CHAPTER 1: INTRODUCTION

1.1 Introduction

Analysis of the determinants of firm performance is utmost important to all stakeholders of a firm, especially to its equity shareholders (Kakani et al. 2001). Initial studies on determinants of firm performance examine industry wide factors and firm specific variables. Important industry wide factors studied for their impact on firm performance are concentration and capital requirement (e.g, Bain 1951, Comanor and Wilson 1967). Firm level variables studied for their impact on firm profitability are size, leverage and age (e.g, Amato 1985, Lee 2009). Further, researchers try to analyze the relative importance of industry wide factors and firm specific variables jointly on firm profitability (Beard and Dess 1979, Beard and Dess 1981).

Researchers examine the impact of listing on firm performance ((Jain and Kini 1994) and Pagano et al. 1998)) as listing provides access to resources for firms, not only in capital markets but also in labor and product markets. Developed economies have well established economic and legal institutions that ensure implementation and enforcement of economic contracts between different parties (La Porta et al. 1997)). Therefore, benefits of listing are more pronounced in developed economies. Unlike developed markets, emerging economies suffer from institutional voids. Absence of well-established financial and legal institutions impedes raising resources from the market. These institutional voids result into the existence and growth of business groups in emerging economies which act as proxy to these institutional requirements (Khanna and Palepu 1997).

With economic reforms in any economy, economic and legal institutions develop. As these institutions develop, one expects that the importance of business groups reduces as they are no longer needed to provide facilities as proxy of established institutions. In Indian context we note
that even though the economic reforms were launched in 1991 and various institutions established to facilitate growth of business, business groups still remain a force to reckon with. Thus in Indian context two factors i.e. group affiliation and listing, play an important role in determining firm performance. No prior research has been conducted to examine the joint impact of listing and group affiliation on firm performance.

Further, the effect of independent variables on firm performance may be impacted by group affiliation and / or listing status. Therefore we analyze firms at aggregate level and also at classified levels for different categories of firms. We classify firms based on listing and group affiliation. As a result we find nine categories of firms. They are as follows; all firms, listed firms, unlisted firms, standalone (SA) firms, business group (BG) firms, standalone unlisted (SAUL) firms, business group unlisted (BGUL) firms, standalone listed (SAL) firms and business group listed (BGL) firms. Regressions are estimated for each of these categories of firms.

1.2 Motivation

Developed economies are characterized by well-established capital, product and labor markets as well as prompt and efficient legal recourse systems (La Porta et al. (1997)). Availability of efficient legal systems ensures systematic enforcement of contracts by all the parties involved. This in turn helps to raise resources from various well established markets in an economy. Listing on stock exchanges makes it easier for firms to obtain required funds from various sources in the developed economies. Listing not only provides access to financial resources but also offers greater bargaining power with other institutions (Kim and Weisbach (2005)). Pagano
et al. (1998) argue that listing is followed by lower cost of credit. Listed firms are able to attract better personnel. Listed firms are more visible through media in capital, labor and product markets. Thus listing plays an important role in growth of a firm in developed markets and has a significant impact on firm performance in these markets.

In case of emerging economies the required institutional framework is absent or weak. Khanna and Palepu (1997 and 2000a) purport the absence of effective financial and legal institutions as a key reason behind existence of business groups in under-developed or emerging economies. Absence of these institutions hampers effective implementation of contracts which are a key towards vibrant labor and product markets in emerging economies. These institutional voids are filled by business groups who provide required support to the affiliated firms to grow and operate in these markets. Business groups provide support in the form of internal capital markets, trained labor and reputation in the product markets (Gopalan et al. (2007) and Kali and Sarkar (2012)). Thus in an under-developed or emerging economy business groups help in growth of firms and group affiliation has positive impact on firm performance.

The economic reforms of 1991 ushered development of financial and regulatory institutions in India. Development of these institutions has further led to development of various financial, labor and product markets in India. These markets provide an alternative to business group structure for obtaining resources for the firm. As Indian economy moves from under-developed stage to developed stage, financial, labor and product market institutions develop. As a result, the effectiveness of business groups should reduce.

Impact of firm diversification on performance has been studied in developed economies. Diversified conglomerates operating in developed economies are analogous to business groups
operating in emerging markets, the only difference being that a conglomerate is the only one listed firm whereas multiple firms of a business group may be listed. Resource based view for diversification argues that performance of conglomerates will be higher than performance of non-diversified firms if there is no active market for resources. The resources provided by conglomerates to its business units are highly valuable. Non-diversified firms (analogous to standalone firms in emerging markets) are not able to gain these benefits and hence perform lower than conglomerates. However, firms do diversify even in presence of strong economic and legal institutions. In such a case the resources are effortlessly available even to non-diversified firms (La Porta et al. (1997)). Agency cost view is another way to explain diversification in conglomerates. Accordingly, firms diversify at an instance of managers as diversification may increase firm’s demands for manager’s particular skills (Montgomery (1994)). Thus the agency view predicts a negative association between diversification and firm value. Empirical studies show that impact of diversification is negative and significant on performance of conglomerates (Montgomery (1985) and Montgomery and Wernerfelt (1988)). Drawing from this analogy, one will expect that performance of business group affiliated firms should reduce as a result of economic reforms and the consequent development of economic and legal institutions.

However, despite institutional environmental changes, business groups in India have still dominated corporate sector activity (Sarkar (2010)). Figure 1.1 shows growth and share of business group firms and standalone firms in terms of total assets (TA), net sales (NS) and number of firms over a period of 1991 through 2013.

**Figure 1.1: Growth and Share of Business Group Firms and Standalone Firms in terms of Total Assets (TA), Net Sales (NS) and Number of Firms.**
We observe from figure 1.1 that share of total assets controlled by business group firms decreased from around 86% during 1991 – 93 to around 79% during 2011 – 13. Share of net sales decreased from around 82% during 1991 – 93 to around 75% during 2011 – 13. Over a period of more than two decades, many standalone firms were incorporated to take benefits of economic reforms. We find that share of number of standalone firms has increased from 50% during 1991 – 93 to around 62% during 2011 – 13.

In spite of increase in number of standalone firms, corporate activity is dominated by business group firms. Though there is decrease in terms of total assets and net sales for business group firms, average total assets and average net sales for firms have increased for business group firms during the corresponding period.

Figure 1.2 shows growth and share of business group firms and standalone firms in terms of average total assets and average net sales.

**Figure 1.2: Growth and Share of Business Group Firms and Standalone Firms in terms of Average Total Assets (ATA) and Average Net Sales (ANS) (Rs. in crore)**
Figure 1.2 shows that average total assets of business group firms is about 6 times the average total assets of standalone firms during 1991-93. This ratio is 6.3 times in the year 2011 – 13. Average net-sales of business group firm is 4 times the average net sales of standalone firms during 1991-93 which increases to 5.6 times in the year 2011 – 13.

Figure 1.3 shows growth and share of business group listed firms and standalone listed firms in terms of average of total assets and average of net sales.

**Figure 1.3: Growth and Share of Business Group Listed Firms and Standalone Listed Firms in terms of Average Total Assets (ATA) and Average Net Sales (ANS) (Rs. in crore)**
As shown by figure 1.3, average total assets of business group listed firm is about 7.3 times the average total assets of standalone listed firms during 1991-93. This ratio increases to about 9.4 times in the year 2011-13. Similarly, average net-sales of business group listed firm is 5.3 times the average net sales of standalone listed firm during 1991-93 which increases to about 8 times in the year 2011-13.

Figure 1.4 shows growth and share of business group unlisted firms and standalone unlisted firms in terms of average of total assets and average of net sales.

**Figure 1.4: Growth and Share of Business Group Unlisted Firms and Standalone Unlisted Firms in terms of Average Total Assets (ATA) and Average Net Sales (ANS) (Rs. in crore)**

![Bar chart showing growth and share of business group unlisted firms and standalone unlisted firms in terms of average of total assets and average of net sales.](image)

*Source: CMIE databases, Prowess*

We observe from figure 1.4 that average total assets of business group unlisted firm is about 3.5 times the average total assets of standalone unlisted firms during 1991-93. This ratio increases to 3.9 times in the year 2011-13. Similarly, average net-sales of business group unlisted firms is about 2.7 times the average net sales of standalone listed firms during 1991-93 which increases to 2.8 times in the year 2011-13.

Dominance of business groups in terms of corporate sector activity is persistent even after the economic reforms. However, it is possible that business group firms suffer from corporate
governance issues due to tunneling (Bertrand et al. (2002)). On the other hand, standalone unlisted firms have least agency cost due to close monitoring by promoters and absence of tunneling or propping. Internal capital market does not exist for standalone unlisted firms. Thus it can be difficult for standalone unlisted firms to achieve higher scale of business operations and dominate corporate sector activity due to limited resources. However, the profitability per unit of assets for standalone unlisted firms can be higher than that of the business group unlisted firms.

India provides a unique setting wherein both business group affiliation and listing are expected to have significant impact on firm performance. Surprisingly, we find no prior research addressing the combined impact of listing and group affiliation on firm performance.

Lee (2009) examines the quadratic relationship between accounting based measure of firm performance, ROA with size (net sales) only for US firms. Market based measure of firm performance such as price to book value ratio is not examined in the literature. In the Indian context, quadratic relationship between firm performance and size (accounting as well as market based measure of firm performance) remains unexplored.

Additionally, the impact of other firm characteristics like promoters’ holding, firm leverage, firm size, age, firm efficiency, export intensity, selling and distributions expenses may be influenced by group affiliation and listing status. This further shows the importance of understanding the joint effect of group affiliation and listing on firm performance. Thus we are motivated to study the joint impact of listing and group affiliation on firm performance.

1.3 Thesis organization
Rest of the thesis is organized as follows. Chapter 2 details existing literature and identifies gaps in literature based on the prior research. Research objectives and hypotheses are formulated in chapter 3. Chapter 4 includes research methodology and data to be used for our study. Chapters 5, 6 and 7 discuss empirical results. Salient findings and conclusions are given in chapter 8.