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, “hot money” and unpredictable?

• Focus of my work: micro (not macro, as in balance of payments)
  - International evidence that FPI reduces firms’ 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)

Corporate Parent / MNC
- RPTs and royalty payments (vs. dividends)
- Control & squeeze out

Indian State
- RPTs and weak governance protections
- Executive turnover with government change

Family/Founder
- RPTs and family control & strength
- Family disputes: loss of strategic focus

Institutional [19%]
Source: MSCI Corporate Governance in India (Feb 2017)

Governance Issues:

Source: Table 4 - OECD Equity Markets Review ASIA 2017
(based on data from FactSet Ownership)
(FOREIGN) INSTITUTIONAL INVESTORS IN INDIA

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

Source: Table 4 - OECD Equity Markets Review ASIA 2017 (based on data from FactSet Ownership)
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

Analysis of the level and change in institutional ownership highlights areas of relative opportunity

Level and change in institutional ownership by country (weighted by market cap): higher levels of institutional are more attractive for activists as it implies a dispersed shareholder base as opposed to a concentrated base with a higher level of insider ownership.

Emerging activist markets: low but fast-growing institutional ownership

High activist activity: high levels of institutional ownership

Growing scope for activism: medium and growing institutional ownership

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. 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>Performance</th>
<th>Governance</th>
<th>Long-Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>M&amp;As</td>
<td>CEO Pay</td>
<td>India?</td>
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<td>P2: “Shareholders at the Gate? ...”</td>
<td>P4: “Are US CEOs Paid More? ...”</td>
<td>Implications for India</td>
</tr>
</tbody>
</table>
**P1: THE COLORS OF INVESTORS’ MONEY: THE ROLE OF INSTITUTIONAL INVESTORS AROUND THE WORLD**

**DATA:**
Institutional holdings:
FactSet/LionShares [>5,000 institutions, >35,000 stocks, 27 countries 2005: $18 trln, 39% of world market cap]

… 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:**
  - Instl preferences (Gompers&Meterick(01));
  - “Value” Stocks (BM);
  - Turnover (TURN);
  - Dividends (DY);
  - Volatility (SIGMA);
  - MSCI Members (MSCI);
  - Investment Opportunities (INVOP);
  - “Prudent-man” Rules (Del Guercio(96));
  - Leverage (LEV);
  - Free-Cash-Flow (CASH);
  - ADR Listing (ADR);
  - ns of Analysts

- **Governance Indicators** (Gillan&Starks(04));
  - Visibility:
    - 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)

**RESULT #2:**
Firms with higher Foreign IO have
- Higher valuation (Tobin Q)
- Higher ROA
[Note: IV results using MSCI]

**INTERPRETATION:**
Better performance suggest investor **MONITORING** (rather than just **OVERVALUATION**)

**TAKEAWAY:**
Performance increases due to increased shareholder pressure

A US$2 trillion from **US-BASED** Foreign institutions
B1 US$1.7 trillion from **NON-US Foreign** institutions
B2 US$1.5 trillion from **DOMESTIC** institutions
P2: SHAREHOLDERS AT THE GATE? INSTITUTIONAL INVESTORS AND CROSS-BORDER MERGERS AND ACQUISITIONS

DATA:
M&As: SDC (2000-05)
Institutional holdings: FactSet
... cross-border flows

1999:

2009:

RESULTS #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

RESULT #3:
3) Deal-level:
   Foreign IO
   => Prob(Deal is cross-border) ↑
   => Prob(Deal success) ↑
   => Combined deal return ↑

INTERPRETATION:
Foreign IO = shareholders at the “gates” that act as Trojan horses facilitating changes of control!

TAKEAWAY:
Increased likelihood of cross-border takeovers
P3: DOES GOVERNANCE TRAVEL AROUND THE WORLD? EVIDENCE FROM INSTITUTIONAL INVESTORS

DATA:
Institutional holdings: FactSet
Governance Index (GOV\textsubscript{41}): Institutional Shareholder Services (ISS) (2004-08) … % of attributes that a firm satisfies: Board (24); Audit (3); Anti-takeover provisions (6); Compensation & ownership (8)

RESULTS:
Foreign IO drives governance improvements
Changes in IO over time drive changes in governance
[Endogeneity: IV using MSCI]

REAL OUTCOMES (NOT COSMETICS!):
Governance indexes criticized (“check-the-box”, etc.) but evidence that IO affects outcomes – ex: higher CEO turnover-performance sensitivity

INTERPRETATION:
International institutional investors lead to convergence in corporate governance worldwide

TAKEAWAY:
Adopt more shareholder-centric (US-style) practices
P4: ARE US CEOS PAID MORE? NEW INTERNATIONAL EVIDENCE

DATA:
Institutional holdings: FactSet
US: S&P’s ExecuComp
Non-US: BoardEx + filings
[2006, 14 countries with mandated disclosure]

RESULT #1:
Predicted level & structure of CEO pay
($1 billion sales, average industry)

Pay Gap smaller if:
- Foreign IO (MSCI, ADR)
- Foreign sales
- Foreign acquisitions
- Board members with foreign (US) experience

RESULT #2:
TAKEAWAY:
International convergence in executive pay practices

INTERPRETATION:
“Law of One Price”?

US Pay Premium ≈ 79%
US Pay Premium ≈ 26%
SOME PRESS COVERAGE ...

MY OP-ED:

Forbes

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 Vermont’s Darden School of Business.

ONE TYPE OF COVERAGE:

CNBC

The Myth of the Overpaid American CEO

John Carney | @carney

Published 3:31 PM ET Tue, 9 July 2013 | Updated 3:51 PM ET Tue, 9 July 2013

OR OPPOSITE?

The Atlantic

U.S. Corporate Executives Aren’t the Only Ones Making Tons of Money

CEO pay has been skyrocketing on both sides of the Atlantic. Now, a flurry of policies in the EU aims to put the massive earnings in check.

FORTUNE

How to get paid like a U.S. CEO

July 5, 2011: 10:57 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.
“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)

“The effects of the short-termist phenomenon are troubling (...) 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)

**P5: ARE FOREIGN INVESTORS LOCUSTS? THE LONG-TERM EFFECTS OF FOREIGN INSTITUTIONAL OWNERSHIP**

**DATA:**

- Physical Capital (CAPEX)
- Intangible Capital (R&D)
- Innovation Output (Patents)

Coloring by geographical region:
- Other
- Asia-Pacific
- Europe
- North America

**RESULTS:**

MSCI addition => +3% Foreign IO … positively associated with:
- +0.3% long-term investment (CAPEX + R&D)
- +12% employment
- +11% innovation output (Patent counts)

[MSCI index suggest causal effect]

Foreign IO positively linked to productivity + shareholder value

**INTERPRETATION:**

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 a firm’s shareholder base can be a positive force!
  Rise of Foreign Institutional Ownership (Foreign IO) 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

- Back to “theory” …
  - **Voice** (Long-term Foreign IO)
  - **Exit** (Short-term Foreign IO)
IMPLICATIONS FOR INDIA

• CORPORATE GOVERNANCE

MSCI

India underperforms. Key areas of concern: audit committee composition, auditor report concerns, related party transactions, poor board attendance.
IMPLICATIONS FOR INDIA (2)

- CEO PAY

“INTERNATIONAL CORPORATE GOVERNANCE SPILLOVERS …”, WITH R. ALBUQUERQUE, M. FERREIRA AND L. MARQUES (REVISE & RESUBMIT)
IMPLICATIONS FOR 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. Insensibily 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 to learn more at ACGA in the next couple of days!
WEBLINKS TO PUBLICATIONS


Thank you!
Table 3-4: Shareholding pattern at the end of March 2016 for the companies listed at NSE

<table>
<thead>
<tr>
<th>Sectors</th>
<th>PROMOTERS</th>
<th></th>
<th>PUBLIC</th>
<th>NON-INSTITUTIONAL</th>
<th>Central Government/State Government</th>
<th>Shares held by Custodians and against which Depository Receipts have been issued</th>
<th>Shares held by Employee Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Indian Promoters</td>
<td>Foreign Promoters</td>
<td>Financial Institutions/ Banks/Insurance Companies</td>
<td>Foreign Institutional Investors</td>
<td>Mutual Funds</td>
<td>Venture Capital Funds including Foreign Venture Capital Funds</td>
<td>Any other</td>
</tr>
<tr>
<td>Banks</td>
<td>46.0%</td>
<td>0.3%</td>
<td>10.9%</td>
<td>16.7%</td>
<td>5.8%</td>
<td>0.0%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Engineering</td>
<td>52.0%</td>
<td>2.2%</td>
<td>9.7%</td>
<td>3.6%</td>
<td>1.1%</td>
<td>0.1%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>43.1%</td>
<td>1.1%</td>
<td>3.7%</td>
<td>19.7%</td>
<td>3.1%</td>
<td>0.0%</td>
<td>4.9%</td>
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<tr>
<td>FMCG</td>
<td>33.7%</td>
<td>9.0%</td>
<td>10.4%</td>
<td>10.5%</td>
<td>2.0%</td>
<td>0.0%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>49.7%</td>
<td>2.6%</td>
<td>5.7%</td>
<td>11.3%</td>
<td>3.6%</td>
<td>0.0%</td>
<td>1.9%</td>
</tr>
<tr>
<td>IT</td>
<td>36.9%</td>
<td>6.7%</td>
<td>3.9%</td>
<td>13.5%</td>
<td>2.7%</td>
<td>0.6%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>52.2%</td>
<td>6.4%</td>
<td>5.7%</td>
<td>8.4%</td>
<td>2.6%</td>
<td>0.3%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Media and Entertainment</td>
<td>39.2%</td>
<td>2.8%</td>
<td>0.1%</td>
<td>8.7%</td>
<td>2.5%</td>
<td>0.0%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>21.0%</td>
<td>0.0%</td>
<td>1.8%</td>
<td>0.9%</td>
<td>0.2%</td>
<td>0.0%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Petrochemicals</td>
<td>57.9%</td>
<td>-4.2%</td>
<td>6.3%</td>
<td>5.1%</td>
<td>2.4%</td>
<td>0.0%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>50.5%</td>
<td>3.3%</td>
<td>2.7%</td>
<td>13.1%</td>
<td>3.3%</td>
<td>0.0%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Services</td>
<td>52.8%</td>
<td>4.2%</td>
<td>4.0%</td>
<td>5.0%</td>
<td>3.8%</td>
<td>1.0%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>48.8%</td>
<td>5.9%</td>
<td>9.1%</td>
<td>13.0%</td>
<td>1.3%</td>
<td>0.0%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Grand Total</td>
<td>43.1%</td>
<td>3.9%</td>
<td>5.8%</td>
<td>8.9%</td>
<td>2.5%</td>
<td>0.1%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

Source: NSE Factbook 2016