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Impact of Institutional Ownership on Firm Performance: Evidence from Automobile Industry of Pakistan

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Abstract

This study investigated the effects of institutional ownership on firm performance by using the data of automobile sector of Pakistani listed firms. This study utilized the data from 2011 to 2020. For estimation, this research used OLS regression method, Hausman test is used to select between fixed and random. Results indicates that random effects model is best. Institutional ownership has negative effect on return on assets and return on equity. These finding support the pressure sensitive hypothesis that more the institutional ownership pressurizing the management of automobile firms, which impact negatively on firm performance of the automobile listed firms of Pakistan. This study theoretically contributed that institutional investors not always improve the firm performance or reduce the agency problem. This study provides insights to policy makers, managers and investors for automobile industry of Pakistan.

Keywords: Institutional Ownership, ROA, ROE, Automobile

1. INTRODUCTION

Numerous books are available that discuss various facets of corporate governance, with a particular emphasis on ownership structure (Yu, 2013; Afza & Nazir, 2015; Ali & Hashmi, 2018). Ownership structure is defined as the allocation of ownership based on voting rights and share capital. The ownership structure reduces the number of disputes between owners and management. According to the agency hypothesis, which was introduced by Jensen and Meckling in 1976, managers work for their own gain, which leads to disputes between management and shareholders. Agency theory and its grave consequences have been the subject of much discussion in the field of finance, and it remains a hot topic in business studies worldwide (Kang & Kim, 2012). All parties involved in the financial markets have been looking for a firm monitoring mechanism to reduce agency concerns for the past few decades. The success of the company is influenced differently by different owners (Arosa et al. 2010). Institutional investors differ in their monitoring skills, share holdings, and incentives to keep an eye on the managers at the lowest possible cost. Accordingly, institutional ownership works better than personal ownership (Afza & Nazir, 2015). The management is somewhat influenced by institutional investors. They are comparable to the financial market's kingmakers. Although they don't actively participate in management, they can use their voting rights to persuade managers to keep an eye on things (Gillan & Starks, 2003). Insurance companies, mutual funds, investment advisors, pension funds, hedge funds, private equity, and university endowments are examples of institutional investors, per Jensen & Meckling (1976). In order to preserve their connections with the companies that they are entitled to as pressure-sensitive, the well-connected institutional investors do not contest management's choices and practices. According to Pistor et al. (2000), holding company management choices were unaffected by institutional investors.

Regarding the relationship between institutional ownership and business performance, two competing hypotheses have surfaced. According to Navissi & Naiker (2006), institutional investors are more inclined to influence management, which enhances corporate performance. However, institutional investors may pressure the board to make less-than-ideal decisions as ownership levels rise. The efficient monitoring theory states that lower ownership levels of shares held by institutional investors are favorably connected with the value of the company; nevertheless, performance may deteriorate as share ownership rises (Aslam & Haron, 2020). This is in line with the convergence of interest hypothesis, which holds that institutional ownership and business efficiency have a positive relationship until it turns negative. Despite the fact that agency theory has long been employed to investigate the connection between ownership and performance, scholars have failed to reach a firm conclusion about whether ownership structure significantly affects company performance. Various academic perspectives and empirical evidence contribute to the ongoing debates on how institutional investors affect company performance, especially in developed countries like the US, Europe, and Japan. Based on sample characteristics and different country settings, these studies aim to clarify any potential relationships.

Institutional ownership of 11 Pakistani companies listed on the Pakistan Stock Exchange between 2011 and 2020 was used in the study. The research question posed in this section is addressed in this study. Does institutional ownership matter in the automotive business in Pakistan? If so, an effort is made to investigate these significant questions. Additionally, this study will give investors, shareholders, and all other stakeholders a thorough understanding of how to determine the maximum shareholder value and better return for an investment decision. The findings of this study will help managers improve performance by fortifying their bond with institutional ownership.

Most studies on ownership structure and firm performance are conducted in developed markets with robust investor protections. However, in order to investigate whether institutional ownership enhances business performance, research has recently focused on developing nations like Pakistan, especially in the automobile industry. By examining the connection between institutional ownership and business performance in Pakistani automobile, listed on the Pakistan Stock Exchange, this study aims to bridge this gap using the most recent data available. By examining a sizable sample of Pakistani automobile industry, the study adds empirical support for the link between institutional ownership and business performance in developing nations.

2. LITERATURE REVIEW

The economy depends heavily on institutional owners. Since they are the company's owners, they have the authority to choose the board of directors, and the board is ultimately responsible for monitoring corporate managers and the performance of the company. If performance is poor, Institutional owners have the option to hang onto their ownership, sell their shares, or speak up during meetings. Exit, loyalty, and voice are the characteristics of these possibilities (Hirschman, 1971). Since they own a greater percentage of the equity, institutional owners can influence management's choices both directly and indirectly through the sale of their shares (Gillan and Stark, 2003). Many academics contend that agency issues are limited by more equity penetration in controlling operations (Admati et al., 1994). There is a positive correlation between stock performance and institutional ownership. The only people with an incentive to keep an eye on manager behavior and company success are larger equity holders. Additionally, efficient monitoring by institutional owners can lower agency costs (Demestz, 1983). The detrimental influence of institutional owners can be eliminated in businesses with fragmented ownership

(Black, 1992). The only people with an incentive to keep an eye on manager behavior and company success are larger equity holders. Additionally, efficient monitoring by institutional owners can lower agency costs (Demestz, 1983). The detrimental influence of institutional owners can be eliminated in businesses with fragmented ownership (Black, 1992).

Performance improvement and performance decrease are the two arguments that arise from the interaction between institutional owners and enterprises' performance. Because institutional investors seek out profitable companies to invest in and maintain vigilance for positive performance, sound corporate governance by institutional owners contributes to the improvement of firms' performance. Arguments for performance reduction, on the other hand, emphasize institutional owners' short-term goals since they require a quick return on their investment, which may not be ideal for long-term organizational growth (David et al., 1998). Institutional owners have the option to sell their holdings without investing more money if performance is not up to par. Additionally, for their own gain, institutional owners may forge closer bonds with the manager at the expense of minority shareholders (Cornett et al., 2007).

Although there is a wealth of research on ownership structure in the field of institutional ownership, the findings vary widely. This fact is demonstrated in the review that follows. The association between ownership structure and firm performance is not new; Tsuk (2005) conducted a thorough investigation of the subject. According to him, the ownership structure detracts from the performance of the company. Refuted this claim by stating that various structure types can optimize a firm's worth. In addition to having a competitive edge, institutional investors are skilled at gathering and analyzing data. In order to confirm its effect on performance, Cornett et al. (2007) examined the institutional ownership structure in New York. They chose 100 companies that were listed between 1993 and 2000 on the S&P. The results showed that institutional ownership improves business performance. Large sums of money are available to institutional investors, who seek larger returns on their investments. They properly monitor and balance the company they invest in. Institutional investors have two kinds of relationships with firms: pressure-sensitive and pressure-resistant, according to Du et al,. (2007), they contend that whereas pressure resistance has little effect on firm performance, pressure sensitivity impairs it. An investor who is sensitive to pressure has a business tie with the company but does not take part in management. Based on their actions, Sahut & Gharbi (2011) clarified the impact of institutional investors. 121 French companies that are part of the SBF120 index for the 2006–2008 analysis are included in the data samples they use. Some institutional investors behave passively, establishing relationships with the company and making concessions to preserve those relationships. Dana (2015) came to the conclusion that institutional ownership has advantages and disadvantages of its own. The performance of a company on the Jordanian stock exchange is not significantly correlated with institutional ownership.

Other research, however, has discovered a weak or non-linear relationship between institutional ownership and corporate performance. Jensen and Meckling (1976) assert that because ownership varies according to the degree of ownership, the relationship between ownership and performance is not always straightforward. Thomsen and Pedersen (2000) found that centralized ownership was positively associated with performance, but that this relationship shifted to the negative as ownership concentration increased above a certain threshold. Their study showed that after a certain level of ownership, a concentration of power in the hands of a few shareholders may lead to inefficiencies and a decline in the company's performance. Additionally, the relationship between performance and institutional ownership was found to have a non-linear pattern by Cui & Mak (2002) and McConnell & Servaes (1990).

3. METHODOLOGY

3.1 Sample Selection

This study examined data from companies in the automotive industry that were listed on the Pakistan Stock Exchange. Data used in this investigation ranged from 2011 to 2020. Every listed automaker in Pakistan was represented in this study population. Eleven firms and 110 year-wise observations remain for analysis after applying filters such as missing values, outlier values related to variables, firms with negative equity value, and the inability to obtain data from annual reports.

3.2 Variables

Table 1 shows the measurement of investigated variables in this study. This study followed the methodology of Ahmad et al., (2019), Hussain et al., (2022) and Hameed et al., (2024).

Table 1: ***Definition of Variables***

Variable	Proxy	Definition
Return on assets	ROA	Net income scaled by total assets
Return on equity	ROE	Net profit scaled by equity

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Institutional ownership	INST	Shares held by institutes (i.e., banks, insurance companies, funds) scaled by total shares issued.
Tangibility	TANG	Fixed assets scaled by total assets.
Market to book	MBR	Sum of market value of equity plus debt to book value of equity plus debt
Firm size	FS	Natural logarithm of total assets.
Leverage	Lev	Total debt to total assets.

3.3 Estimation Method

OLS was employed as an estimating technique in this investigation. Between fixed and random effects models, the Hausman test is used to determine which model is superior. The following equations are used for estimate.

$$ROA_{it} = \alpha_{it} + \beta_1 INST_{it} + \beta_2 TANG_{it} + \beta_3 MBR_{it} + \beta_4 FS_{it} + \beta_5 LEV_{it} + \mu_{it} \ldots\ldots\ldots\ldots\ldots\ldots 1$$

$$ROE_{it} = \alpha_{it} + \beta_1 INST_{it} + \beta_2 TANG_{it} + \beta_3 MBR_{it} + \beta_4 FS_{it} + \beta_5 LEV_{it} + \mu_{it} \ldots\ldots\ldots\ldots\ldots\ldots 2$$

4. RESULTS

Table 2: ***Descriptive Statistics***

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	110	0.075	0.072	-0.091	0.188
ROE	110	0.122	0.186	-0.431	0.448
INST	110	0.203	0.192	0.009	0.655
TANG	110	0.352	0.145	0.150	0.643
MBR	110	1.315	0.630	0.552	2.735
FS	110	15.074	1.188	12.968	17.060
LEV	110	0.461	0.208	0.116	0.839

This study descriptive statistics is shown in Table 2. Mean of return of assets of automobile industry is 0.075. Return of equity mean value is 0.122. Average value of institutional ownership is 0.203. Mean of tangibility is 0.352. Market to book ration average of automobile industry of Pakistan, is 1.315. Firm size mean value is 15.074. Mean of leverage is 0.461.

Table 3: ***Correlation Analysis***

	ROA	ROE	INST	TANG	MBR	FS	LEV
ROA	1						
ROE	0.881***	1					
INST	0.114	-0.0415	1				
TANG	-0.0509	-0.0498	0.0205	1			
MBR	0.468***	0.406***	-0.0957	-0.0400	1		
FS	0.213*	0.298**	0.101	-0.0126	0.277**	1	
LEV	-0.477***	-0.243*	-0.378***	-0.0399	0.103	-0.0117	1

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The correlation analysis from this empirical investigation is shown in Table 3. To ascertain the probability of multicollinearity among variables, correlation is necessary. The literature states that the probability of multicollinearity between variables is calculated using a threshold value of +/-0.70. Since the correlation value is so low, correlation analysis shows that there is no possibility of multicollinearity between variables.

Table 4: ***Regression Analysis***

Equation	1			2		
	OLS	**Fixed**	**ROA**	**ROE**	**ROE**	**ROE**
INST	-0.0828*	-0.121**	-0.0828*	-0.242*	-0.310*	-0.242*
	(0.0383)	(0.0438)	(0.0383)	(0.122)	(0.145)	(0.122)
TANG	-0.113**	-0.147***	-0.113**	-0.352**	-0.491***	-0.352**
	(0.0375)	(0.0409)	(0.0375)	(0.121)	(0.136)	(0.121)
MBR	0.0420***	0.0431***	0.0420***	0.0768**	0.0753**	0.0768**
	(0.00790)	(0.00864)	(0.00790)	(0.0254)	(0.0286)	(0.0254)
FS	0.00162	-0.0118	0.00162	0.0270	-0.00977	0.0270
	(0.00832)	(0.0135)	(0.00832)	(0.0254)	(0.0448)	(0.0254)
LEV	-0.179***	-0.172**	-0.179***	-0.306*	-0.341	-0.306*
	(0.0405)	(0.0529)	(0.0405)	(0.126)	(0.175)	(0.126)
_cons	0.135	0.353	0.135	-0.0713	0.563	-0.0713
	(0.129)	(0.210)	(0.129)	(0.392)	(0.696)	(0.392)
Hausman			0.16			0.17
N	110	110	110	110	110	110

Standard errors in parentheses

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 4 shows the regression results of the study. This study used OLS regression method. Hausman test suggest random effects is suitable over fixed. Regression results of equation 1 suggest that institutional ownership has negative & significant impact on return on assets. This is consistent with Tsuk (2005), Du et al,. (2007) and Hameed et al,. (2024). From control variables, market to book ratio has positive & significant while, tangibility and leverage have negative & significant effect on return on assets. Firm size has insignificant & positive effects on return on assets.

Results of equation 2 shows institutional ownership effects negatively & significantly on return on equity. This is consistent with Tsuk (2005), Du et al,. (2007) and Hameed et al,. (2024). From control variables, market to book ratio has positive & significant while, tangibility and leverage have negative & significant effect on return on equity. Firm size has insignificant & positive effects on return on equity.

5. DISCUSSION AND CONCLUSION

This study investigated the effects of institutional ownership on firm performance by using the data of automobile sector of Pakistani listed firms. This study utilized the data from 2011 to 2020. For estimation, this research used OLS regression method, Hausman test is used to select between fixed and random. Results indicates that random effects model is best. Institutional ownership has negative effect on return on assets and return on equity. These finding support the pressure sensitive hypothesis that more the institutional ownership pressurizing the management of automobile firms, which impact negatively on firm performance of the automobile listed firms of Pakistan. This may be due to inactive or passive monitoring from institutional investors from Pakistan automobile industry.

This study theoretically contributed that institutional investors not always improve the firm performance or reduce the agency problem.

This study provides insights to policy makers, managers and investors for automobile industry of Pakistan.

This study also has a limitation of data and time period related with automobile industry of Pakistan.

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