CHAPTER – 2

THE THEORETICAL FOUNDATION OF THE STUDY

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Every empirical research must be routed to a strong theoretical foundation. This empirical investigation is not an exception of this view. Here in this chapter we will present a detail description on the theoretical foundation of our research. Specifically, in this chapter we will discuss the various existing theories of capital structure, the concepts of agency crisis and the theoretical aspects of ownership structure. The chapter also provides a brief description on the conceptual aspects of financial performance.

2.1. Capital Structure Theories

Capital structure theories represent varied views and perception towards capital structure and especially its association with the profitability and market valuation of a firm. A detail discussion on the various approaches or theories pertaining to capital structure would help us to understand the significance of capital structure, the basis of its determination and to build a concrete perception on whether and to what extent capital structure matters in a business firm.

I. Net Income (NI) Approach

Although the concept and theory of capital structure started receiving much research attention after Modigliani and Miller's (1958) work which viewed capital structure to be irrelevant to firms' overall cost of capital and market valuation but it was Durand (1952) who first gave a formal capital structure theory and viewed capital structure to be relevant to firm' value and overall cost of capital. According to Durand (1952), the value of firm would be highest with lowest weighted average cost of capital when the proportion of debt in the capital structure reaches its maximum level. This approach to interlink capital structure with firms' value is known as net income approach. According to this approach, any alteration in the ratio of debt and equity in the capital structure would lead to a consequent and corresponding change in the overall cost of capital as well as the market valuation of firms. Therefore, a business firm can influence its value by prudently altering its proportion of the debt capital, i.e., degree of financial leverage its capital structure. According to the said approach higher the financial leverage, lower will be the weight average cost of capital of a firm. As a consequence, the return available to shareholders as well as the overall market value of the firm will go up. Similarly, on the flip side, if the financial leverage reduces, the weighted average cost of capital of firm would increase as a result of this, the value of the firm i.e. the market price of the equity shares will come down. However, according to Durand (1952) the NI approach would only hold under the following assumptions:

1. There are no corporate taxes
2. The cost of debt capital (K_d) is less than the cost of equity capital (K_e), i.e., $K_d < K_e$
3. The financial leverage or use of debt capital does not influence the risk perception of the investors.
4. The cost of debt capital and the cost of equity capital will remain unchanged irrespective of any changes in the debt-equity mix of the firm.

5. The dividend payout ratio is hundred percent, it means a firm must not keep a part of profit as retained earnings.

According to the NI approach, the value of the firm is ascertained as follows:

$V = E + D$

Where V = Value of the firm,

E =Market value of the equity

D = Market value of the debt

Again, Market value of equity can be determined as below:

$E = E_e / K_e$

Where, E_e = Equity earnings (i.e., earning available for equity shareholders)

K_e = Cost of equity capital (i.e., equity capitalization rate)

The market value of equity can be determined as follows:

$D = I / K_d$

Where, I = Interest of debt capital

K_d = Cost of debt capital

The overall cost of capital or weighted average of the cost of debt and cost of equity capital (K_0) can now be estimated as

$K_0 = (E/V) K_e + (D/V) K_d$

$K_0 = EBIT / V.$

Therefore, the total value of the firm $(V) = EBIT / K_0$

However, the principal shortcoming of the NI approach is that it assumes a constant cost of debt and cost of equity capital. Empirical explanations evidenced that with the increase in debt in the capital, the cost of equity tends to rise and after a certain stage of leverage the cost of debt capital also starts rising. Furthermore, the splitting of the entire earning of the firm between debt and equity holders to determine market valuation is highly criticised and found impractical. Besides, assumption like equal risk sensitivity among all investors, hundred per cent dividend payout by firm and no corporate tax etc. have no practicality.

II. Net Operating Income (NOI) Approach

The net operating income approach of capital structure was also propounded by Durand (1952) but shared a converse view than the NI approach. This approach views that the value of the firm does not at all affected by the adjustments in the capital structure. In other words, this approach says that the increasing use of debt by a firm will not play any role in determining the weighted average cost of capital and the market value of the firm. The NOI approach finally concludes that the capital structure decision of a firm is irrelevant and hence, there remain no such things as optimal capital structure. In other words, any capital structure or combination of debt and equity can be considered as an optimal capital structure.

The underlying assumptions based of which the NOI approach operates are as follows:

1. There are only two sources of fund i.e. debt and equity.
2. The cost of equity capital (K_e) is greater than the cost of debt capital (K_d), i.e., $K_e > K_d$

3. The overall cost of capital (K_0), of the firm is constant irrespective of the degree of financial leverage or intensity of business risk of the firm.
4. The investors see the firm as a whole and thus capitalize the total earning of the value the firm as a whole. In other way, the split between the equity capital and debt capital is no more relevant in determining the value of firm.
5. The value of the equity capital (E) is a residual value and it is obtained by deducting the value of the debt (D) from the value (V) of the firm as a whole, i.e., E = V- D.
6. For any degree of financial leverage of the firm, the cost of debt capital (k_d) remains constant.
7. The incremental proportion of debt in the capital structure amplifies the risk of the equity holders which leads to increased cost of equity capital (K_e). The cost rises out of increase in equity capitalization rate (K_e) would exactly sets-off the benefits of employing cheaper debt.
8. There are no corporate taxes.

This approach determines the value of the firm as follows:

Value of the firm (V) = EBIT / K_0

Here the cost of equity capital can be estimated as follows:

$$K_e = K_0 + (K_0 - K_d)\ D/E$$

Looking into the limitations of NOI approach we see that, it assumes that the benefits of using cheaper debt capital will be exactly nullified or set-off against the enhancement of cost of equity capitalization rate which leads to no change in the value of the firm. But it is quite unrealistic to assume that the cost of equity will increase exactly to that a level which completely neutralise the positive impact of increased debt issue. Again non-existence of corporate taxes is also an impractical base to establish this approach in the todays world. Finally, the non-existence of optimal capital structure of any firm also not an acceptable argument so far as financing decisions of a firm is taken into consideration.

III. Modigliani-Miller Hypothesis

Modigliani and Miller (1958) have developed and explained a theoretical viewpoint regarding the capital structure of the firm. The MM hypothesis shares quite similar view as the NOI approach of capital structure. The MM hypothesis postulates that in absence of any corporate taxes, the change in the degree of leverage of a firm will have no effect on the firm's overall cost of capital as well as its market value.

The MM hypothesis of capital structure was proposed under the ideal capital market conditions. However, there are a number of other assumptions of this approach as follows:

- Capital markets are perfect, implying that there is no transaction cost; all investors are rational, truly informed and free to buy and sell any share
- The investors have the same expectation regarding a firm's operating income
- All firms belong to same risk class.
- The dividend payout ratio is hundred percent.
- Securities are infinitely divisible
- No investor can individually influence the market price of securities
- There are no floatation costs

- There is no corporate tax

The MM hypothesis states that the value of the firm and the overall cost of capital are independent of its capital structure.

Here, $V = E + D$

Or, $V = EBIT / K_0$, where EBIT refers to earnings before interest and tax

Or, $K_0 = EBIT / V$

$K_0 = (E/V) K_e + (D/V) K_d$

Here, V = Value of the firm,

E =Market value of the equity

D = Market value of the debt

K_e = Cost of equity capital

K_d = Cost of debt capital

K_0 = Overall cost of capital

Here, as both EBIT and overall cost of capital are independent of the capital structure of a firm, the value of the firm remains unaffected by the capital structure choices. According to this hypothesis two firms with identical nature except for their capital structure choices, can't attain varied market value and overall cost of capital. Any difference in their market value is restored through a process of *arbitrage*. Here *arbitrage* process refers the practice of buying security from one market at lower proces and selling them at comparatively higher price in another market.

IV. Traditional Approach

The traditional approach of capital structure goes in between two extreme prepositions or views i.e. relevance and irrelevance of capital structure postulated by NI and NOI approaches respectively. In other words, this approach of capital structure theory involves a blend of two competing postulations previously developed regarding the relationship between the cost of capital, leverage and value of the firm. This approach suggests that through judicious use of both equity and debt capital, the cost of capital of the firm can be minimized and consequently the value of the firm can be maximized. However, the said approach neither completely presumes constant cost of equity and declining overall cost of capital like NI approach nor the increasing cost of equity and constant overall cost of capital like NOI approach.

According to the traditional approach, there are three stages of movement of the weighted average cost of capital based on the degree of leverage of the firm. At the initial stage, increase in financial leverage, i.e., use of cheaper sources of capital, leads to a reduction in overall cost of the firm. This is because in this stage the infusion of more debt capital in the capital structure does not impact the cost of debt and cost of equity capital. Both of the capitalization rates remain fixed or enhance negligibly.

In the second stage, after a certain degree of leverage, due to the increased financial risk perception of the equity shareholders, cost of equity start rising. Here, the rise in the cost of equity (due to added financial risk arising out of higher leverage) will just equalize the benefit of using cheaper debt capital. It will continue to go up to a certain degree of leverage. Hence, in this range of the degree of leverage the average cost of capital will remain unchanged. The degree of leverage at this stage represents an optimum capital structure because here the cost of capital lies at its minimum range and hence, the value of the firm will reach its maximum.

The third stage is the stage of the declining value of the firm. At this stage value of firm starts declining along with the further rise in the financial leverage of the firm. This is because if the firm introduces more debt capital, i.e., enhance its degree of leverage (beyond the second stage), the risk perception of both equity and debt holders will increase significantly. Therefore the overall capitalization rates for both the debt and equity capital start rising and the value of the firm starts declining.

V. Trade-off Theory

Through providing a modified MM proposition, the trade-off theory suggests that the value of the firm become maximized if the capital structure becomes optimized. This capital structure optimization is only possible through the trade-off between costs of financial distress and interest tax shields which occurs due to using of debt capital. In other words, the trade-off theory proposes that a firm through balancing the costs and benefits of an added unit of debt capital in the capital structure can maximize the value of the firm. As per this theory, the moderate debt-equity ratio is rational for a firm. *Financial distress* refers to the risk factors associated with using debt capital like the risk of bankruptcy, losing of creditworthiness etc.

In fact, the interest tax shield is an observable and quantifiable benefit but the costs involved with financial distress are not. Therefore, a company should more cautious regarding this and must keep up the safety of margin before taking benefit of the tax shield. Hence, according to Trade-off theory (Singh and Kumar, 2008) the advantage from tax shield is offset by costs of financial distress. It says that the firm will use debt capital in its capital structure up to the point where the marginal value of tax shields on additional debt is exactly offset by the increased costs of financial distress.

This approach measures the firm value as below:

$V = V^{/}$ + Present value of interest tax shields) – Present Value of Costs of Financial Distress

Where $V^{/}$= the firm value with all equity financing.

VI. The Pecking-Order Theory

The pecking order theory was introduced and popularized by Myers and Majluf (1984). The theory basically explains how asymmetric information is responsible for enhancement of cost of finance in a corporation. This theory believes a firm with growth opportunity wants added financing. This theory also assumes that the capital market is semi-perfect because there is no information asymmetry between the insiders and the outsiders of a firm. In such circumstances, there are three sources of finance, namely, internal funds, debt and new equity. For a corporation internal source of finance will be the first preference, followed by debt capital whereas equity will be considered at last. The pecking order theory suggests that the firms will rely first on internal sources because the information asymmetry costs associated with it is the lowest and lastly equity because it is attached with the highest information asymmetry costs.

Pecking order theory views that the way a firm finances would bear important signals to the public about how the performance of the company. According to this theory, when a firm finances itself internally public perceive the company as financial strong. If a firm chooses to finances its investments through issuing debt, it signifies that the management is confident enough about the ability of the firm to bear its fixed financial obligations. Lastly, if a company finances itself through issuing equity shares, it bears a negative signal that the management perceives its stock to be overvalued in the market and the company seeks to make money out of it before the market price of the shares fall.

VI. Market Timing Theory

The market timing theory of capital structure has been put forward by Baker and Wurgler (2002). The theory postulates that, the current capital structure of a firm is the collective effect of past attempts to time the equity market. According to this theory, the source of capital is determined based on the market value of the share of the company. In other words, the insight of market timing is that firm issues new shares when it thinks its shares are overrated and it has the opportunity of collecting fund through utilizing its equity capital. On the other hand, firms repurchase their own shares when they consider these to be underrated. In a similar way, fluctuations in stock price will affect corporate financing decisions as well as the capital structure of a corporation. Therefore, the current capital structure of a firm is significantly allied to historical market values of its equity capital.

Therefore, according to Baker and Wurgler (2002) market timing is a crucial determinant of a firm's capital structure or use debt and equity and firms do not generally predetermine any debt-equity mix rather they just choose the form of financing which at the time of new issue, seems to be more valued by financial markets.

Thus, from the above discussion it can be understood that, theoretically the capital structure i.e. mix of debt and equity capital of a company has crucial importance and considerable bearings on the governance and performance of companies.

2.2. Ownership Structure: The Conceptual Aspects

Theoretically, ownership structure of a business corporation refers to the pattern of distribution of its ownership to different kinds of investors. It reflects the types of equity holders and their proportion of equity holdings. Conceptually, there may be different kind of participants in the ownership of a publicly held company. Broadly classifying the types, we get four kinds of investors, such as promoters, financial institutions, public and governments. The promoters may be domestic or foreign affiliates. The institutional investors include bank and non-banking financial institutions, mutual fund companies, insurance companies and many more. The shares of companies also go to the hand of common citizens, which is categorised as public shareholdings. Similarly, certain fraction of ownership may also be hold by central or state government(s). Below we have given a detailed description on the prominent shareholding types in the Indian corporate sector:

I. Promoters' Shareholding

Promoters as a kind of shareholder in business corporations could not find good space in the Indian Companies Act, 1956. However, the term promoter was a little explained under section 62 of the Companies Act, 1956. Companies Act, 1956 merely considers a promoter as an individual who has been recognised as a party in the preparation of the prospectus of the company. The Security and Exchange Board of India (SEBI) also gives description on various aspects of promoters in Indian companies. SEBI

(Issue of Capital and Disclosure Requirements) Regulations, 2009 sees promoters as any persons who are in control of the issuer; instrumental in the formulation of a plan and whose names are mentioned in the offer document as so. Besides, SEBI's Substantial Acquisition of Shares and Takeover Regulations, 1997 and Disclosure and Investment Protection Guidelines, 2000 have given special status to promoters. According to SEBI, promoters are also supposed to play crucial role in the form of rigorous monitoring and regulating of corporate affairs by virtue of their ownership and managerial rights.

However, the newly drafted companies act of India i.e. Companies Act, 2013 in its section 2(69) provides a comprehensive definition of the term 'promoter'. According to the aforesaid Act, a promoter may be any individual who has been identified as such in the prospectus of the company or in its annual return. Moreover, a person would be called as promoter when he or she holds either direct or indirect control over the management of affairs of the company as a shareholder or one of the directors or in other status. Again, a promoter is also supposed to provide business advice, directions or instructions to the Board of Directors (BoD) of the company.

A promoter is supposed to have important functions and crucial duties for the concerned company since its inception to winding-up. A promoter is the person who first dreams of the idea of a business corporation. Starting from envisioning the idea to make it a reality, a promoter has to bear all the task and hassle that come in between. Here we outline the following functions that a promoter has to usually undertake:

- To decide and set the name of the company

- To propose the content and other aspects of Articles of Association & Memorandum of Association of the company.
- To propose the name of directors, bankers, auditors and many other important parties to the business
- To decide on the place of the registered and the head office of the company.
- To prepare the prospectus and other crucial documents required for the incorporation of the company.

Apart from these, the Companies Act, 2013 lays down certain aspects relating to liabilities and rights of a promoter. Below we outline these aspects in a comprehensive manner:

- Section 7(6) makes a promoter liable for furnishing any untrue information for incorporation of the company
- Section 13(8) and section 27(2) enunciate about the obligation in allowing exit option to the dissenting shareholders
- Section 35(1) stipulates the liability of a promoter to pay compensation for any misstatement or omission in prospectus caused by him or her.
- Section 102(4) specifies about the liability of promoters to compensate for any gain resulting arises out of non-disclosure or insufficient disclosure of information in explanatory statement.
- Section 167(3) empowers promoters to appoint directors when all the existing directors are in vacation of office.
- Similarly, section 168(3) gives power to promoters to appoint directors in case of resignation by all the existing directors

- Section 257(3) specifies the promoters' duty to appear before the meeting of creditors' committee if so instructed by the interim administrator.
- Section 284(1) specifies the duty of a promoter to extend full cooperation to the company liquidator.
- Section 300(1) stipulates the promoters' liability of being examined before Tribunal upon report of company liquidator

Finally, it is important to note that, shareholding by promoters both domestic and foreign have important bearing on the overall operational efficiency, functioning and financial performance of a business corporation. The impact of promoters on the corporate profitability and market valuation has been theoretically accepted and empirically endorsed. The promoters being the owners of business are supposed to be very much concerned, interested and deeply engaged in the management of affairs of a business enterprise. They are also reasonably expected to normalise type-1 agency crisis i.e. conflict of interest between the managers and the shareholders as a whole by actively motoring and controlling management opportunistic or self-servicing behaviour. In this regard, the domestic promoters normally play much more significant role on ensuring the effective and efficient functioning of businesses (Pandey and Sahu, 2017c).

The empirical studies like Shleifer and Vishny (1986, 1988), Kaur and Gill, (2007), Haldar and Rao (2011), Tawiah et al. (2015), Pandey and Sahu (2017b) etc. find significant linkage between promoters' ownership and financial performance of firms for different economies context. Therefore, based on the theoretical discussion given above, we can sensible hypothesise a significant and likely positive influence of promoters' shareholdings on the profitability and market related performance of Indian manufacturing companies.

II. Institutional Investors

Intuitional investors form an important kind of ownership in the Indian corporate sectors in general and manufacturing firms in particular. On an average, near about one forth of ownership stake of Indian manufacturing firms are seen to be hold by institutional investors (Pandey and Sahu, 2017b). In many countries, institutional investors are gradually becoming dominant players in the capital markets (Gillan and Starks, 2003). The important categories of institutional shareholders are banks, non-banking financial companies (NBFCs), mutual fund companies, insurance companies etc. These financial institutions generally holds a jury of professionally qualified, chartered and highly experienced investment analysts who undertake great deal of efforts in terms of rigorous monitoring and active participation in the management of affairs of the their invested company to ensure good return on their investments. Therefore, institutional shareholding is another crucial component of companies' ownership that influences their operational efficiency, performance and valuation.

However, it is important to note that, the emergence of institutional investors and their activities in the Indian corporate ownership has largely increased after the rigorous stock market reforms that takes place in the subsequent years of as a part of the sweeping economic liberalization of Indian economy initiated in the year 1991. Lets us look at the important stock market reforms that has rigorously modified and finally made a paradigm shift in the institutional investment scenario in Indian corporate sector:

- Four committees namely Pherwani Committee, Ajit Dey Committee, Dave Committee, and Pherwani Committee were set up by the government of India to critically look into the various issues and problems of Indian capital market as a whole.
- The Government of India (GOI) also welcomed a couple of trustworthy and renowned foreign institutional investors (FIIs) including mutual fund companies, investment trusts and asset management companies etc. to invest in Indian stock markets.
- Government relaxed a couple of norms pertaining to the investment of Non-Resident Indians (NRIs) in capital market.
- NRls and the foreign corporate bodies were allowed to buy securities subject to prior permission of RBI.
- The Government of India had established the Over-the-Counter Exchange of India (OTCEI) in 1990 under the Companies Act, 1956 with the objective to provide a cost-effective platform for sourcing finance for the enterprising promoters for their new projects and a transparent & efficient mode of trading for the investors of stock market in general.
- The GOI permitted the mutual funds companies to act as underwriter to public issues
- Aiming at broadening the government security market, in July 1997, FIIs were allowed to invest in government securities.
- Remarkable modernization of stock exchanges was taken place. Electronic on-line and screen based trading system were introduced by a number of stock exchanges.

All these above reforms initiatives have considerably change the status and involvement of Indian and foreign institutional investors in the ownership of Indian corporate firms.

Important Institutional Investors in Indian Corporate Sector

Let us briefly discuss about the important constituents of institutional investors in context of Indian capital market. The following are the important parties which constitute the institutional investment category in Indian security market

a) Banks

Banks are the most common form of financial institutions for any country. Typically, a bank is a financial institution that accepts large volume of deposits of money in general from the public and lends a major part of the deposits to the individuals and organizations having requirements of credit. The banks undertake a flurry of economic activities like accepting deposits from the public, granting loans and advances, providing overdraft facilities, discounting of bills, issuing letter of credit, undertaking safe custody of valuables like jewelleries made with diamond, gold etc., providing consumer finance, granting educational loans etc. Banks are the most important and basic constituent of institutional investors in Indian and many other markets. Practically speaking, banks deals with public savings and the pool of deposits taken from the public becomes the source of investment by banks. The performance of a bank depends upon how wisely they invest their funds and nurture their investment. If a banks continues to fail in earning adequate return from its investment than it no more be capable of maintaining good customer base and may even lose public faith in case any default in repayment to the depositors. Therefore, banks as institutional investors of corporate sector need to be much more sensible, aware and accountable while taking investment decisions and undertaking further course of nurturing of investments. This is why banks are supposed to be the most cautious and engaged institutional investors of corporate enterprises. Being the most prominent category of institutional investor, banks are supposed to exert crucial influence on the quality of management and overall functioning of a business concern including its internal governance mechanism, core business practices and financial performance. In a study, Ameer (2010) shows, how the foreign banks as institutional investor play important role in improving operational efficiency in the form of better inventory and cash management of non-financial business corporation in the industrial sector of a number of Asian economies.

b) Mutual Funds

Mutual fund companies or simply mutual funds are the financial institution that offer small investment opportunities, called ‘unit’ to the public and brings together a pool of investable funds or money and finally invests it in shares, bonds or other form of assets. The combined holding of different kinds of securities and assets is known as portfolio. The mutual fund companies are becoming attractive avenues of investment for small investors because it provides a whole gamete of services and benefits that an individual investor could not avail in normal course of a personal investment process. First of all, it allows investors having very small size of investable fund to participate in equity investment though the purchase of units of mutual funds. Therefore, investors who are unable to purchase a whole lot of securities can also enjoy the taste of security market investment though mutual funds. Secondly, mutual fund allows investors to diversify risk through investment in a bunch of securities with varied risk-return characteristics. Hence, loss from one or more securities is likely to be off-set from gain in other securities. Apart from these, high liquidity, convenience in investment, benefit of professionals' expertise, economies of scale etc. are the important advantages of mutual fund investment which make these institutions an attractive place of investment. Mutual funds are the important constituent of institutional investors group in India.

The mutual fund companies hold experts including security and investment analysts, fund manager etc. those are supposed to exercise considerable degree of control and regulation on the management of affairs of the corporation which they have invested in. The stewardship from the part of fund managers acts as a strong governance mechanism to the management and results into lessening of principle-agents agency crisis in the business corporation. However, the fund managers, influenced by some private incentives, can even act in line with the managers of such a corporation Bebchuk et al. (2017) which may deteriorate the quality of governance and thereby operational efficiency and performance of companies. Therefore, due to self-opportunism the fund managers of mutual funds can compromise stewardship and provide undue support to the management by taking their side.

In this way, mutual funds can play an important role in the governance and performance of companies. Now, the mutual funds are also one of the main constituent of institutional investor category in the Indian manufacturing sector, therefore, we reasonably assume a considerable effect of those mutual funds on the internal governance, agency cost and performance of the companies under the sector.

c) Insurance Companies

Insurance companies are also the important contributor of the institutional investment in the corporate sector. It is a kind of financial institution that generally insure people by selling the promise to pay for certain kind of expenses in return for a regular fee, called a premium. For example, if someone purchases a health insurance from an insurance company than it will pay for the client's entire or a part of the medical bills. Likewise, in life insurance, the company provides client a certain sum of money in case of his death. Insurance businesses, both general and heath, are growing in India and many other countries in the world with a rapid pace due to high demands of health and after death family security, non-life or general aspects of security etc. and this is the reason why this institutions are gradually becoming active participants in the ownership and control of corporate sector. Like any other financial institutions, insurance companies in India are also take active participation in the management of affairs of business corporations which they have invested in. They are also supposed to exercise stewardship in the form of imposing necessary restrictions in uneconomic business activities, infusing regulations to curtail agency problem and bestowing serious participation in the decision making processes of corporate enterprises in India to ensure better return on their investment. Therefore, insurance companies also form an important part of institutional investor category and therefore we reasonably suppose a considerable impact of this kind of investors on the performance of Indian manufacturing companies.

d) Non-Banking Financial Companies (NBFCs)

The non-banking financial institutions are also progressively emerging as the important institutional investor of Indian public limited companies. NBFCs are registered under the Companies Act, 2013 and previously the Companies Act, 1956 of India. This type of financial institutions provides loans and advances to the public, hold securities of corporate firms, undertakes hire-purchase insurance business and chit-fund business etc. The functioning of NBFCs is regulated by the Reserve Bank of India (RBI). Similar to the earlier discussed constituents of institutional investor category, the NBFCs are also treated as important institutional investors having substantial ownership and thereby control in Indian corporate sector. In this study, we also assume NBFCs to have considerable bearing towards the performance of Indian manufacturing firms.

So far we discussed the concept, significance and the important constituents of institutional investor category in Indian manufacturing sector. Now, it is important to understand that in general perspective, how hypothetically institutional ownership is associated with the internal governance and performance of firms. In this connection it can be stated that the theoretical conception and empirical background suggest both favourable as well as adverse impact of institutional ownership on the overall governance and management of a firm. Consequently, in the similar way it is supposed to have both positive as well as negative impact on the corporate financial performance. Actually, the kind of impact the institutional shareholders would exert in a corporate enterprise is largely dependent on the kind of role they are pursuing. This is because, sometimes it may so happen that the investment managers within the institution get their own agency problems with the investors and they for the sake of private benefits give undue support to the management. They reasonably weakly exercise stewardship to the management out of self-opportunism (Bebchuk et al., 2017). Pound (1988) gives a more comprehensive and holistic view on association between institutional ownership and firms' governance and performance. According to him, the effect of institutional ownership on firm governance, performance and valuation is conditioned under three hypotheses; *efficient monitoring hypothesis, conflict-of-interest hypothesis and strategic-alignment hypothesis*. The efficient monitoring hypothesis views the institutional shareholders as investment expert, efficient monitor and active participant towards business affairs of the companies.

According this hypothesis, the institutional investors are professionally qualified, chartered security analysts who not only have the expertise in taking investment decision but also have the required efficiency and understanding on nurturing investment and ensuring stringent & fruitful internal governance in an enterprise. They act as a watchdog to the management and regulate each and every significant decisions taken and actions undertaken in the business to ensure better financial performance. In this way, it acts as disciplinary mechanism towards principle-agents agency clash. Therefore, this argument predicts a favourable impact of institutional ownership on companies' financial performance. On the contrary, the conflict of interest hypothesis postulates a negative impact of institutional shareholding on the performance of companies. According to this hypothesis, in view other business relationship with the company an institutional investor may provide undue support to the management of company (Brickley et al., 1988). With the objective to maintain a healthy business relationship the institutional investors are coerced to vote in favour of management even compromising the interest of the company as a whole.

Again, the strategic-alignment hypothesis views that, many a time the institutional investors and the managers of the company find it advantageous to develop a mutual understanding and cooperate one another compromising the larger interest of the business. This mutual cooperation nullifies the positive effect of active monitoring and leads to lower firm performance. Thus, both the conflict of interest hypothesis and strategic-alignment hypothesis predict an unfavourable impact of institutional ownership on the performance of companies.

Therefore in nutshell it can be said that, institutional investors as whole are really supposed to exercise considerable stewardship or control on the management of companies which would probably not be possible for the individual investors with very small fraction of ownership and almost no expertise in corporate governance. Although in this investigation we are going to measure the impact of institutional shareholders as whole but making a separate discussion on each of the major constituents as done in this chapter is important to have the theoretical and conceptual understanding.

III. Ownership Concentration

Ownership concentration refers to the kind of ownership where a substantial part of total shareholding of a corporation is held by a few circumscribed shareholders. Based on the degree of concentration, ownership structure can take two form; dispersed shareholding and concentrated shareholding. In case of dispersed shareholding structure, the ownership is distributed among large volume of owners whereas in a concentrated shareholding pattern the substantial portion of controlling stake goes to a few large shareholders. However, conceptually when a shareholder can be treated as large is an important question because the concept of large shareholder varies across the markets. Different researchers (Porta et al. 1999; Salerka, 2005; Vintila et al. 2014, Brendea 2014) considered a shareholder as large with different criteria on the percentage of shareholding. However, in most of the cases it is observed that a shareholder is supposed to be large when the ownership stake touches or go beyond five percent.

Now, for the jointly held Indian corporations, ownership concentration is not a new phenomenon rather it remained as an endemic feature since the days of British managing agencies (Balasubramanian, 2010). Not only the Indian one but most of the Asian firms are either family-controlled or state-controlled which makes their ownership traditionally concentrated since their establishments (Shakir, 2008). The scene is still prevalent; in fact, ownership concentration in present days especially in the hands of a few large promoters has become a norm rather than exception in the Indian corporate scene (Pandey and Sahu, 2019a).

Notably, while ownership concentration is noticeable in almost all the sectors indiscriminately in other emerging Asian economies, for India the concentration of ownership is much more prominent in manufacturing sectors only (Selarka, 2005; Altaf, 2016).

Let us come into the discussion on the effect of such large shareholders on the governance and performance of Indian manufacturing firms. Conceptually, these large/ dominant shareholders can exert two types of influences on the corporate governance of Indian manufacturing firms. Firstly, they may safeguard the interest of shareholders fraternity as a whole by promoting the wealth maximization objective through better monitoring management and limiting their opportunistic behavior. Conversely, these large owners can expropriate the minority shareholders and unjustifiably extract more benefits at their costs. The expropriation can take place in various ways such as, diverting firm resources or assets through self-dealing transactions (Johnson et al., 2000), tunneling one firm's resources and profits to another firm to enjoy more cash flow rights especially in a situation when a dominant owner has controlling stake in two different firms with varied rights on cash flows (Bertrand et al., 2002), subversive behavior with minority owner and deprive them from exercising their de jure ownership rights (Goswami, 2002) etc.

The nature of agency crisis in India is seen to be quite different from other economies like United States and United Kingdom in the sense that, where the corporations of these developed countries are facing both kind of agency issues i.e. conflict of interest between managers and shareholders (type 1 or vertical agency crisis) and that between minority and dominant shareholders (type 2 or horizontal agency crisis), the latter issue is much more prevalent in Indian corporate sector (Morck and Yeung, 2003; Roe, 2004).

However, quality of corporate governance in Indian corporation is mainly assessed by its ability to discipline two types of self-servicing attitudes, one is of majority owners and another is of managers (Varma, 1997). It will be very interesting to testify whether the concentrated ownership structure is reducing vertical agency conflict and costs in Indian publicly held manufacturing corporations or it becomes a cause of horizontal agency crisis and lower firm performance. A positive impact on performance with evidence of curtailment in vertical agency cost will definitely endorse their overall internal governance quality. However, the opposite results will indicate the presence of expropriation effect and their inability to serve as an internal governance mechanism.

2.3. The Agency Problem

A jointly held corporation prominently faces two types of agency crisis namely, horizontal and vertical agency crisis. The vertical agency crisis refers to the conflict of interest between owners of the concern and management or controlling agents. The root cause of this crisis is the separation of ownership and control in the modern corporation (Berle and Means, 1932). Notably, the agency contract i.e. the contractual relationship between the principles and agents is referred to as ‘incomplete’ because of the fact that, although typically the agents are supposed to think and act in line with the best interest of the principles, but in practice, they take the benefits of free riding opportunities to realize their private benefits on expense of the principals (Kirchmaier and Grant, 2005; Shleifer and Vishny, 1997). In this way, the separation of these two entities results into substantial conflict of interests (Jensen and Meckling, 1976; Shleifer and Vishny, 1997) which is dubbed in the corporate governance literature as type 1 or vertical agency crisis.

On the other hand, another most prominent form of agency crisis is the horizontal agency crisis that arises out of conflict of interest between majority or large shareholders and the minority shareholders. The existence of large owners under a concentrated ownership structure may bring a new challenge for the minority owners. According to World Bank (1999), a closely held firm with few circumscribed controlling owner faces a situation of undue dominance over and expropriation of minority shareholders by such controlling shareholders. It brings in a challenge for the minority shareholders to prevent and control such extracting behavior of the large shareholders. Some empirical studies endorse a competing hypothesis called expropriation hypothesis and provide evidences of exploiting or expropriating behavior of large shareholders and their action against the value maximization objective of firm as a whole which leads to generation of a horizontal or type II agency crisis (Fama and Jensen, 1983; Shleifer and Vishny, 1997; Burkart and Panunzi, 2006).

2.3.1. Capital Structure and Agency Problem

The capital structure of a corporation is both conceptually and empirically associated with vertical agency crisis. A flurry of empirical evidences is there which established a strong association between the owner-managers agency crisis and the capital structure of a firm. According to most of such empirical investigations, firms' agency cost, performance and value are found to be significantly affected by the changes or modifications in the capital structure or degree of leverage. There is sufficient empirical support to this fact that, when a firm issue more debt, it limits the cash available in the hands of managers (Jensen, 1986) as a result of increased fixed-interest payments obligations. According to the Grossman and Hart (1982), a high debt can play an instrumental role in disciplining managerial discretionary expenses and wasteful use of cash flow by creating a threat of liquidation as a consequence of incapability in repayments. In this way capital structure can regulate the type 1 or vertical agency crisis.

2.3.2. Ownership Structure and Agency Problem

For a publicly held company especially with dispersed ownership structure the challenge for the shareholders is to safeguard their objective from the managerial opportunism (Miguel et al., 2004). Under such a circumstances, the various forms or constituents of ownership i.e. the promoters and institutional shareholders can act as active supervisor of the management and restrain managerial opportunistic behaviour. In SEBI's Substantial Acquisition of Shares and Takeover Regulations, 1997 and Disclosure and Investment Protection Guidelines, 2000, promoters are supposed to exert significant influence on firm activities through rigorously supervising and disciplining corporate affairs by virtue of their shareholding and cash flow rights. Besides promoters, the institutional investors are supposed to have sheer interest and high expertise in nurturing the investment and other corporate decisions in their invested firm. They also closely guide and monitor management of affairs of the corporation and considerably preclude managerial self-servicing attitudes.

Besides these forms of ownership, under a concentrated ownership structure, the controlling owners i.e. large shareholders can play an effective role as proposed by *efficient monitoring hypothesis* (Shleifer and Vishny, 1986; Friend and Lang, 1988). As per the proposition of this hypothesis, owners with substantial proportion of shareholding can be more capable of monitoring and controlling the management of affairs of a company and preventing the opportunistic behaviour of management by virtue of their strong voting rights which ultimately results into decreased vertical or type I agency crisis.

The existence of large owners under a concentrated shareholding pattern may call upon a new challenge for the minority owners. According to World Bank (1999), a closely held firm with few circumscribed controlling owner faces a situation of undue dominance over and expropriation of minority shareholders by such controlling shareholders. It brings in a challenge for the minority shareholders to prevent and control such extracting behaviour of the large shareholders. Some empirical studies endorse a competing hypothesis called *expropriation hypothesis* and provide evidences of exploiting or expropriating behaviour of large shareholders and their action against the value maximization objective of firm as a whole which leads to generation of a *horizontal or type II agency crisis* (Fama and Jensen, 1983; Shleifer and Vishny, 1997; Burkart and Panunzi, 2006).

2.4. Corporate Performance: A Theoretical Discussion

Performance can be simply understood as the degree of sincerity, accuracy, efficiency and effectiveness on which a particular activity is performed. However, to be practical, performance of a business concern is not just about how well a particular activity is performed but much about how far the pre-determined goal attached with the activity is accomplished. For instance, an activity may sometimes be carefully and effectively undertaken with highest possible efforts, but if such efforts don't bring in any goal oriented outcomes then the activity wouldn't be treated as well-performed. Therefore, we must understand that the term 'performance' typically refers to the concluding consequence or outcome of any activity. However, there are a variety of definitions that can be given to the term performance. A formal way of defining performance is; the degree of accomplishment of a given task measured against a preset standard of accuracy, completeness, economy and speed. In context of a business concern, it may imply the level of efficiency and effectiveness on which a pre-determined goal is accomplished by the organization.

To measure performance involves evaluating a numeric outcome through analysis that indicates how well and how far an organization is achieving its pre-determined set of objectives. Performance measurement can involve examination of the performance of many aspects of a business concern such as accounting, finance, marketing and sales, engineering, production and materials management, research and development etc.

According to Armstrong and Baron (1998), an effective performance measurement should contain the following characteristics:

- It should be based on and related with the strategic goals of the business concern and it should also be organizationally significant
- It should be relevant to the objectives of the business and the individuals concerned
- It should reasonably involve measurable output, accomplishment and behaviour that can clearly be defined and for which evidence can be made available
- It should be as far as possible precise and specific in accordance with the purpose of measurement and availability of data

- It should put forward a solid foundation for feedback and action
- It should be comprehensive and it must cover all the key aspects of performance

To ensure successful implementation of a firm's business strategy, implementation of an efficient performance measurement is of high importance. It is an instrument through which an organization monitors and controls the important aspects of its plans and programs, processes and system designed for the purpose of fulfilling its ultimate goal. By providing adequate and crucial performance information, it enables an organization in efficient and effective decision-making from operational to strategic level of business. Moreover, there are a lot of others reasons as to why an effective measurement of the financial performance of an enterprise becomes imperative. In very typical sense, performance measurement provides an efficient tool which helps in determining the efficiency and effectiveness of an organization's current system. In organizations, financial measures of performance become the basis for appraising the quality of financial management. The financial scorecard indicates how well the finance manages have utilised the financial resources in the direction of shareholders value creation.

However, one must understand that, not only the inside stakeholders (viz., shareholders, employee etc.) but the outsiders like creditors, governments and public are also equally keen to get true picture about the financial or non-financial performance of an a business organization.

In a business organization, the performance may be financial or non-financial in nature. Financial performance is associated with the accomplishment of financial objective whereas attainment non-financial performance is attached with the attainment of non-financial objective of an organization. Therefore, in case when a business concern seeks to attain a financial goal like profitability, growth, market value then the efficiency and effectiveness of attaining such a goal is referred to as financial performance. On the other hand, when a business concern strives to attain non-financial goals like customer satisfaction, social performance, environmental performance etc. then the efficiency and effectiveness of attaining any of such goals is referred to as non-financial performance or strategic performance (Santos and Brito, 2012).

Coming to the financial perspective, financial performance refers to the degree of accomplishment of a goal attached with the act of a financial activity. In other words, financial performance refers to the degree to which a financial objective is accomplished. Financial performance can be classified into two types; accounting performance and market performance.

2.4.1 Commonly Used Accounting Performance Measures

A) Return on Assets (ROA): Return on Assets is a very common measure of companies accounting performance. In a business concern, profits are often viewed in relation to its investment in total assets. The ratio between the return in terms of net profit of a firm and its average total assets is called return on assets. For instance, if the ROA of a firm at the end of a particular financial year is say 12 percent, it means the return of the firm is 12 percent of its total assets investment value. A high return on assets suggests good profitability condition and vice versa.

B) Return on Equity (ROE): It is another important and widely used measure of accounting performance of firms where the return in the form of profit is viewed in relation to the equity share capital of a firm. Unlike ROA, it expresses the profitability of a firm exclusively in relation to the owners' equity investment. Return on equity specifically represents how the equity shareholders are fared during a financial year. Since benefiting the owners is the principle goal of a publicly held company, ROE in this sense is the true indicator of performance (Ross et al., 1996). Now, a high ROE indicates greater efficiency of the firm in utilizing its owners' capital and vice-versa.

***C) Return on Capital Employed (ROCE)*:** The profitability ratio of a firm in relation to total capital employed which includes owners' equity and long term liability in form of debt capital is called return on capital employed. It is a measure of accounting performance of a firm which indicates how well a firm has used its total capital supplied by the creditors/lenders and owners together.

D) Return on Net Worth (RONW): Net Worth refers to what actually a business unit is worth. It is the shareholders equity remains after deducting the assets from all outside liabilities. Return on net worth is also recently considered as an important measure of profitability of a business concern. It is the percentage of return of a firm on its shareholders' equity.

***E) Profit Margin*:** Many a times profit margin is also considered as a good indicator of a firm's accounting performance. This represents the profit generated by a business unit for every unit of its revenue or sales.

All these above discussed measures of accounting performance are theoretically and empirically recognised to be highly sensitive to the capital structure and ownership structure of companies. The empirical studies have well established as to how these variables get influenced with changing debt-equity combination (Grossman and Hart, 1982; Jensen, 1986) and also with alteration in the concentration and composition or distribution of ownership among the public, promoters, institutional investors etc. (Abor, 2005; Haldar and Rao, 2011 Pandey and Sahu, 2017b etc.).

2.4.2 Commonly Used Market Performance Measures

A) Market to Book Value Ratio (MBVR)**:** The market price of shares of a firm is compared with its actual book value to kwon whether the firm's securities are overvalued or undervalued. The ratio between market price of share of a firm and its book value is called the market to book value ratio. When the MBVR of a firm is more than one, it indicates the shares of the firm are valued more than their actual book value.

B) Price Earning (P/E) Ratio: It is the ratio between the market value per share of a firm and its earnings per share (EPS). It reveals how much price an investor has to pay for a unit of earning. It is widely calculated and used by investors and security analysts to determine the firm performance and future expectations.

C) Tobin's Q**:** It was first introduced by Kaldor (1966). It represents the ratio between the existing market value of assets of a firm (taken as, existing market price of equity and debt capital) and their replacement cost i.e. cost of such assets if they newly purchased from the market (taken as, the book value of equity and debt capital). Tobin's Q is determined by dividing the market value of equity and debt of a firm by the book value of total assets.

A Tobin's Q of 1.0 reveals that the market value of securities of a firm is solely reflecting its book value.

When Tobin's Q is greater than 1.0, we should assume that the market value is greater than the recorded value of company's assets.

If Tobin's Q is less than 1.0, the market value is less than the recorded value of the firm's assets and it refers to an undervaluation of securities by the investors in the market.

D) Market Value Added (MVA)**:** Investors and analysts are often very much interested to calculate another market performance called market value added. It represents the difference between the market value of a company at a particular time and the amount of capital the investors contributed towards it.

Market Value added = Market Value of the firm (Market value of equity and debt) – Capital investment in the firm.

A high or positive MVA indicates the creation of wealth for the shareholders of the firm and a negative MVA reveals that the firm has destroyed the shareholders wealth or value.

E) Economic Value Added (EVA): Economic value added in an absolute measure of firm performance which refers to the value remains after all the kind of capital providers including stockholders are compensated. It doesn't only consider the debt interest but also covers the cost of equity. It is actually similar to the measurement of net present value (NPV) but where the NPV applies to the whole period of investment, EVA can be used for periodical performance measurement.

Now, similar to accounting performance measures, the market related performance measures discussed above are also highly considered of being responsive to the capital structure and ownership structure policies of companies. The studies like Kumar and Singh (2013), Altaf and Shah (2018), Pandey and Sahu (2017a, 2019a, 2019b) etc. established significant empirical association between capital structure and/or ownership structure including concentration and the above discussed market performance measure(s) in context of different market economies.