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The Decision to Go Public: Does Business Group Affiliation Matter?

Suja Sekhar C., Jijo Lukose P. J.[2]

1. Introduction

Business Groups (BG) are a dominant organizational form in many parts of the world [Colpan et al. (2010), Randall and Morck (2005)]. BGs constitute a fascinating subject of study because though the component firms (also called as 'affiliates') are legally independent, they are bound by formal and informal ties and are accustomed to taking coordinated action as a group (Khanna and Rivkin (2001)). Also a single group would be present in multiple, often diverse industries ranging from steel to chemicals to software.

The emergence and growth of BGs in emerging economies is supposed to compensate for lack of well-functioning capital and labour markets, intermediaries, and network of suppliers and buyers. In India, nearly 70% of market capitalization pertains to BG firms (Marisetty et al. (2008)). While many aspects of these entities like their performance, tendency to support other group firms in times of distress, impact on innovation etc., have been examined, their decision to take one of their group firms public (i.e. initial public offering of an affiliate firm) appears to be unexplored.

Going public is considered a landmark decision in the life of a firm, one that promotes visibility, increases investor-base and provides currency for future acquisitions (Zingales (1995)). However, BG affiliates enjoy close relational ties with each other

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2 Suja Sekhar (Corresponding author) is a Fellow of the Indian Institute of Management, Tiruchirappalli, Tamil Nadu - 620024 (Email: suja.f12001@iimtrichy.ac.in). Jijo Lukose P. J. is Associate Professor at Indian Institute of Management, Kozhikode, IIMK Campus P.O., Kozhikode, Kerala- 673570 (Email: jijo@iimk.ac.in). The authors acknowledge with gratitude financial support from the NSE-IGIDR Corporate Governance Research Initiative 2014-15. The views expressed here are those of the authors and does not represent those of State Bank of India. This summary is adapted from Sekhar, S and Lukose, J (2017), 'The Decision to Go Public: Does Business Group Affiliation Matter?', NSE-IGIDR CG Research Initiative Working Paper available at https://www.nseindia.com/research/content/NSE-IGIDR-WP2-14-15.pdf

and have access to an 'internal capital market' that can fund projects or cover cash shortfalls. Thus, it is interesting to examine how BGs select one firm to go for an Initial Public Offering (IPO) from its portfolio of multiple unlisted eligible[3] affiliates. The present study also examines (i) the differences in motives between Standalones (non-BG firms) and BGs in going public and (ii) how BG heterogeneity can further explain this behavior.

2. Hypotheses

We conjecture that BGs may be able to provide an incubator environment to an affiliate firm for investing in a new project before the affiliate seeks external funding from equity capital markets via an IPO. This would mean that BG firms (as compared to standalone firms) can wait longer before listing. Secondly, going public entails large costs namely the fixed costs of going public (the fees and expenses at the time of listing) and the recurring auditing and reporting expenses that follow. The firm has to also take into account the biggest indirect cost of an unsuccessful IPO, namely the negative publicity and the possibility that it may never be able to raise equity capital again (Dunbar (1998)). We hypothesize that a larger BG firm with greater assets at its disposal would be better poised to bear the costs of listing. Thirdly, a BG has usually been in existence for many years, building reputation and investor confidence over the years (Micelotta and Raynard (2011)). This could allow a BG to take a less profitable affiliate public.

Amongst BG firms, we investigate the choice of affiliate that goes public along three dimensions; investment, relatedness and reputation:

- Investment is measured as the contribution of an affiliate as an investor in other group companies.
- Relatedness is measured as the similarity in the industry of the eligible firm[4] with the core firm in the BG.
- Reputation is measured as the absence of any bankrupt affiliate in the group.

3 A firm is considered as eligible to list if it satisfies the SEBI listing requirements for the year. Broadly these include net worth of Rs. 1 crore, net tangible assets of Rs. 3 crores etc.

4 The core firm is defined as the firm with the largest total assets in the BG.

The competing hypotheses relating to 'investment' can be explained as follows. An affiliate that invests more in other group companies may be retained as a private unlisted firm to preserve control. Or it may be listed to be able to raise capital that is subsequently utilized by the entire group. Along the dimension of 'relatedness', we hypothesize that listing an affiliate in the same industry as the core firm would mean lesser likelihood of investor rejection and reduced possibility of IPO failure. This is because the group has an already established reputation for expertise in that particular industry [Chatterjee and Wernerfelt (1991)]. Finally we examine the impact of the BG's reputation on the choice of affiliate to list. BG firms are known to support affiliates in financial distress to mitigate the possible damage to reputation that bankruptcy can entail (Gopalan et al. (2007)).

3. Data

To study the going public decision of BG firms, our paper uses probit regressions with a pooled sample of IPO-eligible firms during the financial years 2000-2014. The probit regressions seek to assess the impact of a set of financial and macroeconomic variables on the probability of a firm choosing between two options- to go for an IPO or to stay private. An eligible firm is an unlisted non-financial firm that satisfies the criteria for listing set by India's capital market regulator, Securities and Exchange Board of India (SEBI). A firm continues to be part of the sample until it goes for an IPO on either Bombay Stock Exchange (BSE) or National Stock Exchange (NSE) or both.

Our sample contains 417 firms that went for an IPO during 2000-2014 (See Figure 1 below); of these 110 are BG-affiliated and 307 are standalone firms. To arrive at the set of IPOs, we utilize a host of resources, namely, Centre for Monitoring Indian Economy's ProwessIQ database, Thomson Reuters' Thomson One database, trading data available on websites of BSE and NSE, final offer documents available on the SEBI website, Annual Reports of the companies, websites of leading business newspapers like the Hindu Business Line, Economic Times and Financial Express, and a website on IPOs viz., http://www.chittorgarh.com Financial data on firms is provided by ProwessIQ database.

4. Results

Our results indicate that consistent with the internal capital market hypothesis, business group affiliation decreases the possibility of listing. When comparing BG and Standalone firms we find that group affiliation has a moderating effect in that an older BG firm is more likely to list. A BG gives its affiliate an incubator environment to grow in (Ayyagari et al. (2009)). There appears to be no distinction between size of standalone and BG firms when it comes to going public. Profitability is found to be negatively related, indicating that a less profitable BG affiliate may go for an IPO as compared to a standalone. The standalone firm does not possess the privilege of a group name to fall back on and hence needs to be more profitable before it can access the equity markets. The BG could also be retaining a more profitable affiliate away from the mandatory disclosures of listing to preserve private benefits of control.

Amongst BG firms, investment has a positive impact indicating that the affiliate providing equity financing to other group affiliates is more likely to be taken public. The relatedness measure is not statistically significant and so we desist from deriving any conclusions from the same. Reputation, as evidenced by lack of any bankrupt firm in the group till the year prior to IPO, plays a positive and significant role in the choice of affiliate to list. In India, bankruptcy proceedings take more than 4 years to resolve, indicating that the damage to group reputation can be long-lasting. The need to access capital markets multiple times ensures that the BG puts its best foot forward. Our result is broadly in alignment with this 'preservation of reputation' hypothesis in that reputed BGs tend to take their affiliates public.

5. Conclusion

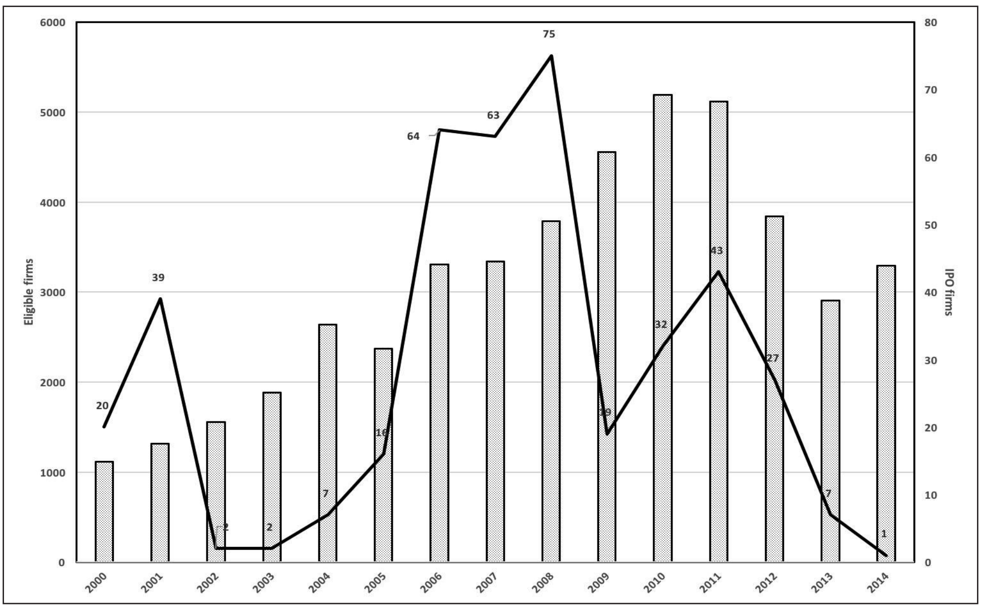
In this paper, we examine the going public decision of Indian firms with emphasis on the impact of Business Group affiliation. Here we document that consistent with the internal capital markets' hypothesis, BG affiliation negatively impacts the odds of listing. BG firms that go public are older and less profitable as compared to a standalone firm. This is consistent with international evidence that family groups are known for their ability to support high-risk, capital-intensive firms that may not be able to raise funds from external capital markets, especially if the markets are not well-developed (Masulis et al. (2011)). Amongst BG firms, investment and reputation increase the likelihood of the affiliate going public.

Table 1: Industry-wise Distribution of IPO Sample

Industry	Standalone	BG	Total
Information and communication	57	32	89
Consumer Nondurables	45	9	54
Manufacturing	42	9	51
Chemicals and Allied Products	33	4	37
Wholesale and retail trade	24	10	34
Health and Healthcare	18	8	26
Business Equipment	17	1	18
Consumer Durables	13	5	18
Construction*	31	15	46
Real estate activities	5	5	10
Transport and storage	5	3	8
Arts, entertainment and recreation	7	1	8
Education	6	1	7
Mining and quarrying	2	0	2
Others(Service-related activities)	2	7	9
Total	**307**	**110**	**417**

This table presents the distribution of the sample as per Fama-French 12 Industry Classification. *Categories from 'Construction' onwards provide the details of industries denoted as 'Others' in the said classification.

Figure 1: Annual distribution of Eligible versus IPO firms



This chart graphically represents a comparison between eligible firms that choose to remain private and IPO firms. A firm once listed is no longer treated as part of the sample.