

## CHAPTER I

### Introduction



#### 1.1 Background and Problem Review

The implications of ownership structure and associated agencies' problems on firm value have been described and investigated extensively on both theoretical and empirical bases in the literature of corporate governance. The separation of ownership and control has been thought of as an efficient way to allow for the specialization of management and risk bearing functions (Fama and Jensen, 1983). Nevertheless, the separation between ownership and control can also cause the agency problem – the expropriation by insiders (Shleifer and Vishny, 1997).

Recently, the literature in the field of corporate governance has recognized the role of investor protection in the relationship between ownership structure and shareholder value. La Porta et al. (1997, 1998) present the importance of law in protecting the rights of outside investors. In a country with a low level of investor protection, the major shareholders of a firm are argued to concentrate their ownership for their benefit of controlling the firm. La Porta et al. (2002) argue that firms with high investor protection policies will have higher valuation than firms with low investor protection policies because insiders of the former will be unable to expropriate. Therefore, investor protection is central to the governance mechanism of firms. Additionally, La Porta et al. (2000) suggest that one way to improve governance on firms from low-protection country is through association with or affiliation to the governance mechanism of a high-protection country. In operating or controlling a local firm, for instance, a large foreign shareholder may well adopt the

governance practices that they are familiar with. In principle, the governance practices of local companies can be improved by foreign investors because of several reasons. For example, enforcement by parent company is an important factor to govern the management in subsidiaries (Boardman et al., 1997; Chhibber and Majumdar, 1999). However, the main objective of rational investors is to maximize their wealth. A large foreign shareholder may expropriate from a local company to increase their wealth. Therefore, there is no guarantee that foreign investors will not expropriate from a local company, especially in a country with low level of investor protection. Therefore, the conjecture that poor governance of firms in a low-protection country can be improved by association with good governance mechanism remarks an empirical issue yet to be investigated. This thesis attempts to bridge this gap.

In a similar study, Oxelheim and Randoy (2003) examine the impact of breaking away from a segmented capital market by importing the governance mechanism from Anglo-American countries. The signals to improve corporate governance practice are a cross-listing in high investor protection markets and inclusion of foreign board members from good governance countries. According to Stulz (1999), the result of breaking away from a segmented market is reduction of cross-broader information asymmetries. Foreign exchange listing causes the convergence in corporate governance practice because of the legal pressure in foreign stock markets. Oxelheim and Randoy (2003) find that firms with an Anglo-American board member have a higher Tobin's q ratio and accordingly argue that firms with Anglo-American board member are willing to improve their governance practices. However, the authors base their study on companies listed in Norway and Sweden market and foreign board members from the United States, the United Kingdom, and Canada, where the Anglo-American system is in place. As a result, it is difficult to

infer from their study that foreign ownership leads to governance improvement. First, Norway and Sweden have relatively high level of investor protection (see, La Porta et al., 1998). The foreign investors can not easily expropriate from local investors because of the countries' investor protection. Second, several firms in Norway and Sweden have an international cross-listing on the foreign markets, especially the Anglo-American markets. Governance in Norwegian and Swedish firms may therefore be influence by the cross-listing effect rather than the effect of foreign ownership.

There are reasons for arguing that samples in Thailand are interesting to be investigated in this empirical issue. Thailand's capital market is known to provide low protection for outside equity investors (La Porta et al., 1998 and Alba et al., 1998). Moreover, interesting governance changes have occurred in Thailand. The Financial Crisis in 1997 is an important event in relation to the evolution of corporate governance in Thailand, where the Crisis pushed the Securities Exchange Committee of Thailand (Thai SEC) to promote corporate governance and set up the institutions for improving corporate governance mechanisms in Thailand. The Thai Institute of Directors Association and the Department of Special Investigation were established during this period (in 1999 and 2002 respectively). The Thai SEC and Stock Exchange of Thailand (SET) promoted the '15 principles of good corporate governance' to stimulate the protection for outside investors and to monitor accounting standards of firms listed in the SET. The Thai government promoted the year 2002 as a year of good governance. Moreover, Thai firms' ownership barriers to foreign investors have been reduced since 1997, along with the increased transparency and the decrease of foreign ownership limit of Thai firms. In sum, corporate governance environment in Thailand differs from Norway and Sweden. As mentioned

above, the investor protection in Thai capital market is relatively low and almost all of the SET-listed firms do not have cross-listing on foreign capital markets. Furthermore, interesting event on corporate governance changes have occurred in Thailand. The effective way to investigate the impact of foreign ownership on governance in local firms is therefore to employ a sample of firms from a low-investor protection country that has experience important governance-related event, such as Thailand.

## **1.2 Statement of Problem / Research Questions**

To bridge the gap discussed above, the problem to be investigated in this thesis can be stated as follows:

Can corporate governance in companies from a low-investor protection country be improved through foreign ownership – especially when foreign owners come from a high-investor protection country?

## **1.3 Objective of the Study**

Following the problem stated above, the objective of this thesis is to investigate the impact of investor protection on shareholder value by using the foreign ownership as the means of investigating the investor protection effect.

## **1.4 Scope of the Study**

The sample consists of all the listed companies in the SET during 1993-2005. The foreign ownership data is available during that period. The ownership data on

listed firms in SET is available from 1993. However, the detail on their nationality is available only in 1997-2005. The data of listed firms in SET is obtained from I-SIM and SETSMART.

### **1.5 Contribution**

This thesis seeks to provide empirical evidence on one of the most important gaps in the corporate governance literature; no prior studies have directly tested the effect of investor protection on shareholder value in a low-protection country. Additionally, the by-product and yet paramount benefit of this thesis is to provide evidence on the effectiveness or success of the governance code promoted by the SEC in an emerging market.