Institutional Investors & Corporate Governance: International Evidence

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FOREIGN INSTITUTIONAL INVESTORS ("FPI")

• Perception:
  - Foreign Direct Investment (FDI): take control of the company in which investment is made … long term and less fluctuating?
  - Foreign Portfolio Investment (FPI): minority investment in shares, etc. … speculative and unpredictable?

• Focus of my work: micro (not macro, as in balance of payments, etc.)
  - International evidence that FPI reduces cost of capital and it can play a value-increasing governance/monitoring role
OWNERSHIP STRUCTURE IN INDIA

Average Share Ownership
(100 largest listed companies, end-of-2016)

GOVERNANCE ISSUES:

Corporation [31%]: Foreign MNC is controller
- RPTs and royalty payments (vs. dividends)
- Control & squeeze out

Government [20%]: Controller is Indian State
- RPTs and Weak governance protections
- Executive turnover associated with government change

Individual/Family [9%]: Family conglomerates
- RPTs and family control & strength
- Family disputes: Loss of strategic focus

Institutional [19%]

Source: FactSet, OECD calculations - see methodology for details.
(FOREIGN) INSTITUTIONAL INVESTORS IN INDIA

Figure 20. Institutional investors, domestic versus foreign, as of end 2016

Source: FactSet, OECD calculations. See methodology for details.
THE INCREASING ROLE OF INSTITUTIONAL OWNERSHIP (IN ADVANCED ECONOMIES)

Institutional Investor Holdings = $28 Trillion in Public Equities [2011]

Source: OECD Institutional Investors Database, SWF Institute, IMF, Preqin, BlackRock, McKinsey Global Institute

Source: Deutsche Bank Research “Shareholder Activism: Battle for the Boardroom” [2014]
THE GOVERNANCE ROLE OF (FOREIGN) INSTITUTIONAL INVESTORS: THE THEORY

• In widely-held firms, investors may be disengaged and not push for shareholder value. Given the size of their holdings as a group, institutional owners can impact corporate governance:
  - through “voice” (voting their shares, using quiet diplomacy in persuading management, via confrontational proxy fights)
  - and/or by threatening to “exit” (selling and depressing stock prices)

• Special role played by foreign institutions (Foreign IO) since domestic institutions (Domestic IO) are more prone to be loyal to management due to “business ties” and other conflicts of interest
# The Governance Role of (Foreign) Institutional Investors: International Evidence

<table>
<thead>
<tr>
<th><strong>Performance</strong></th>
<th><strong>Governance</strong></th>
<th><strong>Long-Term</strong></th>
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## M&As

| P2: “Shareholders at the Gate? ...”<br> RFS (2010) |

## CEO Pay


## India?

| Implications for India |
DATA:

Novel dataset (FactSet/LionShares) of equity holdings: 27 countries, >5,000 institutions, >35,000 stocks, Period: 2000-05

- $ 18 trillion [Dec-2005]
  - 38.5% of world market cap
  - 49.9% of market float

Non-US firms (US$ 5.2 trillion): 3 investor groups with equal “pocket sizes” … by country of institution (rows) and stock (columns)

RESULT #1:

Different Investor Preferences by US-BASED vs NON-US Foreign vs DOMESTIC Investors

- Firm-level characteristics:
  - Insf preferences (Gomperst&Metricsh(01)):  “Prudent-man” Rules (Del Guercio(96)):
    - Firm Size (SIZE)
    - Past Return (RET)
    - “Value” Stocks (BM)
    - Turnover (TURN)
    - “Investment Opportunities” (INVOP)
  - Governance Indicators (Gillard&Starks(04)):
    - Leverage (LEV)
    - Free-Cash-Flow (FCF)
    - Close-to-Hold Shares
    - US Governance Rating
    - Foreign Sales
  - Investor Protection (LLSV(97)):
    - Legal = ANTI*RULE (LEGAL)
    - Disclosure quality (DISC)
  - Distance/Familiarity (Chan et al.(05)):
    - Geographical distance (DISTANCE)
    - English language (ENGLISH)
  - Size & Development of Market:
    - GDP per capita (GDP)
    - Stock Market Cap (MCAP)

- Country-level factors:
  - US$2 trillion from U.S.-BASED Foreign institutions
  - US$1.7 trillion from NON-U.S. Foreign institutions
  - US$1.5 trillion from DOMESTIC institutions

RESULT #2:

Firms with higher foreign institutional ownership (Foreign IO) have
  - Higher valuations (Tobin Q)
  - Higher operating performance (ROA, Net Profit Margins, less CAPEX)
  - Takeaway: Performance increases due to increased shareholder pressure to perform

INTERPRETATION:

Better performance suggest investors MONITORING (rather than just high stock prices due to OVERVALUATION)

TAKEAWAY:

Performance increases due to increased shareholder pressure to perform
DATA:
Institutional holdings: FactSet/LionShares
M&A Data: SDC (2000-05, completed, >50%)

Cross-border flows at peak levels (“Multipolar world!”):
- 1999:
-2009:

RESULT #1 & #2:
1) Country-level: Institutional Investors Increase % of Cross-Border M&A deals

2) Country-pair level: Pairwise Cross-Border Flows Increase % of Cross-Border M&A deals

\[ \text{CROSS}\_\text{BORDER}(i,j) = \# \text{ of deals target country } i, \text{ bidder from } j \]

\[ \text{IO}(i,j) = \% \text{ of country } i's \text{ Market Cap held by institutions from } j \]

TAKEAWAY:
Increased likelihood of cross-border takeovers

RESULT #3:
2) Deal-level:
Prob(Deal is Cross-Border) ↑ with Foreign IO
Prob(Deal Success) ↑ with Foreign IO
Prob(Full Shares Acquired) ↑ with Foreign IO
Combined (Announcement Return)CAR ↑ with Foreign IO

INTERPRETATION:
International institutional investors = shareholders at the “gates” that act as Trojan horses facilitating changes of control!
Institutional holdings: FactSet/LionShares

ISS/RiskMetrics (2004-08): Governance Index (GOV$_{41}$): % of attributes that a firm satisfies, using minimally acceptable guidelines set by ISS. Board (24); Audit (3); Anti-takeover provisions (6); Compensation and ownership (8).

**RESULTS ON GOVERNANCE INDEX (GOV$_{41}$):**

Outside the U.S., Foreign IO drive governance improvements

Changes in institutional ownership over time drive changes in governance (but not the opposite)

[Endogeneity: IV using MSCI dummy as instrument]

**REAL OUTCOMES (NOT JUST “COMESTIC CHANGES”!):**

Governance indexes criticized (“check-the-box”, not good predictors of fraud, etc.)

- Higher CEO turnover-performance sensitivity in firms with higher institutional ownership
- Firm valuation goes up after institutional ownership increases (not the reverse)

**INTERPRETATION:**

International institutional investors lead to convergence in corporate governance practices worldwide

**TAKEAWAY:**

Adoption of more shareholder-centric (US-style) practices
Institutional holdings: FactSet/LionShares
US firms: S&P’s ExecuComp
Non-US firms: BoardEx [CEO pay + bios, boards] + Company Filings [annual reports, proxy statements, 20F forms …]
14 countries with mandated individual-level compensation disclosure
final sample = 3,263 CEOs

DATA:

RESULT #1:
Predicted Level & Structure of CEO Pay ($1 billion sales)

b) Control for sales, industry

RESULT #2:
Pay Gap smaller for Non-US firms with:
- Foreign investors (Foreign IO, MSCI, ADR)
- Foreign sales
- Foreign (US) acquisitions
- Board members with foreign (US) experience

INTERPRETATION:
Convergence towards US (incentive-based) pay among Non-US firms that are more "Internationalized" …almost "Law of One Price"?

TAKEAWAY:
Convergence to international (US) executive compensation practices
MY OP-ED:

Forbes

11/3/2013 11:25 AM | 145 views

Do CEOs Make Much More In The U.S. Than Elsewhere?

This article is by Pedro Matos, an associate professor of business administration at the University of Virginia’s Darden School of Business.

There has been a good deal of press coverage of the numbers of errors in the paychecks of American chief executives. Many people, especially workers who have faced stagnant or lower wages in a tough economy, believe U.S. CEOs make too much. This perception is usually supported with estimates by firms like Towers Watson, which conduct surveys showing that CEOs in the U.S. earn much more than their counterparts abroad. But is it true?

The difficulty in answering this question has come from a lack of good data on executive compensation across countries. But thanks to recently expanded disclosure rules, my co-authors and I were able to analyze data from more than 5,000 businesses across the U.S. and 13 other countries (mostly in Europe). In a recent paper, we showed that the conventional wisdom that U.S. CEO pay is out of sync with the rest of the world is inaccurate or, at least, outdated.

ONE TYPE OF COVERAGE:

The Myth of the Overpaid American CEO

John Carney | dcarney
Published 3:51 PM ET Tue, 9 July 2013 | Updated 3:51 PM ET Tue, 9 July 2013

The fact is that U.S. companies are more likely to be owned by institutional owners and to have independent boards. These features of the American corporate ownership are closely linked to a larger fraction of compensation being paid in stock, for the very good reason that diversified institutional shareholders are interested in a rising stock market and want to provide incentives for stocks across the board to rise. Concentrated ownership—by families, by the government, by banks—is far more common outside the U.S. and apparently has an effect on how CEOs are paid.

Pedro Matos, an associate professor of business administration at the University of Virginia’s Darden School of Business, was one of the authors of that study.

"In other words, the world is flat for CEOs, or nearly so," Matos wrote in Forbes earlier this year.

ANOTHER TYPE OF COVERAGE:

How to get paid like a U.S. CEO

July 5, 2013 10:07 AM ET

While millions are still out of work, U.S. CEOs received a 28% pay raise this past year. A lot of factors are driving the increases. Job performance isn’t one of them.

By Eleanor Holmbeck, contributor

FORTUNE - Did you get a decent raise last year? How about the last couple years? Time to change jobs, tie in some performance or signal your petpee?

If you were a CEO of an S&P 500 company last year and your pay only went up 28%, then sorry, but just save your arts don’t bother you.

So with millions out of work, how do U.S. CEOs keep that pay rising in good times and bad? The short answer is no easy of support and a few well distinctions. Here’s how it’s done.
**MOTIVATION:**

**Foreign Institutional Investors:**

“We support those companies, who act in interest of their future and in the interest of their employees against irresponsible *locust swarms*, who measure success in quarterly intervals, suck off substance and let companies die once they have eaten them away.”

Franz Müntefering, German SPD Chairman (2005)

**Long-term Institutional Investors:**

“The effects of the *short-termist phenomenon* are troubling (...) In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while *underinvesting in innovation, skilled workforces or essential CAPEX necessary to sustain long-term growth*.”

Laurence Fink, CEO, BlackRock (2015)
RESULT #2:

First stage: MSCI addition $\Rightarrow$ +3% in Foreign IO

Second stage: +3% in Foreign IO is positively associated with ...  
+0.3% long-term investment (CAPEX + R&D)  
+12% employment  
+11% innovation output (Patent counts)  
IV and Diff-in-diff (additions) MSCI index suggest causal effect  

Foreign IO positively linked to productivity and shareholder value  

INTERPRETATION:  

Common fear that foreign portfolio flows are “hot money” seeking short-term gains, with no concern for the long-term prospects of local firms … evidence above runs counter to these concerns: foreign institutional investors are NOT "locusts". Evidence in support of monitoring role of Foreign IO.  

TAKEAWAY:  

Can sustain long-term investing
TO RECAP ...

• Globalization of firm’s shareholder base can be a positive force!

• Rise of Foreign Institutional Ownership on average leads to:
  - Performance: Increased shareholder pressure to perform
  - M&As: Increased likelihood of cross-border takeovers
  - Governance: Adoption of more shareholder-centric (US-style) practices
  - CEO Pay: Convergence to international (US) executive compensation practices
  - LT Investing: Can sustain long-term investing
India underperforms. Key areas of concern: audit committee composition, auditor report concerns, related party transactions, poor board attendance.

"Worst in Class" Significant Governance Risks (Score below 3.0)

"Best in Class" Minimal Governance Risks (Score above 8.0)
BACK TO INDIA (2)

• CEO PAY

“International Corporate Governance Spillovers …”, with R. Albuquerque, M. Ferreira and L. Marques (revise & resubmit)

Bloomberg
BACK TO INDIA (3)

• LONG-TERM INVESTING
CONCLUSIONS

• Policy-making should be evidence-based! Support academic research on the Indian market!

“It is a capital mistake to theorize before one has data. Insensibility one begins to twist facts to suit theories, instead of theories to suit facts.”

The Adventures of Sherlock Holmes

“A Scandal in Bohemia”

• I look forward myself to learn more at ACGA in the next couple of days!
WEBLINKS TO PUBLICATIONS


Thank you!