

OWNERSHIP STRUCTURE, FINANCING CHOICE AND FIRM PERFORMANCE OF PAKISTAN MANUFACTURING SECTOR

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DECLARATION

I Hina Batool solemnly declare and affirm on oath that I myself have authored this MPhil Thesis with my own work and means, and I have not used any further means except those I have explicitly mentioned in this document. All items copied from internet or other written sources have been properly mentioned in quotation marks and with a reference to the source of citation.

Hina Batool

Dedication

To My Beloved Parents

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First, I give thanks to ALLAH for being merciful and giving me strength to complete this study.

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ABSTRACT

This study aims to inquire the area of corporate governance by identifying the role of institutional, foreign and government ownership in financing choices and performance of firms listed on Karachi Stock Exchange (KSE) Pakistan. Data of 100 non financial firms for the period of 2003 to 2011 has been used. This study shows that foreign ownership and government ownership enhance the firm performance as compared to the institutional shareholders. Institutional owners and foreign investors both influence financing choice taken by firm, but in opposite direction. Institutional investors use debt as monitoring device. With all other control variables financial reporting quality is also considered.

This study implies that Pakistani market discourages the use of leverage. Institutional owners prefer high leverage as compared to foreign ownership. Institutional investor's high preference is to lower the monitoring cost while foreign investors' aim is to reduce bankruptcy cost. So, management should pay high attention to set optimal capital structure.

Abbreviations and Acronym

	Karachi Stock Exchange
SECP	Security Exchange Commission of Pakistan
CEO	Corporate Executive Officer
PROF	Profitability of Firm
LEV	Leverage of Firm
IO	Institutional Ownership
FO	Foreign Ownership
GO	Government Ownership
ROA	Return on Assets
ROE	Return on Equity
DTOE	Debt to Equity
DTOA	Debt to Assets
GRW	Growth of Firm
TANG	Tangibility
LIQ	Liquidity
DY	Dividend Yield
AQ	Audit Quality

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CHAPTER#1

INTRODUCTION

A land mark study in the area of the ownership structure is done by Berle and Mean (1932). They have done pioneer work on 'separation of ownership and control' which started the debate on principal-agent problem. Subsequent Most of the studied explored the relationship between ownership type and firm performance and compared management controlled firms and owner controlled firms (Herman, 1981; McEachern, 1975; Sorenson, 1974; Lerner, 1971). The relationship is explained by Jensen and Meckling (1976) through as 'agency theory' and 'theory of corporate ownership'. Corporate governance is a mechanism that creates shareholder value through monitoring corporate affairs. It entails processes and structure that ensure the protection of interest of all the shareholders. Investors invest their money to increase their wealth. Corporate governance ensures that investor get return on investment and their wealth is protected against management expropriation. Investors rely on the mechanism to control management through compensation schemes, internal control mechanism and monitoring debt control. These mechanisms may differ geographically, leads to distinct system of corporate governance. These mechanisms may affect the behavior of the firm and in turn firm performance. There are sets of mechanisms that can best interpret the corporate governance that induce controller of the firm and the owner of the firm to make financing decision to maximize the value of shareholder wealth and firm. The objectives of these

mechanisms, external or internal in nature solve the principal-agent problem by reducing 'agency cost'. Internal mechanism deals with CEO, chair person and board of directors. Ownership is another important internal mechanism; there are two key features of ownership structure its composition and concentration. Firstly the recent studies shows that Asian firms are family oriented so, said to be highly concentrated. Second, its composition that means who is the owner or the shareholder of the firm that includes family, government, companies, institutions, individuals, and foreign companies also. Ownership structure can be divided into insider and outsider owners. Inside owners include employees and managers and outsider can be divided into individuals, institutions and government. These specifications vary from country to country. The study of ownership structure is of great importance due to its linkage to the capital structure interrelated through agency problem and its strategic impact on firm value.

Agency relationship conventionally is the conflict of interest between the principal and the agent. In financial term agency relation bears a cost as a type of internal cost arises when managers (agent) act on the behalf of the shareholder (principal) but take decision in divergent to their objective. This conflict of interest result in weak decision of firms leading to the agency theory which highlights that principal and agent's different goals and capacities influence the corporate behavior and outcome (Milgrom and Robert 1992).

Berle and Means (1932) explored the conflict between managers and shareholders and argue that outside shareholders are too dispersed to monitor managers so; the resources are used to satisfy managers self interest rather than other shareholders wealth

maximization which is the main purpose of the company. After this study researchers tried to address and highlight the problem in many studies. In the earlier study, Williamson (1963) view that management always has preference of utility maximization of management and staff over profit maximization of shareholder and reason is owner's inability to monitor.

The root cause of agency problem is information asymmetry, limited liability of debt financing and controlling interest of partial ownership. If the financial and human capital markets are unable to resolve the agency problem without cost it may reduce the market value. The new institutional economics constitutes the principle agent theory consider institutions nexus of contracts of complex nature. The reason of this contractual conflict is information asymmetry and transaction cost which affect the contractual parties' utility. The information asymmetry add positive to the utility of agents only on the cost of other parties and such harmful action cannot be avoided by the principals.

Ownership structure as a mechanism of corporate governance influence the firm performance along with the agency cost as its existence is accepted. Excluding the effect of agency cost the dependency of firm performance on ownership structure is not found. Earlier studies show that this relation is two folded. One dimension is the ownership concentration and other is the identity. Ownership concentration is said to be concentrated when one or few owners control firm activity effectively. In Asian countries like Pakistan most of the firms has concentrated ownership as compared to the diffused ownership in UK and USA. The studies showed that in firms with diffused ownership,

the agency problem arises due to conflict of interest among managers and other outside shareholders while in concentrated ownership the problem is of different nature it is the conflict between minority shareholders and the manager or the controlling shareholders.

In ICMAP research report 2011 showed dominant presence of institutional investors in Pharmaceutical, Fertilizers, Sugar and Cement sector with 94% of institutional shareholding in Wyeth laboratories, 84% in Dawood Hercules, 74% in sugar mill Mirpurkhas and 48% in D.G Khan Cement respectively and also found 72% shareholding in Fauji Fertilizer Company.

In the global financial market institutional investors play a very important role. In the world of financial market institutional investors through their expertise not only manage firm financial decision but also improve market features by influencing corporate governance, market psychology and by improving disclosures and liquidity

Institutional investors enhance corporate governance and transparency because they are in better position to influence firm management and they have more influence over their target because of their large pool of assets as compared to other investors. This leads to better control over their investment and it plays main role in enhancing corporate governance.

Institutional investors are capable to provide professional service. They provide better risk management through their broad investment policies and procedure to achieve more stable and high returns to their investment. They have potential to exploit economies of

scale to bargain the costs and can broaden their research by hiring professional with high quality investment expertise.

1.2. RESEARCH QUESTION

- Does institutional ownership influence the corporate financing choice and of firms in Pakistan?
- Does audit quality play any role in determining Capital structure and corporate value?
- Is there any role of state ownership in determination of capital structure and firm performance?
- Is there any role of foreign ownership in determination of capital structure and firm performance?

1.3. OBJECTIVES OF THE STUDY

This study focuses on the connection between institutional ownership, financing decision and corporate performance of companies listed at Karachi Stock Exchange (KSE). Institutional investor includes financial and non-financial institutions.

The objectives of the study included are:

- To provide insight about the role of institutional ownership in corporate financing choice and firm performance
- To explore the role of foreign ownership in performance and corporate financing choice of firm
- To provide insight about the role of government ownership in corporate financing choice and its influence on firm performance
- To identify the determinants of institutional, foreign and government ownership

1.4. SIGNIFICANCE AND CONTRIBUTION

In Pakistan most of the studies considered ownership concentration and managerial ownership as their main focus. There are few studies done on ownership identity or mix in relation with dividend policy and firm performance. Ownership of other than managers or family are still unexplored so, there is need to extend the work to other types of ownership. Some prior studies showed significant relation between ownership structure and firm performance while some studies showed insignificant relation as there observed that ownership structure affect the firm performance through the channel of financial decision process. In this study latter view is extended for institutional ownership in manufacturing sector of Pakistan.

Prior studies concentrated on the concentration of ownership, as in Pakistan most of the companies are owned and controlled by families because the corporate culture is still in developing phase. But now institutional investors are also playing influential role along with other shareholders. Numbers of studies on corporate governance are done on the insider ownership and their concentration, ownership type or mix and this topic still needed to be explored from different dimension.

Institutional investors as large shareholders have power to influence the decision and efficiency of the firms. This study contributes by providing evidence on connection between firm decisions and efficiency with institutional government and foreign ownership along with the consideration financial reporting quality.

In addition this study will also focus on monitoring effect of institutional investors; as they can be a very favorable for improving corporate governance and firm performance.

1.5. PLAN OF THE STUDY:

The remaining part of the study is organized as follow. Second chapter reviews the literature on the issue. Third chapter describe the model specification, methodology data and variable description used in the study. Fourth chapter presents empirical findings of the study. Last chapter concludes the study and present the policy implication of the study.

CHAPTER#2

THEORITICAL BACKGROUND

Agency relationship is defined as a “contract” by Jensen and Meckling “which involves delegating some decision making authority to agent”. Study of such conflict became a major part of economic literature.

The principal-agent theory has its central role as it argued that manager’s action cannot be controlled costlessly by the outside shareholder. This study emphasized the importance of ownership structure. Jensen and Meckling (1976) identifies following costs

- Monitoring cost
- Bonding cost
- Residual loss

Principal monitoring cost arises when shareholder’s monitoring activities designed to limit manager’s harmful action increase. Managers take certain actions to assure the shareholders that their actions would not harm their interest. Despite of all these optimal expenditure the result are not encouraging as there is still a loss due to difference in manager’s decision and the decision for the shareholder’s wealth maximization. This bears a cost due to agency relation and is termed as residual loss.

Agency cost can be minimized in different ways by concentrating the ownership especially involving institutions that can monitor efficiently as compared to other

shareholders. Secondly by incentive alignment argument suggests that encouraging managerial ownership in firm can also decrease agency cost. Free cash flow hypothesis argues that by acquiring debt managers left with little cash at their discretion.

There are different hypothesized effects of ownership structure on the firm performance. First Jensen and Meckling (1976) argue that greater the insider ownership it would better align the manager incentive with other shareholder hence reduce the agency problem contributing toward better performance. James (1998) and Stein (1989) focus on the family ownership and argue that such firm emphasize on long term goal so have positive contribution through better investment decisions. Third blockholders other than management through their controlling and monitoring capabilities would have beneficial impact on firm performance.

There are some reasons implying negative relation between firm performance and ownership concentration (insider or outsider). First, the increase in the level of control, increase the conflict of interests of controlling and minority shareholders so main purpose and goals of business operations are put aside. Second investors acting as controlling shareholders take decisions and policies according to their desire which maximize their personal benefits. Third firm with concentrated ownership due to their risk-averse behavior follow those strategies which give low profitability. It happens in most of family owned businesses. Fourth controlling share holders can get private benefits facilitated by separate control and cash flow rights which weakens their alignment of interest with

minority shareholder (Johnson et al 2000 DeAngelo (1985). So, there is no clear effect of ownership structure on firm performance due to the two-way interdependence.

In the corporate sector the ownership structure not only deals with concentrated ownership but also ownership type or mix. And different ownership structures have different impacts on firm performance and operations. The ownership types include insider owners, government, family and institutions etc.

Institutional ownership in the equity market obtained great attention with the growing market. Institutional owners are of different nature domestic, financial, nonfinancial, and foreign etc. Connell and Servaes (1990) discuss the relationship between corporate value and ownership structure in three ways. First, the *effective monitoring* argument, which states that institutional owners can monitor management cost effectively as compared to the other small and dispersed shareholders. This is due to the greater expertise of institutional investors adding positively to the firm value. Second, according to the *conflict of interest* the institutional investors build intrapersonal business relationships with firms and persuade other shareholders through their voting rights consider only their own benefits such activities would have negative impact on the firm performance. Third, *strategic alignment* suggests that institutional owners consider it advantageous to cooperate with the management and work for both parties' benefits which reduce the beneficial impact of monitoring effect on the firm performance.

Institutional investors through agency cost, information asymmetry and tax may affect the capital structure of firm. Institutional investor relationship with capital structure is of

interesting nature. Institutional owner through effective monitoring effect reduce the cost and act as substitute to debt, and they may also act as complements. Institutional owner decrease the information gap and reduce the agency cost driving the firm toward more equity financing and in other case institutional owners provide opportunities to outside investors to use device such as debt that limit wealth expropriation and thus better align the goals of management by increasing investor protection. Institutional ownership is negatively associated with leverage. Keeping in view the relevant theories of capital structure and some institutional characteristics, it can be suggested that interaction between these friction (agency cost and information asymmetry) and institutional investors is quite logical. Jensen and Meckling (1976) argue that over-indulgement of managers in activities is only beneficial for them as it is incentivized by conflict which is costly for the achievement of goals. So, the institutional owner acts as effective monitors by reducing agency cost and can influence the capital structure.

Some studies suggest that agency conflict drives capital structure La Porta et al. (2000) proposed two models, the substitute model and outcome model. The substitution model suggest that firm with institutional holdings may need less debt. Institutional investors attract outside investor by providing protection. The other model views that institutional investor limit the wealth tunneling and may force the management to implement law and increase investors protection and empowerment.

Capital structure may be chosen by firm in response to the information environment in which these operate. Generally firm with high level of information asymmetry may prefer debt over equity because of the low adverse selection cost than equity.

Institutional investors are more informed than any other investor as these have considerable resources to collect information. High institutional holding should have low leverage because the information gathering and trading reduce the information gap that in turn reduce the adverse selection cost of equity raised due to the asymmetric information. Institutional investors have relative tax advantage over other investor as many of them are tax exempted so, high institutional holding favor issue of equity.

Institutional investors are more informed type of investors than others so, they play a very important role in capital structure decision by reducing information asymmetry gap and their economic stake increase with the increase in the ownership because they have incentives to monitor management to protect their investment and can also control managers through their voting rights and debt acts as internal control mechanism on management. Institutional shareholding and debt may act as substitute or complements.

In the world wide corporate governance mechanism institutional investor becomes increasingly important because of their capability to monitor firm management and lowering the agency cost which adds positive to the firm performance and on the other hand they align their benefits with the management which may lower the firm value.

In emerging economy the state involvement in the economy not only regulates the private sector but also offer incentive to various sectors. Government owned firms produce

consumer, agriculture and industrial goods. Government owned firms are regulated and get incentive and show better performance. The *property right theories* of firms suggest that government owned firms show weak performance as compared to other firms. The impact of government ownership remained unclear because it involve monopolies, institutional framework also influence the impact of government ownership on the firm performance. In market imperfect business strategies lower the position of the firm. This competition also influence government owned firms. The competition forces enable the firm to raise capital needed to finance the firm.

Government owned firms have direct influence on the market and incentives do not prefer external financing. This is because government owned firm has lowest default risk due to low debt levels.

Ownership influence firm performance differently due to difference in goals, power, incentives, monitoring abilities and resource. Foreign investment flows between industrial, developed and developing economies. This flow of investment from developed to emerging market is of great importance. Foreign shareholders influence differently because they have different market cost. Legal frame work is also improving.

Resource based theory proposed that firms get comparative advantage which is due to the possession of rare and valuable resources. In the emerging economies this difference exists between different shareholders. Being either domestic or foreign owner, the impact of owner on firm is different. Foreign owners with diversified resources and monitoring capabilities contribute to improve firm performance.

In Pakistan most of studies are focused managerial ownership and other ownership identities are not explored to that extent. Most of the firms operate under inside owners individual investors; large institutional investors are also attracting attention of academics. Institutional investor role has enhanced from last few decades with this passage of time promulgation of Code of Corporate Governance 2002 is also contribute to regulate the active participation of shareholder in the business activities of the firms.

This study is an effort to explore role different ownership identities in determining the firms' behavior. These ownership identities include institutional ownership, foreign ownership and government ownership. This study is an attempt to bridge this gap.

CHAPTER#3

REVIEW OF LITERATURE

3.1. INTRODUCTION

Financial decisions are related to the capital structure decision. Capital structure and firm performance has significant and positive association. Ownership structure influence firm value through financial decisions. Capital structure as important determinant of dividend policy has negative impact. It means that highly leverage firm avoid high dividend payout policy. Dividend policy of a firm as a part of financial decision positively and significantly influences the firm performance because in emerging market firm signal their high market value by distributing dividend (Gul 1999, Adaogul 2000) and outside blockholders demand high payout ratio which in turn enhance the monitoring process (Farinha 2003) and it creates tax benefit also. In developing countries the ownership is concentrated, relatively small number of shareholder possess major shareholding which are the government, institutions and individuals (Omran et al 2008), whereas ownership structures is highly diffused in the developed countries having potential for managers and shareholder conflict. Ownership type has different hypothesized impact. In this study the motivation of ownership structure is to maximize firm value so the impact is expected to be positive as more monitoring of managers improves the firm performance.

3.2. INSTITUTIONAL OWNERSHIP

The relevant literature shows the consideration of shareholder identity. Different authors argued that the monitoring cost of managers and objective function vary substantially for different types of owners. The implication is that, it is important, not only how much is shareholder concentration, but also who this shareholder is, that is, an individual shareholder, manager, financial and non-financial institution, foreign investors or government (Welch, 2000; Xu and Wang, 1997) (Shleifer and Vishny, 1997)

Institutional ownership as compared to individual investors are considered with more willingness and capacity to supervise manager. The separation of control and ownership creates the agency problem and institutional ownership enhance the corporate governance mechanism by mitigating this problem Federal Reserve Financial Economists report (1998) concludes that institutional investors monitor the activities of managers and their decisions at the lower cost which mitigates the agency problem. Secondly with their increase shareholdings, institutional investors supervise the activities of managers and with expertise, these shareholders intrude the manager's profit minimizing decision.

The increasing benefits of the institutional investors have a positive influence on firms activity and in turn its performance as hypothesized by Pound (1988). The empirical studies done by Brickley, Lease and Smith, (1988) support the monitoring role of institutional investor on managers. The *efficient monitoring hypothesis* is opposed by two other hypotheses predicting a negative relationship between firm performance and institutional ownership. The *strategic alignment hypothesis* proposes that insider and

institutional owners cooperate for mutual benefits which reduce the net profit of investors and it may be due to inter business relationship of firms with institutional owners. The *conflict of interest hypothesis* suggests that they may use their voting rights against the manager creating divergence of interests damaging the business relationship with managers.

Number of studies has been conducted to examine the role of institutional ownership to influence firm performance positively or negatively. Following the study of Pound (1988) study these hypothesis were examined by McConnell and Servaes (1990) and reported consistent result of positive association between institutional ownership and firm performance measured by Tobin's Q. Other studies Alfaraih et al. (2012) also support the monitoring hypothesis and compare the institutional and government ownership. Mutairi (2011) report positive relationship between the institutional ownership and firm performance in Kuwait. Same results are reported Crutchley et al. (1999) this study highlight the importance of R & D expenditure and Institutional investors for their monitoring activities for profitable firm. Hsu and Wang (2013) reveal that firm profitability is positively related to institutional ownership and institutional owners have preference for profitable corporations. Effective control theory is also support by Salehi et al. (2012) who argue that firm value and institutional investors has positive and meaningful association.

Different studies also consider the non linearity of the ownership. Mutairi (2011) found absence of nonlinearity in case of government and institutional ownership. But Salehi et

al. (2012) support profit theory which constitutes that institutional ownership concentration adversely influence firm performance and this study conclude the non linear relationship of institutional ownership and performance. This study proves the Convergence of interest hypothesis and entrenchment hypothesis opposing the results of Mutairi (2011). New dimension of ownership by Bhattacharya and Graham (2007) explore the typology of ownership by further categorizing into pressure sensitive institutional owners (banks, and non-bank trusts and insurance companies) and pressure resistant owners for 116 firms of nine different industries of Finland. It proposes a two way causality between institutional investor and firm value, significant adverse effect of institutional owners is reported. While other study done by Chen et al. (2008) report that in less diversified market of New Zealand institutional owners and managers build strong relationship and become less focus on the monitoring. This strategic alignment adversely affects the firm performance. Empirical analysis reveals that institutional managers by themselves create new type of agency problem. The New Zealand institutional investors prefer to invest in firm of large size with low director equity stake.

Huyghebaert and Hulle (2004) discuss the role of institutional investor in corporate finance in the context of IPOs of Belgian firms from 1984 to 2000 and reported that stock prices are positively related to the institutional owner. Companies issuing shares for funds generation mostly place to the institutional investors which reduce the underpricing value and increase the liquidity which shows future activity in stock market by the conveying information regarding companies. Institutional investor contribution toward the corporate governance is found unclear. Firms are less likely to be monitored rather

they pre-allocated shares to institutional investors and such firm has high fraction of inside directors in the board. Institutional investor as compared to small investor has not only large amount to invest but also more resources on hand to monitor firm decision making process and performance. These investors reduce the cost of capital and increase liquidity by decreasing harmful level of information asymmetries and the improve quality of corporate governance and has beneficial impact on IPO companies.

Agency theory has always been remained topic of interest as financial decisions are found linked with agency problem. Crutchley et al. (1999) hypothesize that managers, dividend, leverage and institutional ownership to address the agency cost for the period of 1987 and 1993. In late 1990's institutional investors employ agency control mechanism such as managerial ownership, leverage and dividends. Apart from monitoring the conflict of interest hypothesis is supported by Cornett (2004). Maug (1988) concludes that short term oriented goals of institutional owners and liquidity of their holdings offset the incentives to monitor managers driving to long term profit. Similarly in a cross-sectional study McConnell and Servas (1990) and Clay (2001) discuss for long term relationship and report no evidence. In the earlier literature the negative influence due to high concentration is ignored.

Institutional owners through agency cost and information asymmetry influence a firm's capital structure. Institutional investors play a positive role by reducing conflict of interest (Shleifer and Vishny 1986, Admati and Pfleiderer 2009, and Levit 2012) and information asymmetry associated to the equity (Sias 2004, Bushee and Goodman 2007). Number of studies has been done on capital structure of firm. In the last century most of

the literature focused on the trade off and pecking order theory of capital structure. These studies identify some key factors of capital structure such growth, size and tangibility (Titman and Wessels, 1988, Rajan and Zingales, 1995 and Booth et al., 2001). Other than these determinant agency theory proposes that agency cost arise due to the conflict of interest between the share holders and different corporate governance mechanisms intend to mitigate this cost which influences the financial structure choice (Hassan and Butt 2009). Changes in the capital structure decision can solve the agency problem. Agency cost not only rise between managers and other shareholders but also between debt holders and shareholder (Jensen and Meckling, 1976). It is expected that an increase in debt, constraint the management activities and indicate its willingness to pay the cash out (Harvey et al., 2004) while the risk of bankruptcy in case of non-payment of debt drives the management toward better investment decisions (Grossman and Hart, 1980) to minimize the bankruptcy risk. Jensen and Mecklings (1976), Myers (1977), and Smith and Warner (1979) argue that with the increased usage of debt can cause assets substitution problem. Debt can be a riskier alternative and its cost increases as the firm undertake riskier investment. This indicates overinvestment in the risky projects which is not known to the debt holders. Chaganti and Damanpour (1991) divide firms controlled by management into low and high institutional ownership and state that degree of influence of outside institutional owner on capital structure and firm performance can be changed by internal alliance such as insider institutional owners, family owners and corporate executives. Outside institutional investor's size effect capital structure significantly and this relationship is moderated by inside institutional and family

shareholdings while the executive shareholdings enhance the relationship between the outside institutional investors and firm value. The result contradicts with the view of conflict between executives and owners but in favor of argument that managers align their interests with those of shareholders (Jensen and Meckling (1976)).

Chen et al. (2008) report that corporate decision are mostly influenced by institutional investor as they have real interest and ability to influence more than the small investors Brailsford et. al (1999) identify a significant relationship between firm leverage and distribution of ownership between external blockholders and managers. Leverage can be reduced by external blockholders as they reduced the managers opportunity to get personal benefit due to the incentive and capability of monitoring managers which supports active monitoring argument. The relationship between leverage and external blockholder changes with change in the managerial ownership level. At low level of managerial ownership the external blockholders and leverage are associated positively because of the combine effect of external blockholder's monitoring effect and managerial ownership's convergence of interest effect while high managerial ownership induce the entrenchment effect which diminishes the blockholders monitoring effect. Management ownership and leverage ratio indicate positive relation (Short, Keasey and Duxbury (2002)). However an opposite relation is observed between financial leverage and large external share holders, these shareholders affect the agency cost of equity financing and debt financing (Hasan and Butt2009). The literature provides that institutional investors may act as substitute or complements of debt.

Empirical evidences show that capital structure decisions vary around the world subject to specific assumptions and condition. Eldomiaty and Ismail (2009) argue that dynamic business affair causes changes in firm's capital structure in developed countries. The capital structure decision vary from the countries in underdeveloped region. The use of debt financing gives benefits to firms but it also bears a cost. Ross et al. (2008) argue that firm can only optimize their maximum profit when the marginal cost and marginal benefits are equal. Firms follow its target debt Myers (1984) point two classification of target debt when the trade-off between cost and benefit of debt is for one period it is static trade off. Second, it adjusts changes with the changes in cost and benefits of debt over the time. Barry et al. (2008) ignore the target debt equity ratio and argue that level of leverage changes with need and other factor of firm. Huang and Ritter (2009) and Bancel and Mittoo (2004) support the trade-off theory and Miguel and Pindado, (2001) also support the free cash flow theory for the Spanish corporations. Cook and Tang (2010) conclude that developed countries firms adjust their capital structure rapidly in boom and recession. Beattie et al. (2006), Antoniou et al (2008), Huang and Song (2006), Teker et al (2009) and Drobetz and Fix (2005) provide evidences supporting both the trade off theory as well as pecking order theory. In developing countries corporate leverage constitute of long term and short term debt (Booth et al. 2001). Pecking order theory suggest that profitable firm prefer internal financing so profitability and debt of firm have a negative association other studies like Tong and Green (2005), Brounen et al., (2006), Allen and Mizuno (1989) and Mazur (2007) support pecking order theory. In case of Pakistan corporate structure follows the pecking order theory (Qureshi 2009).

Trade off theory with bankruptcy cost constitutes a positive relationship between leverage and tangibility while the market timing theory suggests a negative relationship between leverage and tangibility. Bas et al. (2009) state that in developing countries leverage and tangibility has negative relationship. It means that firms borrow less when tangible assets increases collateral while opposite results are reported by Rajan and Zingler (1995). Huang and Song (2006), Titman and Wessels (1988) report that firm borrow more when tangibility increases collateral. Ali (2008) and Hijazi and Shah (2008) support trade off theory and report positive relationship between leverage and tangibility.

Firms with more tangible assets are supposed to be more secure from bankruptcy and institution prefer such firms. Al Najjar and Taylor (2008) argue that institutional investors prefer firms with less tangible assets which decrease collateral to borrow less.

Graves and Waddock (1990) suggest that agency problem can be resolved by institutional owners as these are professional decision makers and can influence the firm performance and managers which alters the agency cost dividend policy. Agency cost based explanation for dividends is provided by different studies. Earlier studies show that the monitoring effect of institutional owners on managers of the firm reduces the agency cost. Dividend payment expose the firm to the capital market by disciplining the management reduce the agency cost. So, firms are less interested in agency cost when institutional owners acting as effective monitors with high degree of holdings and reduce the dividend. Dividend payout and institutional holdings are predicted to be inversely related (Al-Najjar, 2009). Grinstein and Michaely (2005), Wen and Jia (2010), Maury and Pajuste (2002) report negative relationship between dividend payout and institutional

ownership. Gill (2012) report inversely relation between institutional owner and dividend for four different cases holding size, profitability and leverage constant. Kouki and Guizani (2009) analyze that most of the institutional investors are debt-holder so to avoid dividend payment to other shareholder they have a preference of interest payment to themselves. According to the signaling theory dividend payment signals the good performance of the firm but presence of institutional ownership signal firm's good efficiency and reduce the use of dividend as signal (Zeckhauser and Pound 1990). It is not necessary that firm has better future prospect even though they posses superior information regarding firms position in market so, there exist a mix relationship between institutional ownership and dividend policy (Short et al., 2002). Agency theories on dividend payout support the negative association between payout and institutional investors, reducing cash flow to management discretions. This theory is supported by different empirical studies which (Rozeff, 1982; Easterbrook, 1984; Jensen, 1986; Eckbo and Verma, 1994). Crutchley et al., (1999) report positive association between institutional investors and dividends. Positive relationship between dividend policy and institutional ownership is predicted by tax- based hypothesis which constitutes that institutional investors due to tax differential treatment prefer dividend over capital gains. Wiberg (2008) reports positive but marginally diminishing trend between dividend and institutional investors for Swedish companies. Jensen, Solberg, and Zorn (1992) provide evidence about positive association between payout and institutional investors and Han et al. (1999) also support tax based hypothesis using tobit model which suggest dividend clientele effect. Manos (2002) provide evidence that in case of Indian firms institutional

investors prefer dividend payout. Obema et al. (2008) reveals that institutional investor vote for higher dividend payout ratio which enhances monitoring of management.

In Pakistan the financial sector and corporate governance is in the developing phase. Afza (2010) state that, due to this reason firms management do not efficiently monitor and have greater tendency to increase their cash flow by lowering the dividend payout. Shah (2009) find positive association between institutional owners and dividend policy in Pakistan. While other study by Saif et al., (2013) concludes that dividend payout and institutional investors are inversely related supporting the finding of Kumar (2003) on India. So, it is summarize that agency cost based hypotheses suggest negative relationship between dividends and institutional ownership. Tax based hypotheses suggest positive correlation between dividends and institutional ownership

Hasan and Ali (2009) using a sample of 59 firms concluded a negative significant association between managerial ownership and leverage while a positive and insignificant association between the institutional ownership and leverage. "Concentration of ownership by parties other than a firms management, whether by individuals or institutions, is supposed to spur the monitoring capacity of the blockholder. Brailsford et al. (2002) provide support for a positive relation between external blockholders and leverage, and suggest that this correlation varies across the level of managerial ownership. Moreover, Chaganti and Damanpour (1991) show evidence that the size of outside institutional shareholding has a significant impact on a firms capital structure. Nevertheless, Holderness and Sheehan (1988) state that large blockholders or their

representatives almost always serve as directors or officers in the firm where they invest, thus their ownership should be included to that for managers. Institutional owners are capable of advising the firm to improve corporate governance because they influence various vital decisions of firm (Shleifer and Vishny 1986, Hartzell and Starks 2003)”. They can also recommend about choice of auditor Han et al. (2009) suggest that long term institutional investor employ corporate governance mechanism by hiring big4 audit companies reducing the monitoring cost. Alfaraih (2012) also report significant role audit quality in improving firm performance.

According to the above discuss it is hypothesized that

H₁: Institutional ownership have a significant impact on firm performance

H₂: Institutional ownership and leverage are significantly associated with each other

H₃:There expect a significant relationship between firm performance and leverage

3.3. GOVERNMENT OWNERSHIP

Firm financial decisions are not only depended on their characteristic but also the monitoring and enforcement mechanism provided by the authoritative institute in the financial system. Empirical studies done by Rajan and Zingales (1995), La Porta et al. (1997), Booth et al. (2001), and Giannetti (2003) provide that financing decisions of the firms are influenced by country’s financial system development and governance framework. Shleifer and Vishny (1994) suggest that government ownership has political

goals at the expense of other shareholder in the firms whereas Dewenter and Malatesta (2001) argue that state owned firms as compared to private firms are highly leveraged. Sun et al., (2005) report negative association between government ownership and firm performance. Joher et al (2008) reveals that government linked companies exhibit high performance and low leverage records. Douma, George and Kabir (2006) report that association between firm performance and ownership structure are subject to the goals of owners while Kräussl and Lucas (2011) add that this association varies region to region.

Borisova et al. (2012) argue that State ownership may be positively associated with the firm performance because state owned firms are in advantage. These firms can access resources as compare to other firms and can generate fund easily. The role as state institution gives these firms an opportunity to have easy access to the credit market to finance their projects.

Kang and Kim (2012) suggest that state ownership improve the firm performance of Chinese industry. Najid and Abdul Rahman (2011) find positive impact on performance. In another study it is further argued that there may exist a negative association which is due to politically rather than commercially motivated goals.

Government owned firms are not profit driven and the motivational level to enhance firm performance is near to negligible due to lack of incentives and monitoring mechanism leading to misallocation of firm resources so it may affect performance negatively.

Thomsen, Pedersen and Kvist (2006) identify two systems i.e. control based system and market based system. First system is characterized by high ownership by government,

corporate and family. While second one is a system of disperse ownership among individuals, financial and non financial institutions and other shareholders. It reveal that in control based system there exist a negative relationship among firm performance and blockholder ownership and no association is found in case of market based system. Andres (2008) support the negative association between firm performance and state ownership and argue that state representatives in the firms work for their own private benefits rather than for the welfare of the state. Majumdar (1998) observe that state owned firms has weak performance as compared to firms with private ownership and mixed ownership. Studies conducted by Ramaswamy, (2001) in India also draw the same results.

Jiang (2004) report that state shareholding has positive correlations with performance of Chinese state owned firms. Chen Xiao (2000) report positive correlation between firm profitability and institutional shareholding while negatively correlating with state ownership. Alfaraih et al., (2012) report negative relationship between firm performance and government ownership. There exist a mix relationship between government ownership and firm performance and institutional ownership. on the basis of above discussion it is hypothesized that

H₄: There exist a significant relationship between government ownership and capital structure

H₅: There exist a significant relationship between government ownership and firm performance

3.4. FOREIGN OWNERSHIP

Globalization and foreign engagements in emerging economy has positive influence on the financial growth of the host country Javid and Iqbal, 2008 question the link between capital structure and firm performance. Ramachandran and Shah (1998) provide evidence that foreign ownership has positive influence on firm value. Earlier literature shows that capital structure maneuvers the agency problem in term of managerial, institutional and other large blockholder ownership (Agrawal and Knoeber 1996). In transition process foreign investor's capital relax the borrowing constraint to the firms and the foreign ownership signals the credit worthiness of the firm (Csermely and Vincze, 2000). Foreign ownership is medium of economic growth, local firms always welcome foreign investors as they get benefit from capital inflow and technologies and professional expertise (Csermely and Vincze 2000). The foreign ownership may influence the capital structure in two ways. According to Gurunlu and Gursoy (2010) foreign investors diversify earnings, lower the fluctuations in the cash flow and risk of so such firms maintain higher leverage as compare to the other firm so leverage and foreigner ownership are positively related. On the hand firm with high shareholdings by foreign owner generally hold their retained earnings and prefer internal financing thus lowering the leverage level. This negative association is also supported by Li et al., 2009 and Lee and Kwok, (1988). Egger et al., (2010) argue that higher foreign ownership lead to higher leverage ratio due to corporate tax regulation of the host country. Government rule and regulation affect the foreign ownership level in a country so investors prefer to invest in their own country because they expect a high return from domestic equity market as compared to the other

market (French and Poterba, 1991) but Bartramet al., (2010) opposes and argue that international investors aspire to maximize the returns by diversifying the risk.

The inflow of foreign capital brings complexity to the domestic market. Firms always seek optimal level of the financing mode i.e. through retained earnings, equity or debt financing. Gedajlovic et al., (2005) report that foreign investors are associated with low investment and high dividend. Yudaeva et al. (2003) argue that foreign ownership have higher productivity than domestically owned firms in Russia. Emerging market has great importance for foreign investors. Douma, George and Kabir (2006), report that foreign ownership has positive association with the firm performance because such investors monitor corporate governance mechanism of firms. Boardman et al., (1997) report the difference of firm performance due to the foreign ownership. Gurbuz and Aybars (2010) state that foreign ownership add value to performance through technological innovation and provision of financial resources to the local market.

So it is hypothesized that:

H₆: Foreign shareholder and debt of firm are inversely related

H₇: Foreign investors and firm performance are positively related

There are different studies focusing on the corporate governance of Pakistan. Cheema and Bari (2003) did comparative analysis of corporate governance system of Asian countries including Pakistan. Javid and Iqbal (2007) construct composite index of corporate governance and indicates that efficient corporate governance mechanism

increase the firm perform. Study by Hasan and Ali (2009) relate corporate governance with managerial and institutional ownership. These studies are done after the proclamation of corporate governance. And with the gradual advancement in the financial sector it is needed to explore the role of other ownership identities. Pound (1988) and McConnell and Servaes (1990) test different hypothesis for ownership structure. In case of Pakistan the role of other ownership identities are not explored to that extend as compared to the managerial ownership. This study incorporates different ownership identities in relation with usage of leverage by the firms and their performance. This study also incorporates external corporate governance mechanism. Most of the studies support efficient monitoring role of institutional and foreign ownership enhancing the firms' profitability. And they also alter the financing choice of the firms. Majority of the study is done on developing economies and the results of emerging economy are quite different from the other studies.

CHAPTER #4

DATA AND METHODOLOGY

4.1. DATA AND SAMPLE SELECTION

The study is conducted to examine the relationship between institutional government and foreign ownership with financial decisions and firm performance of 100 non financial companies listed on Karachi Stock Exchange. Data on manufacturing sector have been taken From Karachi Stock Exchange and financial statement analysis published by State Bank of Pakistan. The data sample period is 2003 to 2011 such period is taken as ownership information is reported after the promulgation of code of corporate governance in 2002.

Data on the shareholdings of institutional, foreign and government has been taken from annual financial report of individual companies.

4.2. VARIABLE DESCRIPTION

Institutional ownership

Presence of institutional investors in company aid in two ways. Firstly these investors act as effective device of monitoring company decision and reduce the agency cost and increase the profitability. Secondly these institutions may act as a source of long term

financing and ready to offer debt to those companies under their influence. This conveys positive sign to public and other creditor. Institutional ownership is measured by the institutions shareholdings reported in annual reports.

$$IO = \frac{\textit{Total shares held by institutions}}{\textit{Total Share outstanding}} * 100$$

Government Ownership

Government ownership is represented by percentage of shareholding by the state. State ownership has different goals; their objective is different from the goals of other investors that is focused on maximization of wealth. In the case of dominant government ownership presence of independent directors is an incentive to monitor management effectively which improve the performance of the firm. Government ownership is measured by using following formula

$$GO = \frac{\textit{Total shares held by state}}{\textit{Total Share outstanding}} * 100$$

Foreign Ownership

Shareholdings percentage of foreign investors is used to measure foreign ownership. Foreign capital investment always adds value to the firm. Presence of foreign investors are likely to enhance firm performance. Such investors may contribute through better

monitoring of the firm to enhance firm profitability. Foreign ownership is measured by using this formula

$$FO = \frac{\text{Total shares held by foreign investors}}{\text{Total Share outstanding}} * 100$$

Financing choice

Capital structure (leverage)

Capital structure is the financial mix of debt and equity measured by total debt to equity ratio and total debt to total asset ratio. Modigliani and Miller (1958) propose the theory of irrelevance that discusses the firm value and capital structure under perfect market condition, without considering tax and bankruptcy cost. Imperfections in the real world of capital market cause it relevance considering tax, bankruptcy cost, cost of asymmetric information, agency cost and credit risk; after other theories that explain capital structure include trade off theory, pecking order theory, agency cost theory. Book based measure is used for leverage. In another context the leverage can be measured in two ways by using long term debt or total debt. In case of Pakistan total debt is used because the main source of funding is commercial banks which are reluctant to extend financing for long term so the firms' tendency toward short financing prevail. Following Proxies are used to measure the leverage.

$$\frac{D}{E} \text{ Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}} * 100$$

$$\frac{D}{A} \text{Ratio} = \frac{\text{Total Liabilities}}{\text{Total Asset}} * 100$$

Firm performance

Profitability

Firms main objective is to maximize the wealth through different business operation for which funds are needed. Information asymmetries may change the funds generation behavior. Companies' first priority of financing is to generate funds internally. According to pecking order theory, firm value and debt ratio are negatively related. On the other hand, trade off theory suggests that there is tradeoff between cost of debt i.e. financial distress cost, and benefits of debt i.e. tax benefit of debt; firm can increase their value by using debt up to optimal level.

For profitability both accounting based measure and market based measure are used that are ROA, ROE and Tobin's Q respectively. These measures are different in time perspective, accounting measure is backward looking measure while Tobin's Q is forward looking measure of profitability. Secondly investor's psychology cannot affect the accounting based measure but Tobin's Q show sensitivity in this case depending on the investor perception of the future outcomes of current business strategies. Institutional investor prefer firm with high profitability because of the low risk of financial crisis and bankruptcy while some studies show negative relation between institutional shareholding and ROE.

$$ROE = (Net\ income)/(Total\ Equity)$$

$$ROA = (Net\ Income)/(Total\ Assets)$$

$$Tobin'sQ = \frac{Market\ value\ of\ Equity + Market\ Value\ of\ Liabilities}{Book\ value\ of\ Equity + Book\ value\ of\ Liabilities}$$

Control Variables

Size

Large companies have more resources of investments reducing the risk of financial distress and have better opportunities to increase the performance of firm. Institutional investor prefer firm of large size. Some studies report that when firm profit decrease it limits its borrowing capacity. Financial institutions are more willing to lend money to large size firm and firm size. Firms of large size are more diversified and can reduce their financial distress cost and have higher debt ratio but firms of small size prefer lower leverage level. Pecking order theory, a conservative approach suggests negative relation between debt ratio and firm size. Firms of large size and good position in market prefer equity issuance for financing so these are negatively related. In case of Pakistan there exist positive relation between firm size and debt. Size is measured by taking logarithm of total assets.

$$Size = Log (Total\ Assets)$$

Growth

Investments options increase with increase growth opportunities. Firm high growth rate conveys positive information regarding firms' future performance. Agency theory suggests that firm with low growth rate will adopt debt financing so, growth and leverage are associated negatively and reduce the conflict between shareholder and lender by transferring wealth to shareholder. This also supports pecking order theory that growing firm first prefers internal financing which is not enough for firm growth, growing firm use debt financing and results in high leverage level. Institutional investor prefer firm with high growth rate of future profitability. This control variable is measured by sales growth. In Pakistan presence of pecking order theory is observed.

$$Growth = (Current\ sales - Previous\ sales) / (Previous\ Sales) * 100$$

Tangibility

Tangibility of the firm shows that ratio of fixed assets possessed by firm. The firms with more assets uses these assets as collateral to the debt holder so higher the tangibility the firm have more chance to get loans and it results in high debt ratio. Pecking and trade off theory supports the positive relationship while the matching maturity principle shows the opposite relationship. Financial institutions need collateral for long term financing in Pakistan so it is positively related to capital structure. Fixed asset ratio is used to measure firms tangibility quantify by using ratio of fixed asset to total asset.

$$TANG = Fixed\ Assets / Total\ Assets$$

Liquidity

Current ratio is used for liquidity calculated as ratio of current assets to current liabilities. Liquidity shows firm capability of paying back the short term liabilities and firms with higher liquidity ratio may possess high debt ratio because such firm hold enough cash to adopt debt financing so managers avoid deviating from their goals to private benefits. On the other hand firms with high liquidity, they fulfill their obligation through working capital and generate funds internally to approach capital for future investment leading to negative effect on debt ratio. Firms with high agency cost have limited access to debt financing restricted by outside investors which results in negative correlation between cash flow and debt ratio this leads to uncertain relationship between institutional ownership and firm liquidity. It depends on the time horizon of the investment because low probability of long term investment is shown by high liquidity firms and institutional investor perceive it as bad signal on the other hand it may convey a positive signal to institutional investors as liquidity show firm ability to fulfill short term liabilities.

$$\text{Liquidity} = \text{CurrentAssets} / (\text{Current Liabilities})$$

Dividend policy

There is difference in the information level of outsider investors and managers about the income distribution of firm. This information asymmetry leads to more debt financing and high dividend convey a positive signal to the outside investor while agency theory argue that there will be reduction in cash inflow when firm pay high dividend and firm will need external financing. In stock market announcement of dividend lower the

information asymmetry and firm with stable dividend are preferred by institutional owners. According to agency theory institutional investors and dividend payout are positively related while signaling theory suggests negative relationship.

Due to information asymmetry dividend policy of firm is measured by dividend payout that may affect the institutional shareholdings calculated by ratio of dividend per share (DPS) and earnings per share (EPS).

$$\text{Dividend Yield} = \text{DPS}/\text{EPS}$$

Quality of Financial Reporting

Dummy variable is used to explore the quality of financial reporting. It equals to 1 if the financial statements are audited by 4 Big auditing firms which high audit quality otherwise 0. In Pakistan 4 big auditing firms are Deloitte Touche, A. F. Ferguson & Co., Ernst & Young and KPMG. Audit plays a very important role to ensure that of financial statement are consistent with IFRS International Financial Reporting Standard. Institutional investors have incentive to monitor management at lower agency cost. Choice of audit quality is one of the mechanisms of audit quality that could influence institutional shareholdings. Managers choose high audit quality to disclose their financial reporting which attract the outside investors including institutional investors. Institutional investors invest in those firms that have high quality financial reports. Institutional investors demand high audit quality because it lowers the monitoring cost by reducing information asymmetry and agency cost.

4.3. METHODOLOGY

This study used simultaneous equation model to examine the relation between ownership, capital structure and firm performance. Under this data model variable of institutional ownership, capital structure and firm performance are taken as dependent variable respectively.

In order to study the impact of Institutional Ownership in financing decision following econometric modeling is used:

$$IO_{it} = \alpha + \beta_1 Leverage_{it} + \beta_2 PROF_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} + \beta_8 AQ_{it} + \varepsilon_{it} \quad (1)$$

$$Leverage_{it} = \alpha + \beta_1 IO_{it} + \beta_2 PROF_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} + \beta_8 AQ_{it} + \varepsilon_{it} \quad (2)$$

$$PROF_{it} = \alpha + \beta_1 Leverage_{it} + \beta_2 IO_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} + \beta_8 AQ_{it} + \varepsilon_{it} \quad (3)$$

In order to explore the role of foreign investors following equations are employed:

$$FO_{it} = \alpha + \beta_1 Leverage_{it} + \beta_2 PROF_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} + \beta_8 AQ_{it} + \varepsilon_{it} \quad (4)$$

$$\begin{aligned} Leverage_{it} = & \alpha + \beta_1 FO_{it} + \beta_2 PROF_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} \\ & + \beta_8 AQ_{it} + \varepsilon_{it} \end{aligned} \quad (5)$$

$$\begin{aligned} PROF_{it} = & \alpha + \beta_1 Leverage_{it} + \beta_2 FO_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} \\ & + \beta_8 AQ_{it} + \varepsilon_{it} \end{aligned} \quad (6)$$

In order to explain the role of government ownership

$$\begin{aligned} GO_{it} = & \alpha + \beta_1 Leverage_{it} + \beta_2 PROF_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} \\ & + \beta_8 AQ_{it} + \varepsilon_{it} \end{aligned} \quad (7)$$

$$\begin{aligned} Leverage_{it} = & \alpha + \beta_1 GO_{it} + \beta_2 PROF_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} \\ & + \beta_8 AQ_{it} + \varepsilon_{it} \end{aligned} \quad (8)$$

$$\begin{aligned} PROF_{it} = & \alpha + \beta_1 Leverage_{it} + \beta_2 GO_{it} + \beta_3 DY_{it} + \beta_4 SIZE_{it} + \beta_5 TANG_{it} + \beta_6 GRW_{it} + \beta_7 LIQ_{it} \\ & + \beta_8 AQ_{it} + \varepsilon_{it} \end{aligned} \quad (9)$$

4.4. ESTIMATION TECHNIQUE

In order to identify the relationship between ownership, corporate financing choices and profitability this study builds a simultaneous equation model. Simultaneous equations models are different from single equation econometric modeling as they considered more than one or two dependent variables, and consist of set of equations. Single equation tests the governance mechanism on firm performance but did not test if the causation is in

another direction because some of the corporate governance mechanisms are related internally therefore, to capture the potential of multiple relationship between institutional ownership, capital structure and firm performance, a set of simultaneous equations using generalized method of moment GMM is applied. A structural model is used with Capital structure, institutional ownership and performance as dependent variable.

In multiple regression model endogeneity may occur and instrumental variable approach is used to solve the issue of endogeneity. This is the orthogonality condition which states that the explanatory variables and lagged dependent variables which is used as instruments are found uncorrelated with some of the variables captured as error term so disallowing the use of ordinary least square OLS. Violation of orthogonal condition leads to endogeneity and with all these econometric issues and use of instrumental variable approach is needed to cater the endogeneity problem. Generalized method of moments GMM technique is useful for the system of equation estimated across firm as it deals with the heteroskedasticity and over time interdependence of error term.

The three structural equations to be estimated are as follows:

$$\text{Leverage} = f(\text{profitability}, \text{Ownership}, \dots)$$

$$\text{Ownership} = f(\text{profitability}, \text{Leverage}, \dots)$$

$$\text{profitability} = f(\text{Ownership}, \text{Leverage}, \dots)$$

Test of endogeneity

Instrument variables are those variables that used as a device for the endogenous variable. The criterion of these instrument variables is that these have correlation with endogenous variables but uncorrelated the error terms. First to check the endogeneity Durbin Wu Hausman test is applied. The test reports the endogeneity of ownership variables, leverage and profitability of the firms.

Test of instruments

Instrument variable approach leads to the use of instruments and its validity is examined by sargan test proposed by John Denis Sargan in 1958. This test is also known as J test for over identification. To satisfy all moment condition it is suggested to examine the specification test of existence of correlation between error term and instruments. This test jointly hypothesized that instruments excluded are correctly excluded from the model and that instruments are valid as they show no association with the error terms.

CHAPTER #5

DATA ANALYSIS AND RESULTS DISCUSSION

5.1. SUMMARY STATISTIC

Table 5. 1

Descriptive statistics

All the statistics are calculated for 100 non financial firms. Institutional ownership (IO), government ownership (GO) and foreign ownership (FO) is defined as percentage of shareholdings of institutional investors, government and foreign investors. Return on Assets (ROA) and Return on Equity (ROE) are accounting base measure of profitability, Tobin's Q is market based measure of profitability defined as market value of equity and book value of debt to total assets. Leverage is measure by Debt to Asset (DTOA) and Debt to Equity (DTOE). Debt to Asset (DTOA) is defined as total debt to total assets and Debt to Equity (DTOE) is defined as total debt to equity. Log of assets (SIZE) is measure of size. Growth (GRW) is defined as growth in the sale of a firm. Tangibility (TANG) is defined as fixed assets at cost divided by total assets. Liquidity (LIQ) is defined as current asset to current liabilities. Dividend yield (DY) defined as dividend per share to earning per share. Audit Quality (AQ) measure the transparency of financial reports dummy is used AQ = 1 when financial reporting is audited by one of Big-4 audit firm.

Variables	Mean	Median	Maximum	Minimum	Standard Deviation
IO	0.357	0.294	0.983	0.000	0.261
FO	0.167	0.000	0.950	0.000	0.285
GO	0.047	0.000	0.950	0.000	0.182
ROA	0.105	0.083	0.738	-0.327	0.129
ROE	0.209	0.195	1.379	-2.949	0.329
TOBINSQ	1.289	1.047	7.841	0.005	0.836
DTOE	1.881	1.371	28.638	-9.681	2.529
DTOA	0.118	0.069	0.860	0.000	0.139

SIZE	0.085	0.085	0.125	0.022	0.015
GRW	0.186	0.157	2.856	-1.280	0.321
TANG	0.673	0.697	4.065	0.000	0.325
LIQ	1.459	1.171	9.649	0.010	1.026
DY	0.027	0.017	0.426	-0.326	0.046
AQ	0.642	1.000	1.000	0.000	0.480

In Pakistani companies, average of institutional ownership is approximately 35.7%, average of the foreign ownership is 16.7% and average government ownership is 4.7%. Largest foreign ownership is 98%, institutional ownership is 95% and government ownership is 95%. Minimum ownership in each case appears to zero. Average return on equity is 10.5% whereas return on assets is found as 20.9%. Market base measure Tobin's Q also indicates good financial performance of companies. Companies are generally less debt dependent as average debt to assets ratio found is 11% whereas most of the debt dependent firm has 86% debt. Liquidity of companies is weak whereas a modest growth ratio is observed. Volatility of earning is high and on average firms has low dividend yield. In case of Pakistani firms more than half of the companies prefer Big-4 audit companies. Percentage of fixed assets held by firm are 67%.

Among ownership variables more variation is observed in the foreign ownership with standard deviation of 0.28. Standard deviation of institutional ownership is 0.26 while lowest variation is observed in government ownership with standard deviation of 0.18.

Volatility in the market leads to high variation in firm's market performance showed by standard deviation of 0.83. Accounting based measures of profitability show low fluctuations, deviation of return on equity and return on assets is 0.32 and 0.12 respectively. Statistic shows that standard deviation of liquidity and debt to assets is 2.5 and 1.02 respectively. Liquidity and Debt to equity has more variations as compared to all other variables because of their high standard deviations, which indicates the variations in the data. Descriptive state shows that Pakistani companies do not changes dividend policy frequently.

Firm specific variables i.e. Size, Growth, Tangibility, Liquidity, Dividend yield and Audit Quality are included as independent variable. The statistics shows that mean of all firm specific variables except size and tangibility and audit quality, is less than median which represents the negative skewness of data while other variables growth, liquidity, dividend yield has mean greater than median indicates that the variables are positively skewed. The variables for ownership structure are shareholdings of institutions, foreign and government and their statistics shows that these variables has higher mean than median representing the positive skewness of data.

Corporate financing choice of firms are measured by the usage of leverage, test by two different proxies are positively skewed. Return on assets (ROA), return on equity (ROE) and Tobin's Q measures the profitability of the firms which are also positively skewed as represented by the statistics given in the above table.

5.2. CORRELATION ANALYSIS

Table 5. 2

Correlation Matrix

All the statistics are calculated for 100 non financial firms. The given table abbreviated (IO) as institutional ownership, (GO) government ownership, (FO) foreign ownership, (ROA) Return on Assets, (ROE) Return on Equity , (TQ) as Tobin's Q, (D_{TOA}) Debt to Asset, (D_{TOE}) Debt to Equity, (SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	IO	FO	GO	ROA	ROE	TQ	DTOE	DTOA	SIZE	GRW	TANG	LIQ	DY	AQ
IO	1													
FO	-0.40	1												
GO	-0.25	-0.11	1											
ROA	-0.14	0.25	0.23	1										
ROE	-0.10	0.20	0.14	0.73	1									
TQ	-0.15	0.33	0.21	0.47	0.36	1								
DTOE	0.01	-0.05	-0.10	-0.30	-0.35	-0.10	1							
DTOA	0.16	-0.32	-0.04	-0.37	-0.24	-0.10	0.24	1						
SIZE	0.06	0.10	0.42	0.09	0.15	0.05	0.00	0.02	1					
GRW	0.05	-0.06	-0.07	0.07	0.13	0.01	0.03	0.05	0.01	1				
TANG	-0.02	-0.24	0.04	-0.14	-0.18	0.07	0.00	0.33	-0.15	-0.03	1			
LIQ	0.07	0.14	0.01	0.45	0.20	0.06	-0.25	-0.19	0.02	-0.06	-0.29	1		
DY	-0.07	0.19	0.06	0.24	0.24	0.18	-0.08	-0.16	0.09	-0.03	-0.08	0.06	1	
AQ	-0.19	0.40	0.19	0.33	0.32	0.26	-0.15	-0.21	0.27	-0.02	-0.18	0.22	0.16	1

Table 5.2 shows the correlation matrix. Correlation analysis between ownership, corporate financing choice, profitability and firm specific variables shows the absence of high degree correlation. So this analysis indicates the non existence of multi-collinearity between the independent variables

5.3. RESULTS AND DISCUSSION

5.3.1. Model 1: Institutional Ownership, Leverage and Firm Market Performance

In Pakistan not only families and managers but institutions also invest in the capital market. Institutions include financial institutions and different investment companies. Models consist of system of linear equations using profitability, leverage and ownership proxies as dependent variable.

Table 5. 3

Institutional Ownership, Leverage and Firm Market Performance

(Profitability: Tobin's Q)

$$IO_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$LEV_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 IO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$PROF_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 IO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

All the statistics are calculated for 100 non financial firms. In the given table abbreviate (PROF) Profitability variable measured by Tobin's Q, (LEV) as leverage measured by debt to assets, (IO) as institutional ownership, (SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	IO	LEV	PROF (Tobin's Q)
IO		0.124*** (3.608)	-0.174 (-0.933)
PROF	-0.026 (-1.364)	0.000 (-3.067)	0.350
	0.172	0.002	

LEV	0.880*** (4.210)		-1.359*** (-3.376)
	0.000		0.000
SIZE	2.549** (1.912)	0.271 (0.489)	-2.032* (2.017)
	0.056	0.624	0.043
GRW	0.050* (1.721)	0.466 (2.461)	0.153*** (5.001)
	0.085	0.013	0.000
TANG	0.124*** (2.194)	0.109*** (4.098)	0.425 (1.386)
	0.028	0.000	0.165
LIQ	0.029 (1.240)	-0.178 (-1.121)	0.041*** (2.472)
	0.214	0.2622	0.013
DY	(-0.144)	-0.450	1.145
	-0.818	(-0.450)	(1.400)
	0.413	0.652	0.161
AQ	-0.102** (-2.047)	-0.019 (-1.176)	0.128*** (4.401)
	0.040	0.239	0.000
Constant	0.166 (1.365)	2.883*** (4.742)	0.895* (1.650)
	0.172	0.000	0.098
J-statistic	0.074		

Coefficients estimates of the model reported in the first row, t-stat is reported in parenthesis () in second row. Further ***, **, * represent variables are significant at 1%, 5%, 10% respectively. J-stat of the estimate report rejection of condition $J_c > J_t$. So, it indicates the validity of model.

Model using Institutional ownership, leverage and Tobin's Q as dependent variables the results are presented in table 5.3. Leverage level of firm show positive relationship with institutional investors. This shows that institutional investors and debt acts as complements in case of Pakistani firms. Increase in the debt increase the governance mechanism leading to increase in the investors' protection attracting more investors from the market.

Firms with large size and high growth are preferred by the institutional investors. Such firms in the growing phase give high returns and have more excessable resources indicating the reliable position in the market. Tangibility increase with high fixed capital in the firm which lowers the bankruptcy cost and ability to facilitate the creditors increase such firms are preferred by institutional investors.

Liquidity shows positive relationship with institutional investor while dividend yield shows negative relationship supporting the agency cost based hypothesis but relationship is insignificant. In case of Pakistan when firm pay dividend the institutional investors become less concerned to reduce agency cost. Audit Quality and institutional investors substitute each other to monitor firm business activities.

Leverage as dependent variable measured by debt to asset ratio. This result shows that leverage and profitability is inversely related which shows that higher the profit lower will be the debt ratio of firm. The firm will use previous retained earnings for further financing which lower the business risk. These results support the pecking order theory. Tangibility results indicate positive and significant relationship with debt. Firms with high collateral value of firm assets will have greater debt, which allow the firm to get financing from the institutions. Results support the trade off theory consistent with results of Rajan and Zinglers (1995) and Ali (2008). Institutional shareholding and leverage represent a positive relationship which indicate that institutional owners of Pakistan employ debt as control mechanism to monitor managers and allow external financing because debtholders are not involved in the decision making process of firm.

Tobin's Q as market measure of profitability is used as dependent variable. The result shows that leverage is inversely associated with the firm profitability. Reliance on external financing indicates the unhealthy status of the firms in the market. Firm growth lead to better market position of firm and it influence the firm market performance positively. Growth opportunities to the firm indicate profit potential of firm in future. Governance variable measured through audit quality (AQ) give results that selection of one of Big-4 companies add positive to the market performance of the firm.

5.3.2. Model 2: Foreign Ownership, Leverage and Firm Market Performance

To provide insight about the role of foreign ownership in corporate financing choice and performance following model is used. Using foreign ownership, leverage and profitability as dependent variable.

Table 5. 4

**Foreign Ownership, Leverage and Firm Market Performance
(Profitability: Tobin's Q)**

$$FO_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$LEV_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 FO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$PROF_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 FO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

All the statistics are calculated for 100 non financial firms. In the given table abbreviate (PROF) Profitability variable measured by Tobin's Q, (LEV) as leverage measured by debt to assets, (FO) foreign ownership,

(SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	FO	LEV	PROF (Tobin's Q)
FO		-0.101*** (-4.373)	1.086*** (3.965)
PROF	0.137*** (4.393)	-0.011 (-1.185)	0.000
LEV	-0.769*** (-6.063)	0.235	-0.616 (-1.337)
SIZE	0.542 (0.328)	1.053* (1.823)	0.181 -1.423** (1.934)
GRW	0.742 -0.024 (-1.203)	0.068 0.664*** (3.388)	0.053 0.121** (1.942)
TANG	0.229 -0.242*** (-3.745)	0.000 0.109*** (3.964)	0.052 0.483* (1.644)
LIQ	0.000 -0.002 (-0.119)	0.000 -0.008 (-1.516)	0.100 0.008 (0.166)
DY	0.905 (0.102)	0.129 -0.142 (-1.415)	0.867 1.002 (1.266)
AQ	0.427 0.668 0.081* (2.362)	0.1572 -0.020 (-1.147)	0.205 0.225*** (2.837)
Constant	0.018 0.030 (0.200)	0.251 2.371*** (3.803)	0.004 0.869 (1.687)
	0.840	0.000	0.091
J-statistic	0.054		

Coefficients estimates of the model reported in the first row, t-stat is reported in parenthesis () in second row. Further ***, **, * represent variables are significant at 1%, 5%, 10% respectively. J-stat of the estimate report rejection of condition $J_c > J_1$. So, it indicates the validity of model.

Second model is estimated by changing the proxy of ownership. In the table 5.4 results are estimated by using foreign ownership as dependent variable.

Results with foreign ownership as dependent variable, shows that profitable firms attract more foreign investors. And such investors prefer low levered firms because foreign investors believe in trade off theory of capital structure. Foreign investors preferred firms with low tangible assets because firms with higher tangible assets for collateral will have higher debt level which is undesirable for the foreigner investors. Audit Quality assuring the transparency of firm have positive influence on the foreign ownership.

The results of second equation of model indicate that foreign owners have negative effect on leverage. It mean foreigner do not prefer high leverage level. Foreign investor prefer large firm and capital market is preferred for firms' project financing (Li et al., 2009). Firm size and tangibility support trade off theory. This shows that greater the firm size greater be the leverage level of firm consistent with the study of Ali (2008). This positive association suggests that large sized firms are preferred by the creditors due to their diversity and stability in the market. Result of growth coefficient show that the results are consistent with the study of Tong and Green (2005) and Ali (2011).

Profitability as dependent variable give results which shows that foreign ownership has positive impact on the firm performance supporting the result of (George and Kabir 2006) through their monitoring mechanism and technological innovation. Increase in firm size will gradually decrease the efficient operation of management so have an adverse effect on firm performance. Significant values of tangibility and growth shows that it significantly contributes toward firm performance

5.3.3. Model 3: Government Ownership, Leverage and Firm Market Performance

In order to explore the role of government ownership following results are derived.

Table 5. 5

Government Ownership, Leverage and Firm Market Performance

(Profitability: Tobin's Q)

$$GO_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$LEV_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 GO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$PROF_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 GO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

All the statistics are calculated for 100 non financial firms. In the given table abbreviate (PROF) Profitability variable measured by Tobin's Q, (LEV) as leverage measured by debt to assets, (GO) government ownership, (SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	GO	LEV	PROF (Tobin's Q)
GO		0.087 (1.339)	1.132** (1.936)
PROF	0.065** (2.270)	-0.024*** (-2.997)	0.180 0.052
LEV	0.023	0.002	-1.337*** (-3.205)
SIZE	-0.227 (-1.591)	1.175*** (2.391)	0.001 -1.011 (-0.242)
	0.111	0.016	0.808
	3.821*** (3.716)		
	0.000		

GRW	-0.024** (-1.970)	0.577*** (2.984)	0.123* (1.731)
	0.048	0.002	0.083
TANG	0.038 (0.601)	0.116*** (4.425)	0.406 (1.286)
	0.547	0.000	0.198
LIQ	-0.011 (-1.325)	-0.007 (-1.449)	0.086 (1.389)
	0.185	0.147	0.164
DY	(-0.129) -1.312	-0.114 (-0.113)	1.040 (1.284)
	0.189	0.909	0.199
AQ	-0.003 (-0.179)	-0.042*** (-2.711)	0.261*** (2.918)
	0.857	0.006	0.003
Constant	-0.348*** (-2.730)	2.525*** (4.110)	0.809 (1.890)
	0.006	0.000	0.058
J-statistic	0.064		

Coefficients estimates of the model reported in the first row, t-stat is reported in parenthesis () in second row. Further ***, **, * represent variables are significant at 1%, 5%, 10% respectively. J-stat of the estimate report rejection of condition $J_c > J_1$. So, it indicates the validity of model.

Government ownership is usually in large sized firms. Their ownership in the monopolistic market shows a stable market position indicated by positive relationship between firm performance and government shareholdings. So, the significant and positive relation between government ownership and performance is due to involvement of monopolies. Firm growth will lower the influence of government stake in industry resulting in negative association between growth and government ownership.

Using leverage as dependent variable results found that Government shareholders have no significant impact on market for debt and the result are consistent to Borisova et al. (2012) and Dewenter and Malatesta (2001). Firm with high profitability exhibits low

leverage level indicating the preference of internal financing. Coefficients of firms' tangibility and size shows that firms with large size has more fixed assets that can be used as collateral to get financing from the institutions.

Last column shows the results with market measure as dependent variable government ownership affects firm performance positively supporting the results of Kang (2012) and Najid and Abdul Rahman (2011). High levered firms show low level of profit whereas growth contributes positively to firm performance. Firms in the growing phase are always preferred by the investors. The results of external governance measured by audit quality shows that it is a significant determinant of firm performance.

5.3.4. Model 1: Institutional Ownership, Leverage and Firm Performance

Different proxies of leverage and profitability have been use including debt assets, debt to equity and return on assets, return on equity respectively.

Table 5. 6

Institutional Ownership, Leverage and Firm Performance

(Profitability: Return on Assets)

$$IO_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$LEV_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 IO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$PROF_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 IO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

All the statistics are calculated for 100 non financial firms. In the given table abbreviate PROF as Profitability is measured by Return on Asset (ROA), LEV as leverage measured by debt to assets, (IO) as institutional ownership, (SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	IO	LEV	PROF (ROA)
IO		0.086*** (2.556)	-0.039 (-1.439)
PROF	-0.606*** (-3.421)	-0.444*** (-7.931)	0.150
LEV	0.670*** (3.054)	0.000	-0.315*** (-6.643)
SIZE	0.002	0.642 (1.186)	0.000
GRW	3.022** (2.249)	0.235 (2.119)	0.470 (0.874)
TANG	0.071*** (2.402)	0.030** (2.119)	0.050*** (3.778)
LIQ	0.016	0.034	0.000
DY	-0.091* (-1.623)	0.111*** (4.279)	0.057*** (3.052)
AQ	0.100	0.000	0.002
Constant	0.061*** (2.797)	0.014** (1.988)	0.054*** (6.737)
	0.005	0.046	0.000
	-0.068 (-0.338)	-0.072 (-0.861)	0.248*** (2.588)
	0.735	0.389	0.009
	-0.086* (-1.755)	-0.008 (-0.547)	0.039*** (3.202)
	0.079	0.584	0.001
	0.095 (0.725)	2.073*** (3.344)	0.049 (1.013)
	0.468	0.000	0.310
J-statistic	0.059		

Coefficients estimates of the model reported in the first row, t-stat is reported in parenthesis () in second row. Further ***, **, * represent variables are significant at 1%, 5%, 10% respectively. J-stat of the estimate report rejection of condition $J_c > J_t$. So, it indicates the validity of model.

Using first model with return to assets as dependent variable the results are reported in the above table 5.6. Results are consistent with the outcome reported earlier in table 5.3 the impact of profitability on institutional shareholdings is significantly negative. Tangibility coefficient shows different results reported earlier institutional investor prefer firms with low tangible assets which shows the underinvestment of firm and liquidity showed positive relationship with institutional investor.

Second column in the table 5.6 represent that Institutional owners increase the use of debt for the monitoring purpose. Relationship between firm performance and leverage support pecking order theory. This indicates that with increase in the profit firm will go for more internal financing. The results represent that the firm specific variable show consistent result. Firm size and tangibility support trade off theory while growth show result consistent with pecking order theory. Coefficients of liquidity shows that cash in hand will lead to more external financing and the results are same for all owners.

Using return on assets as dependent variable results changes. The association between leverage and return on asset is significantly. This implies companies prefer lower debt to increase their profitability. Growth of the firm significantly improves the firm performance. High tangibility means firm own greater value fixed assets which increases return on assets. High liquidity indicates that the firm is fulfilling its short term business operation adding value to the firm. Liquidity and firm performance is positively related. Dividend yield and Audit quality positively influence firms for all the ownership types. This indicates that increase in the dividend payment signal good performance of the firm

and transparency of financial report is also an indicator for determining the firm performance.

5.3.5. Model 2: Foreign Ownership, Leverage and Firm Performance

For the robustness of the results of foreign ownership different proxies of leverage and profitability is applied.

Table 5. 7
Foreign Ownership, Leverage and Firm Performance
(Profitability: Return on Assets)

$$FO_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$LEV_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 FO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$PROF_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 FO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

All the statistics are calculated for 100 non financial firms. In the given table abbreviate PROF as Profitability is measured by Return on Asset (ROA), (LEV) as leverage measured by debt to assets (FO) foreign ownership, (SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	FO	LEV	PROF (ROA)
FO		-0.090*** (-4.015)	0.022 (0.804)
PROF	0.258 (1.139)	-0.452*** (-8.409)	0.421
	0.254	0.000	

LEV	-0.874*** (-6.224)		-0.345*** (-7.240)
	0.000		0.000
SIZE	0.643 (0.457)	1.105** (2.095)	0.569 (1.186)
	0.647	0.036	0.235
GRW	-0.027 (-1.170)	0.031** (2.205)	0.046*** (3.520)
	0.242	0.027	0.000
TANG	-0.048 (-0.775)	0.113*** (4.352)	0.058*** (3.234)
	0.437	0.000	0.001
LIQ	-0.014 (-0.579)	0.015*** (2.411)	0.050*** (5.492)
	0.562	0.016	0.000
DY	0.289 (1.119)	-0.010 (-0.122)	0.296*** (3.230)
	0.262	0.902	0.001
AQ	0.131*** (3.679)	0.003 (0.206)	0.040*** (3.569)
	0.000	0.836	0.000
Constant	0.134 (1.067)	-0.025 (-0.481)	-0.067 (-1.429)
	0.286	0.630	0.153
J-statistic	0.063		

Coefficients estimates of the model reported in the first row, t-stat is reported in parenthesis () in second row. Further ***, **, * represent variables are significant at 1%, 5%, 10% respectively. J-stat of the estimate report rejection of condition $J_c > J_t$. So, it indicates the validity of model.

Results in table 5.7 indicate that foreign investor prefer low levered firms to avoid bankruptcy cost and prefer Big-4 audit firms to ensure transparency which lower their monitoring cost. The results of leverage in second column give the same results reported earlier supporting trade off and pecking order theory for size, tangibility and growth respectively.

Foreign owner substitute the debt employ by their own funds. So as foreign ownership increases debt dependency decreases. Coefficient of firm performance measured by return on assets shows that it has negative influence on firm debt usage.

All variable expect size and foreign ownership give significant results by applying return on assets as proxy of profitability. The result shows that firms with high fixed assets increase firm profitability in terms of firms' assets. Liquidity and growth of firm indicate that firms are efficiently operating and have ability to compete in the market. Dividend yield signals out good impact on outside investors. Governance mechanism reported by audit quality is reported as one of significant determinant of firm value because transparency of firm has a positive impact on the investors in market.

5.3.5. Model 3: Government Ownership, Leverage and Firm Performance

Now for government ownership following results were obtained using debt to asset and return to assets as proxy for leverage and profitability.

Table 5. 8

Government Ownership, Leverage and Firm Performance

(Profitability: Return on Assets)

$$GO_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$LEV_{i,t} = \alpha + \beta_1 PROF_{i,t} + \beta_2 GO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW_{i,t} + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

$$PROF_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 GO_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 GRW + \beta_5 TANG_{i,t} + \beta_6 LIQ_{i,t} + \beta_7 DY_{i,t} + \beta_8 AQ_{i,t}$$

All the statistics are calculated for 100 non financial firms. In the given table abbreviate PROF as Profitability is measured by Return on Asset (ROA), LEV as leverage measured by debt to assets, (GO) government ownership, (SIZE) as size of firm, (GRW) as Growth, (TANG) as Tangibility, (LIQ) as Liquidity, (DY) as Dividend yield, (AQ) as Audit Quality.

	GO	LEV	PROF (ROA)
GO		-0.017 (-0.553)	0.185*** (3.548)
PROF	0.898*** (6.510)	-0.444*** (-6.479)	0.000
LEV	-0.082 (-1.010)	0.000	-0.259*** (-5.136)
SIZE	0.312 3.647*** (5.075)	1.120** (2.169)	0.000 -0.288 (-0.611)
GRW	0.000 -0.069*** (-4.099)	0.030 0.026** (1.985)	0.540 0.054*** (4.493)
TANG	0.000 0.037 (0.969)	0.047 0.109*** (5.167)	0.000 0.033* (1.667)
LIQ	0.332 -0.053*** (-4.805)	0.000 0.014** (2.192)	0.095 0.052*** (5.960)
DY	0.000 -0.328*** (-3.109)	0.028 -0.046 (-0.521)	0.000 0.278*** (3.225)
AQ	0.001 -0.022 (-1.452)	0.601 -0.022 (-1.506)	0.001 0.038*** (3.321)
Constant	0.146 -0.270*** (-3.278)	0.132 0.132*** (3.416)	0.000 0.003 (0.066)
	0.001	0.000	0.946
J-statistic	0.060		

Coefficients estimates of the model reported in the first row, t-stat is reported in parenthesis () in second row. Further ***, **, * represent variables are significant at 1%, 5%, 10% respectively. J-stat of the estimate report rejection of condition $J_c > J_1$. So, it indicates the validity of model.

Results of government ownership are consistent with the result in table 5.6 with few exceptions. All the ownership type showed preference of large firms with stable position in the market; firms with high free cash flow are not preferred by government shareholders. Dividend yield showed negative relationship supporting the agency cost based hypothesis.

Government ownership significantly increases the firm value than other ownership types. State owned firm with stable position lower the default risk and have an easy excess to the advantageous resources. All owners other than government ownership are very concerned to the leverage level.

State owned firms with high value of assets indicate strong and positive associate of size and tangibility with return on assets. Firm profitability can be enhanced by improving firms financial reporting quality.

This result shows that most of variable highly significantly influence firm value as compared to previous result derive with market based measure. This difference is due to the changing in the proxy of profitability to an accounting base measure i.e. Return to Assets (ROA). This variable is measure by using book values so the market condition is not captured.

CHAPTER #6

CONCLUSION AND POLICY IMPLICATIONS

6.1. CONCLUSION

This study analyzes the impact of ownership identities on the firm performance and corporate financing choices. Different ownership identities are included which are institutional ownership, foreign ownership and government ownership. All of these ownerships are measured by their respective shareholding percentage. Firm performance is measured by Tobin's Q and return on assets. Financing choice is measure by the usage of leverage.

Study reveal that after controlling for firm specific variable i.e. tangibility, size, growth, liquidity dividend yield and audit quality. Institutional investors do not actively participate in determining the form performance and this participation drive the profitability slightly down. While others, government ownership and foreign ownership are more concerned with firm business activities. These determinants are positively and significantly related to the performance. This study shows presence of foreign owner indicate investor's protection driving toward more profitability and efficiency. On the other hand investee firm's resources are drawn off by the institutions.

Ownership is also a significant determinant of the financing choice adopted by the firm. Institutional investors approve the usage of leverage as monitoring device on

management. Institutional ownership and debt are complementary which are less concerned to firm performance. Foreign owners as most diversified owners rely on their own funding. This is showed by negative and significant relation between foreign owners and leverage. Foreign investors always intended to avoid bankruptcy cost.

Firm performance and their choices also determined different characteristic of the firms. This study suggests firm performance as significant determinant of foreign ownership and government ownership. Better performance always encourages more foreign investors to participate in the market. This study reveals that firm performance positively influence government ownership which indicate that firms with almost 95% of the government ownership take advantage of having an edge of being only the service or good provider in the market.

This study further suggests that leverage is also important to determinant ownership. it is being noticed that with all other variable leverage is also an important determinant of institutional and foreign ownership. Usage of leverage influence owners differently. Institutional investors perceive its usage to monitor inside owners while foreign investors have more investable firm and also enjoy tax allowance provided by Foreign Private Investment (Promotion and Protection) Act, 1976.

6.2. POLICY IMPLICATION

Decision maker should be aware that owner's identity may influence the performance and financial choices adopted by the firm. Institutional ownership is now taking roots in the corporate sector of Pakistan. It is still in the infancy phase. But the development in the mutual fund industry is an indicator that institutional investor will play a vital role in the future. Presently Pakistan corporate sector is dominated by family owned business where concentrated ownership appears to dominate the decision making.

Management should be careful in managing debt as it appears that debt is not being utilized optimally. Market discourages the firm on usage of leverage irrespective of ownership type.

Company should focus on improving the quality of financial reporting as it significantly influences performance. The SECP should take steps to improve the monitoring process of the audit firms.

Favorable conditions and relaxation must be provided to foreign investors. They not only increase competition but through their expertise they also introduce different advancement to the market. Policy maker should lay down such prudent rules and procedures which attract more institutional investments and foreign as well as domestic investors.

Companies should be vigilant about the use of debt. Institutional owners prefer high debt whereas foreign owner prefer low debt. The preference of institutional owner is logical as

they want to share the monitoring cost. On the other hand foreign owner replace debt to reduce bankruptcy cost.

Leverage is not consider as good news in Pakistan and it appears that its not being used optimally. So, management should be careful in using debt and effect he made to get maximum benefit from the use of this low cost financing.

6.3. FOR FURTHER RESEARCH

Due to the data unavailability of shareholdings pattern of some firms sample remained limited to 100 firms only.

Inclusion of corporate governance factors like board size, CEO/Chair duality and board composition etc. could have been more helpful in explaining the behavior of Pakistani enterprises.

Other than corporate governance, investment factor can also be included which can explain the investment pattern of different owners.

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