ABSTRACT

Role of Institutional Investors in Emerging Economy Firms: The Case of Internationalization

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Extant literature acknowledges the increasing involvement of institutional investors in strategic decisions of a firm in developed as well as emerging economies. Such institutional investors may be foreign (FII) or domestic (pressure resistant or pressure sensitive types). Based on this classification of institutional investors, studies in developed economies identify that pressure-sensitive institutions such as banks and insurance companies, owing to their existing business relationship with a firm, are poor monitors of the firm. On the other hand, pressure-resistant institutions such as mutual funds with only investor role, have the option of responding to inappropriate firm strategic decision by voicing their opinions or exiting the firm. Such behaviour of investors in a firm shapes their governance role towards firm strategic decisions.

We argue that, owing to several reasons, the governance role of investors in emerging economy firms need not be identical to that in developed economy firms. Firstly, unique agency issues may exist in an emerging economy, where the possibility of expropriation of minority shareholders by promoters results in principal-principal agency issues. In such a setting, an institutional shareholder could well be a minority shareholder. Secondly, in an emerging economy Pressure-Sensitive Institutional Investors can monitor firm strategic decisions through nominee directors on their boards. Additionally, the absence of formal institutional infrastructure (imperfect institutions and institutional voids) in emerging economies often leave local banks and mutual funds at an advantage over FIIs in gathering information better using informal-reciprocal relations. While studies have pointed out that institutional investors have a positive influence on internationalization decisions of firms, they have not distinguished between various kinds of institutional investors.

This study attempts to distinguish between various kinds of institutional investors (FII, domestic pressure resistant-PRDII, domestic pressure sensitive-PSDII) by understanding their governance role in monitoring firm strategic decision of internationalization. For a more complete understanding, interactive influence (moderating effect) of different corporate governance mechanisms (such as independence of board, promoter ownership) on the governance role is studied.

Our sample consists of 30385 firm year observations spread over a 10-year period (2005-2014), for 4531 unique firms. To account for many firms not pursuing internationalization as a strategy, we tested our hypotheses using Tobit Random effects panel regression model.

We find that all three categories of institutional investors act as monitors for the firms. However, their preferences for internationalization strategy are different. For instance, while FIIs and PRDIIs support firm internationalization as a strategy, PSDIIs dissuade the firm from overseas expansion. Also, these investors have different preferences for ownership and board characteristics of a firm. For example, foreign institutional investors prefer promoter-owned firms that would protect them against country-level risks where as domestic investors are cautious of promoter-owned firms due their inability to monitor these firms. The preference for type of board members also depends on the time frame of investment of institutions.

Our work is relevant from a theoretical, managerial and investor perspective. We add to the existing agency theory by highlighting how alternate monitoring mechanisms aid certain category of institutional investors in alleviating principal-principal agency problem.

This study has attempted to understand the monitoring capability of institutional investors using one strategy of a firm, namely internationalization, and also one mode of internationalization viz., foreign investments. Future research could expand the study across multiple strategies. They could also consider different modes of internationalization of different types of institutional investors and evaluate their monitoring capabilities and preferences in each one of these separately. Industry based differences could also be studied in further detail.