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Monitoring by Institutional Investors and its Influence on Equity Issue

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1. Introduction

Degree of information asymmetry and firm specific governance mechanisms influence equity prices. This assumes that there is a delay in information dissemination to various investors and stakeholders of any firm. Information asymmetry in varying magnitudes can exist between a) Investors and Managers b) Promoters and Non-Promoters c) Institutional and Retail Investors. A transparent and effective governance mechanism would be instrumental in mitigating the same. Independent directors, directors' attendance, duality of chief executive officer and chairman of the board, insider ownership, proportion of executive and non-executive members on the board, independence of the audit committee etc. are some critical governance characteristics that can potentially reduce the degree of information asymmetry between the investors and the firm. As a result, both these factors influence equity valuation.

Given this, it is very difficult to isolate the effect of good governance on equity price from the effect of the degree of information asymmetry as good governance tends to partially mitigate the latter. Equity issuance through qualified institutional placements (QIPs) in the Indian capital market provides an opportunity to delineate the effect of information asymmetry and firm specific governance since it has participation of institutional investors (II) only and the base price is defined as per regulatory guidelines. Thus, information asymmetry related to pricing and participation by heterogeneous class of investors is eliminated to a greater extent (as retail investors are not allowed) due to the regulatory framework. However, what is striking is that even in this setup, QIPs are issued at a premium over the base price. In this study, we argue

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that QIP placements allow informed investors to offer a premium only if the existing II are perceived to be active monitors of the firm and so there is a possibility that firm performance may improve because of adhering to better governance norms. We propose that the premium paid by these II for QIP issues would directly reflect the expected increase in firm value due to increased monitoring with the increase in the concentration of ownership of II post QIP. All else being equal, this increase in value is attributed to monitoring by existing II, with perceived improvement in the governance mechanisms by reducing the agency cost. The act of monitoring is extremely important to mitigate the agency problem since shareholders own the firm and have cash flow rights. However, they do not run the firm but appoint their representatives (Board of Directors) to oversee the management. The management acts as an agent in managing the firm on a day to day basis. This results in the return horizon of managers and shareholders to differ significantly; since management maybe driven by a short term outlook based on expected incentives and pay, shareholders might have a long term outlook of value building and thus incur monitoring costs (an example of agency cost) to align this conflict arising from divergence in outlook.

Predominantly, ownership structure (concentrated/dispersed ownership) defines the governance mechanism of a firm and also controls the agency cost which determines firm performance. The significant stake of insiders with higher control and cash flow rights leads to expropriation of wealth of the minority shareholders. Since these insiders tend to also act as managers, this results in high agency cost, moral hazard and underinvestment problems. If the firm has dispersed ownership, then the incentive to monitor closely is higher. Proportion of Insider Ownership (IO) and II determines the ownership pattern which in turn influences the utility of other stakeholders. The extant literature links ownership structure and firm performance with agency cost due to the degree of divergence of cash flow (owners) and control (managers) rights. Concentrated ownership of insiders with both control and cash flow rights is susceptible to higher agency cost. To mitigate this, the outside stakeholders/block holders such as II would be willing to expend higher costs of monitoring. On the other hand in firms with dispersed ownership, the cost of monitoring per investor would be high given the smaller stakes they hold, thus reducing the monitoring effectiveness.

The linkage between the ownership structure and firm performance has resulted in inconclusive results indicating positive as well as negative relationship. The review of extant literature indicates that the inconclusive results are due to difficulty in delineating the effect of information asymmetry due to participation by heterogeneous class of investors and governance factors.

The equity issuance through QIP provides a natural experimental setup since the regulatory framework of these issues is structured in such a way that it tries to eliminate (if not totally but minimizes) the degree of information asymmetry. This is obtained mainly by two important provisions that the Securities and Exchange Board of India (SEBI) has defined while issuing equity through QIP mode.

1. The QIP issue is open to only institutional investors. This controls the heterogeneity of the investors' group. This aspect is critical since there are evidences in the literature that the heterogeneity of investors' participation creates greater conflict as the investment objectives of different categories of investors vary which results in mispricing of the issue. There is a greater degree of information asymmetry among the various classes of investors resulting in large variation in the equity valuation. The participation of different classes of investors with heterogeneous expectations of their investment objectives brings larger variability in the equity prices. Heterogeneity can also arise from different investment horizons (Miller, 1977; Rock, 1986) etc. On the basis of these studies, we argue that the regulatory framework of allowing only II to participate in the equity issue is likely to control for information asymmetry to a large extent.

2. The second important characteristic of the QIP issue is that, the issue is offered with the base price prescribed by the regulator and it is mentioned in the placement document. The minimum price is derived from historical prices in accordance with Issue of Capital and Disclosure Requirements Regulations, 2009 (ICDR). Based on this clause, the minimum price of QIP is determined as average of weekly high and low closing prices in preceding two weeks from the relevant date. Clause 85(1) of the ICDR Regulations allows the issuer to offer the issue at a discount up to 5% of the floor price with prior approval of the shareholders. The provision of offering the QIP issue at a discounted price was introduced by SEBI in 2012 through an amendment to ICDR regulations. This provision of supporting the equity issue with regulatory base price also helps in controlling the variability of price of QIP issue.

2. Objective and Rationale of the Study

With the given regulatory structure as briefed above, QIP issues are observed to obtain premium over and above the minimum regulatory price. In this study, we argue that QIP investors will offer premium price over and above the minimum regulatory price only if they perceive that the existing ownership structure will reduce agency cost (by reducing monitoring cost) and increase governance efficiency. This effect is translated into value addition through the monitoring effect of II. Given the above, this study is aimed at analyzing the role of existing ownership structure in fetching the price premium for QIP issues in Indian market. We also try to evaluate the effect of other governance parameters in influencing the probability of price premium.

3. Design of the Study

The study analyzed 188 equity issues through QIP in Indian market between September 2006 and December 2014. The list of QIP offerings is collected from NSE website and issue details are obtained through the placement document of QIP. The data regarding various firm specific variables and ownership details are obtained from Prowess database.

In the model, we consider QIP premium as dependent variable and the ownership related variables as independent variables in addition to various firm specific and issue specific variables. The evidence in the extant literature indicate the potential endogeneity related problem with ownership variables since these are likely to be correlated with error term. For example, a large firm is more likely to have stable cash flows and less volatility in returns which would result in higher institutional ownership and higher QIP premium as compared to a smaller firm. This would negate the argument of a causal relationship between ownership variables and QIP premium. We address this concern by conducting appropriate econometric tests. Among the ownership variables, we consider the ownership categories of II such as foreign II, mutual funds, insurance and domestic financial investors to analyze the impact of typology of II on QIP premium.

4. Results and Conclusion

The study reveals that the existing ownership structure has a significant role in determining the price of QIP issues. Our empirical results reveal that existing ownership of insiders and II is significant in determining the probability as well as magnitude of the QIP premium. Based on this evidence, we interpret that the QIP premium is due to monitoring by existing II, thus, enhancing governance efficiency. As a result, new investors are ready to pay a premium price for the equity issue offered through QIP with the expectation of further value enhancement. The relationship between the probabilities of obtaining QIP premium is found nonlinear with the ownership of insiders and II. These results also hold true in determining the magnitude of the price premium. Both results support the argument that the ownership of institutional investors has a positive monitoring effect in reducing the agency cost and increase the governance efficiency up to a threshold level. Marginal probability analysis revealed that the optimum ownership stake of institutional investors is 35%.

Our empirical investigation related to different types of existing II reveal that different categories of existing II are insignificant in determining the probability of obtaining price premium. In other words the concentration of institutional investors has significant influence on governance efficiency. Our empirical investigation associated with other corporate governance characteristics indicates that dual role of CEO and Chairman of the Board is positively associated in determining the price premium. The separation of the roles of CEO and Chairman enables a mechanism to monitor the CEO and results in greater degree of board independence through effective monitoring. Contrarily, the dual role of CEO and chairperson is evaluated by considering the costs and benefits associated with the role of CEO. The separation of roles can lead to higher costs than benefits. The argument that promotes the duality of the roles is associated with easy and unified information flow at lower cost. Our result supports cost efficiency related argument associated with CEO duality in emerging markets (Brickley et al., 1997; Dey et al., 2011). The findings of this study provide important implications to the issuer while issuing equity through QIP. The study also provides insights to prospective institutional investors who are participating in the QIP issue.