such as argued a negative relationship between the level of owner-managers' ownership and firm value (Fama and Jensen, 1983). As managerial holdings increase, managers have greater incentives to entrench or to avoid risk in their investment choices (Cary, 1969 ; Parrino *et al.*, 2005 ). Ownership structure is an incentive device for reducing the agency costs associated with the separation of ownership and management, which can be used to protect property rights of the firm (Barbosa and Louri, 2002).

## **Literature Review**

### ***Managerial Ownership***

A vibrant strand of this literature concerns the relationship between managerial ownership levels, the direct investment decisions made by management and the inherent value of the firm, as proxies by Tobin's Q ratio (Jensen and Meckling, 1976). Corporate value increases when the managerial ownership decreases (McConnell and Servaes, 1990). Coles *et al.*, (2003) find that there is no correlation between profitability and ownership concentration. Sun *et al.*, (2002) found that state ownership and firm performance was positively related, irrespective of the type of state ownership.

### ***Board Structure***

There are the issues surrounding how board structure and board turnover influenced firm performance. The key characteristics are the total board size, the ratio from inside to outside directors and also the rate of turnover of director (Furtado and Karan, 1990). Vance (1964), reports a positive correlation between proportions of inside directors and a number of performance measures. The studies mostly small and non-listed companies in Turkey and finds that separation of chairman and general manager positions has significant positive impact on firm performance. Board structure does not have a significant impact on performance (Kula, 2005; Selekler-Goksen and Karatas, 2008).

### ***Ownership Concentration***

The number of large-block owners and the total percentage of the company's shares that they own define as ownership concentration. Large-block shareholders are investors who typically own at least five percent (5%) of the company's shares. The positive effect of ownership concentration can be explained by the efficient monitoring hypothesis, which contends that higher concentration of ownership gives large shareholders stronger incentives and greater power at lower cost to

monitor management. Grossman and Hart, (1986) argued that shareholders with a large stake in the company show more willingness to play an active role in corporate decisions because they partially internalize the benefits from their monitoring effort.

Conceptually, concentrated ownership may improve performance by increasing monitoring and alleviating the free-rider problem in takeovers (Shleifer and Vishny, 1986). Concentrated ownership gives them both more powerful incentives to become involved in governance, as well as a means to influence managers by means of direct access strategies and the threat of using their concentrated voting rights (Yeh *et al.*, 2006)

### **Issues**

Literature argues changes in insider ownership tend to affect firm value but the results do seem to be conclusive (Wu and Chen, 2006). demonstrated that changes in share ownership by insiders can affect firm value. McConnell *et al.*, (2006) argues there could be a curvilinear relationship between insider ownership and firm performance, in which it has been observed that ownership level below 14% would give a positive impact on firm value, whereas, ownership level above 40% would create a negative impact on firm value. Findings on the curvilinear relationship were put forward by discussed rigourously by found a negative relationship between insider ownership and performance, and supported by (Bhabra, 2007; Short and Keasey, 1999; Demsetz, 1983).

Different views and theories relating to the insider ownership and firm value have motivated many researchers to conduct further testing on different populations and contexts. In view of this, an empirical investigation will be of great input for many researchers and practitioners to gain a clear understanding of the effect of insider ownership (i.e. managerial ownership) on firm value among the Malaysian corporations. This paper focuses on how increasing managerial ownership affects firm financial performance. Different impacts on the ownership structure will result in different levels of firm value maximization.

### **Objective of the Study**

The objective of the study is to investigate the relationship between managerial ownership and firm performance. Specifically, this study also examines the effect of the fraction of share owned by manager on firm performance.

### **Research Methodology**

This study used the secondary data that were mainly taken from financial databases and annual reports over the period 2004-2008. A sample of 282 non-financial listed companies was considered and these companies were among the largest companies based on market capitalization. Pooled data analysis was adopted as the data comprised of both time series and cross-sections.

### **Variables Measurements**

Dependent variable is the firm performance, and the independent variables were three levels of insider ownership, defined as the percentage of shares owned by directors and there were four control variables; growth, firm size, block holding and leverage.

Due to curvilinear effect that exists between insider ownership and firm value, further modification required on the model used for testing the effect of managerial ownership (insider ownership) on

firm value. Hence, to incorporate the square and cube of insider ownership as regressors together with the original ownership. This permits the model to endogenously determine the effect of managerial ownership<sup>24</sup>. Hence, the model can be derived as follows;

$$\text{Firm value} = \alpha + \beta_{mo} + \beta_{mo2} + \beta_{mo3} + \beta_{\text{control variables}} (1)$$

- Firm value = Tobin's Q
- (mo)<sup>1</sup> = % of share own by director
- (mo)<sup>2</sup> = square % of share own by director
- (mo)<sup>3</sup> = cube % of share own by director
- control variables: growth, firm size, block holding and leverage

#### Formulae:

Tobin's Q = (MVE + PS + DEBT)/TA, MVE is the market value of equity, PS is preferred stock, DEBT is the value of short-term liabilities net of short-term assets plus the book value of long-term debt, and TA is the book value of total assets. Growth = (Current Year Sales – Previous Year Sales)/Previous Year Sales, firm size = Log of assets, Block Holding = (above 5% held by the shareholders)/number of outstanding shares, Leverage = Total Debt/Total Asset

#### Analysis and Discussions

Table 1 below presents bivariate correlation coefficients among all the variables. There is a significant negative correlation between managerial ownership (mo) and firm value (-0.057) at 0.05. Firm size and leverage are inversely correlated with firm value (-0.315 and -0.086 respectively). As expected, strong correlations are found among mo, mo2 and mo3.

Table 1: Correlation Results

Variables	Mean	1	2	3	4	5	6	7	8
1.Tobin's Q	1.935	1	-0.057*	-0.043	-0.020	-0.315**	-0.086**	0.060*	-0.008
2.MO	8.746		1	0.694* *	0.0281* *	-0.217**	-0.078**	0.003	0.000
3.MO <sup>2</sup>	175.303			1	0.874**	-0.115**	-0.032	0.052*	0.004
4.MO <sup>3</sup>	4676				1	-0.046	0.000	0.022	0.002
5.Firmsize	8.725					1	0.209**	0.049	-0.014

<b>6.Leverage</b>	0.259		1	-0102**	-0.039
<b>7.Blockholdings</b>	0.516			1	-0.002
<b>7.Growth</b>	1.106				1

\*significance level at 0.05, \*\*significance level at 0.01

Table. 2. Pooled Data Regression Results

Variable	Coefficient	Std. Error	t-Statistic
MO	-0.0683	0.0234	<b>-2.9206**</b>
MO2	0.0019	0.0012	1.6278
MO3	0.0000	0.0000	-1.5995
Growth	-0.0046	0.0078	-0.5841
Firm size	-1.3690	0.1024	-13.375**
Block holdings	0.5545	0.2044	2.7131**
Leverage	-0.2759	0.2552	-1.0811
Constant	14.0529	0.9127	15.397**
R-squared	13%		
F-statistic	29.429**		

Dependent variable: Tobin's Q, \*sig at 0.05, \*\*sig at 0.01.

Table 2 presents regression output in which managerial ownership(mo) has a significant impact on firm value at 0.01. However, there is no evidence to support the effect of increasing managerial ownership (mo2 and mo3) on firm value. Hence, the model can be written as follows;

$$Firm\ value = 14.053 - 0.068MO - 0.002MO2 + 0.0000MO3 - 0.005GROWTH - 1.369FIRMSIZE + 0.555BLOCK\ HOLDING - 0.276LEVERAGE$$

The normal plot of regression standardized residuals for the dependent variables indicates a relatively normal distribution (Figure 1). There is also no clear correlation between the residuals and the predicted values, consistent with assumptions of linearity (Figure 2).

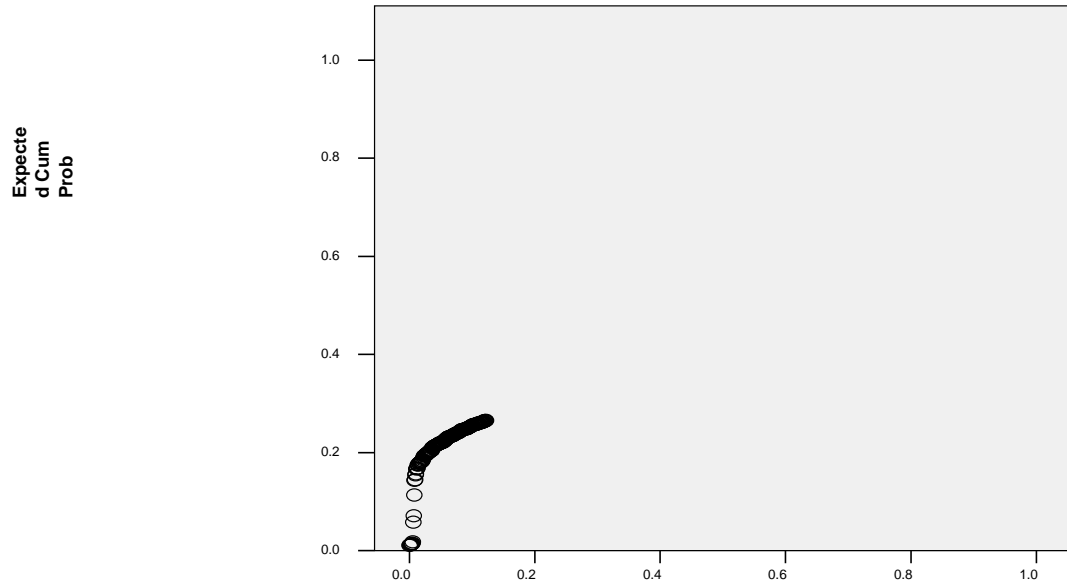


Figure 1: Normal P-P Plot of Regression Standardized Residual  
**Scatterplot**

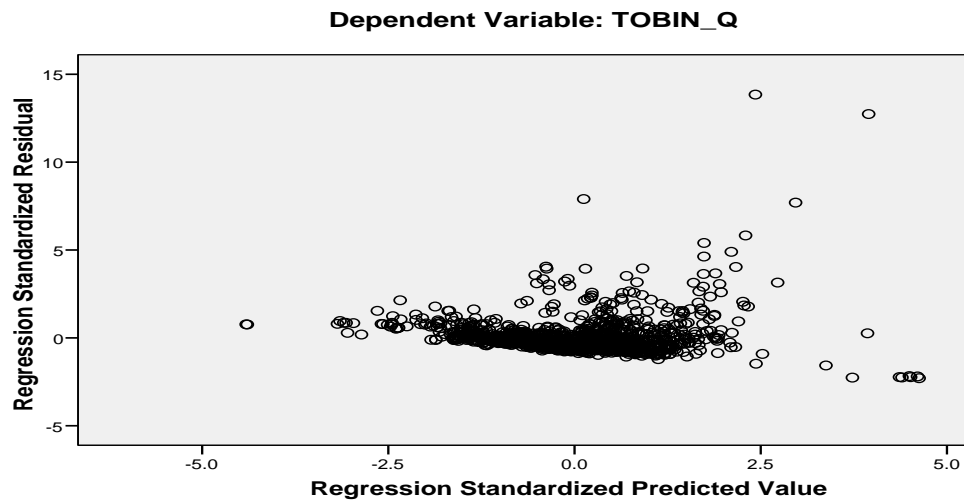


Figure 2: Scatter Plot of Regression Standardized Residual

**Implications of the Study**

Higher levels of insider ownership and ownership concentration may not always reflect greater incentives to maximize value and monitor managers, but may be associated with greater managerial entrenchment. Beside, managerial entrenchment effects associated with practical control may take place at lower levels of ownership.

One of the costliest manifestations of the agency problem is managerial entrenchment.

Managers, who place a great value on control but own only a small equity stake, work to ensure their own job security thereby entrenching themselves and staying on in that position even if no longer competent or qualified to run the firm. As insider ownership increases, agency costs may be reduced since managers bear a larger share of these costs. However, managers holding a substantial portion of a firm's equity may have enough voting power to ensure that their position inside the company is secure. As a result, they may become to a great extent insulated from external disciplining forces such as the takeover threat or the managerial labor market.

Furthermore, the restriction in Malaysia is more transparent compare with other foreign firm. Therefore, even the manager hold larger amount of share but they are not directly to affect the firm value. Although the executive remuneration is an important factor which will influence the company performance, but the executive remuneration in Malaysia is not significant, so the high remuneration for director will not affect the firm performance.

### **Limitations**

Lack of transparency in the annual reports could affect the quality of input. Different companies tend to adopt different accounting policies and accounting periods and hence, interpretations may differ. Though all companies selected were from non-financial sector, however, there were many industries involved and thus homogeneous characteristics of the sample might not be consistent.

The proposed model and hypotheses of this study are rigorously tested with market capitalization analysis, descriptive statistics, panel unit root test, cook's distance outliers test, pooled OLS, random effect, and fixed Effect techniques.

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