CHAPTER II

Literature Review

Corporate governance is a set of mechanisms through which outside investors protect themselves against the agency problem (La Porta et al, 2000). Recently, most of the literature in corporate governance area is concerned with the importance of nation governance practices (see, Denis and McConnell, 2003). Some studies suggest that corporate governance could converge by the liberalization of capital markets (see, Stulz, 1999). The ownership structure, especially foreign ownership, is the one issue that is interesting to investigate, because it is related to the corporate governance convergence or transfer of governance practices. This section is described as follows, Section 2.1 describes agency problem theory and the important of corporate governance, the proposed relationship between foreign ownership and firms' value is presented in section 2.2, and the corporate governance environment in Thailand are described in section 2.3.

2.1 Agency Problem, Corporate Governance, and Investor Protection

Jensen and Mecking (1976) suggest that the agency problem is the conflict of interest between the principals (shareholders) and the agents (managers). The concept is that without direct monitoring by the principals, agents are more likely to pursue some activities that improve their own welfare at the expense of the principals. In other words, managers shall pursue their own interest rather than the wealth of shareholders. Shleifer and Vishny (1986) contend that the value of a corporation with many small shareholders tend to be less than a corporation with a large shareholder

because the minority shareholders in the former may not pay attention to monitor the performance of management, a result of the free-rider problem. Thus, investors need the guarantee that their funds will be used to their best interest for their wealth.

As Shleifer and Vishny (1997) point out, "corporate governance deals with the way that suppliers of capital to corporations assure themselves of getting a return on their investment." Therefore, corporate governance is the important mechanism for protection of principals' interests. La Porta et al. (1997 and 1998) posit that investor protection through legal context is the essential element of corporate governance.

Investor protection is the mechanism that protects wealth expropriation - from outside investors, minority shareholders, and debt holders - by controlling shareholders. Investor protection depends on a variety of factors such as the treatment of the investor's rights in company, bankruptcy and securities legislation, along with rules of information disclosure. La Porta et al. (2002) empirically find that the value of a firm - the Tobin's q ratio - is the outcome of good investor protection. One explanation of this phenomenon is that investor protection increases the costs of expropriation by insiders. Broadly observed, La Porta et al. (1998) find that the different degrees of the protection in each country resulted from the origin of legal - civil and common law. However, under the same system, the investor protection mechanism of firms is likely to differ, especially in the low-investor protection countries. For Thailand, according to the Corporate Governance Report of Thai Listed Companies by the Thai Institute of Directors Association, the levels of corporate governance and investor protection of SET listed companies are different.

Apparently, investor protection has positive effect to the shareholder value. Therefore, the one way to enhance shareholder value of a local company is to improve firm's governance. La Porta et al. (2000) posit that to improve corporate governance

of a company from a low investor protection country is through association with the governance mechanism of a high investor protection country. The relationship between foreign ownership and corporate governance will be discussed in the next section.

2.2 Foreign Ownership and Corporate Governance Convergence

There is an empirical study related to corporate governance convergence. The study of Oxelheim and Randoy (2003) show that governance mechanism can be transferred to local companies by owning and monitoring foreign investors. Oxelheim and Randoy (2003) examine the impact of breaking away from a segmented capital market by importing the governance mechanism from Anglo-American countries, which is the most demanding mechanism. The study finds higher Tobin's q ratio in firms with a foreign board member from US, UK, and Canada. The reward of firms that switches to the Anglo-American system is low cost of capital with higher firm value. This result implies that foreign (Anglo-American) board membership imports good governance system to improve the firms' governance. Therefore, foreign shareholders are important as they act as a channel for transfer of better governance mechanism. This may imply that governance mechanism of a firm in a low-protection country can be improved by associating with governance mechanism from a high-protection country (La Porta et al., 2000). Foreign investors have the incentive to improve governance practices of local companies because they find more opportunities to get high return from the governance improvement. For instance, the target company has the opportunities to grow but bad governance practices create the agency problem in the company. If a foreign investor can improve the corporate governance practices of domestic firms, his wealth will increase. However, the study

of Oxelheim and Randoy (2003) is based on companies in Norway and Sweden, the countries that have strong investor protection (see, La Porta et al., 1998). Furthermore, several companies in Norway and Sweden are cross-listed in foreign countries. The results may be unclear regarding the increase in firms' value through the transfer of good governance by foreign ownership.

There is an amount of literature which points out that firms with large foreign ownership will have high performance because of better governance mechanism. Boardman et al. (1997) and Chhibber and Majumdar (1999) suggest that foreign subsidiaries should follow the strategies and standard of governance practices from head office at a home country. Moreover, the managers in foreign subsidiaries will have to face performance pressures from head office. As Ade-Ajayi (2004) observes, the decision to maintain governance practices in foreign subsidiaries is forced by targeted brand value from head office.

There are many pieces of writing which discuss the incentive to monitor the companies of foreign institutional investors. Brickley et al. (1988) argue that the institutional investors play the role which is similar to that of other block holders; they have more incentives to monitor the companies than minority shareholders. Additionally, Gillan and Starks (2003) add that the increase of foreign institutional investments has become an important influence in firms' governance - either through direct intervention or indirect supply-demand effect. In other words, foreign institutions can directly monitor the companies, or the companies must have shown satisfactory performance to attract foreign institutions with affluent capital. Limpaphayom and Connelly (2004) contend that after the 1997 Crisis, the institutional investors put more attention to the firm's corporate governance practices

because of the campaign by SET and SEC. Consequently, positive effects on firm governance should be derived from the influence of foreign institutional shareholders.

However, in practice, there is no guarantee that a large foreign shareholder will not expropriate wealth from a local company - especially in emerging markets - as the main objective of rational investors is to maximize their wealth.

According to Johnson et al. (2000), "tunneling" or the transfer of resources to its controlling shareholder is one way to expropriate wealth from a local company by a foreign controlling shareholder. As discuss by Johnson et al. (2000), tunneling can be taken in various forms, such as the expropriation of corporate opportunities from a firm by its controlling shareholder, transfer pricing of assets from a firm to its controlling shareholder at non-market price, loan guarantee using the firm's asset as collateral, and so on. Thus, tunneling should be consider as a tool for a large foreign shareholder who want to expropriate wealth from a local company located in an emerging market with low investor protection country, such as Thailand.

As discussed above, the past study of Oxelheim and Randoy (2003) is conducted in countries with high protection laws, where a large foreign shareholder cannot easily expropriate wealth from a local company. This empirical issue is interesting to investigate even if existing literature is already tested in good investor protection countries, as a different perspective may be gained when investigating in a country with low investor protection, such as Thailand.

However, the value of foreign-controlled firms may arise from other than the transfer of corporate governance. Dunning (1995) describes that a multinational firm will transfer the firm specific advantages, such as knowledge and technology, to their subsidiary in a host country. Therefore, this thesis provides the evidence to support

the argument that the effect of a large foreign shareholder arise primarily from corporate governance transfer, and not by technological transfer.

2.3 Corporate Governance in Thailand

Investor protection in Thailand is relatively low, even if the legal origin is common law as La Porta et al. (1998) argue. According to Mitton (2002), Limpaphayom and Connelly (2004) and Alba et al. (1998), weak corporate governance practices in Thai market are the cause of the 1997 Financial Crisis.

The consequence of financial crisis 1997 is corporate governance reform. After 1997, corporate governance gained certain acknowledgement from Thai authorities as a remedy to the Crisis. Momentum and awareness to the movement reached its peak in 2002, as "The Year of Good Corporate Governance" – with the Prime Minister naming 2002 as such.

The aftermath of the Crisis set the stages for reform. The effort is directed to corporate governance as a part of a larger structural reform on the financial market. New rules and regulations, new guidelines along with profession organizations are created to target these key flaws: shareholder rights, disclosure, directorship, bankruptcy reform and accounting standards.

The targets of the reform are to protect investor's rights, improve board accountability, and to increase transparency and disclosures. The reform improved on the protection of shareholders; improve board accountability as well as increasing disclosure and transparency.

In 2001, SET released a report on corporate governance which created ground principles, recommendations, and best practice guidelines for directors, the board, management, shareholders, risk management and reporting, and business ethics.

The year 2002, the "The Year of Good Corporate Governance" is the effort from the Public and Private sector to promote the corporate governance in the Thai market. The Prime Minister chaired the National Corporate Governance committee which included representatives from the Ministries of Finance and Commerce, the Bank of Thailand, and regulatory bodies such as the Securities and Exchange Commission (SEC), the Stock Exchange of Thailand (SET). Industry representatives are also included through the participation of representatives from the Thai Chamber of Commerce (TCC), the Federation of Thai Industries (FTI), the Thai Bankers' Association, the Certified Accountants and Auditors of Thailand, the Listed Companies Association, the Association of Securities Companies, the Association of Investment Management Companies (AIMC), the Thai Investors' Association, and the Thai Institute of Directors' Association.

As a result of dramatic improvements in corporate governance, the effect of foreign ownership on shareholder value is somewhat likely to have less effect before the reform effort on corporate governance. In other words, the role of foreign controlling shareholder in relation to improving corporate governance will be clear in an environment with low level of investor protection. Vice versa, where investor protection is high, the role of foreign controlling shareholder on firms' governance would not be necessary.

The other consequences of the crisis are the change of foreign ownership restriction, where firms can shift their foreign ownership limit higher than 49%. According to Lam (1997) and Bailey and Jagtiani (1994), this event affects

shareholder value because foreign investors' barrier in Thailand has been reduced. The result of the change in foreign ownership limit is a positive effect on shareholder value. One explanation of this phenomenon is that foreign investors pay higher price for stocks than domestic investors (Stulz and Wasserfallen, 1995). Another explanation is that the increase of foreign ownership in a local company will reduce the agency cost (Boardman et al., 1997) as described in section 2.2.

The effect of corporate governance in Thailand has been investigated in several studies. For instance, Tirapat (2001) investigates corporate governance mechanisms in Thailand and finds that large concentration of ownership is an effective control mechanism. Firms with large ownership concentration have superior performance, measured by Tobin's q ratio and return on asset (ROA). This phenomenon may imply that concentrate ownership is the effective mechanism in Thailand, where investor protection is relatively low. However, the study of Tirapat (2001) does not focus on the effect of foreign ownership on firm value. Wiwattanakantang (2001) finds that companies with controlling shareholders, especially foreign controlling shareholders, will exhibit high ROA. The controlling shareholder is a large shareholder who holds shares more than 25%. However, this particular study by Wiwattanakantang (2001) contains some limitations and may not be a reliable answer for this empirical issue, since this study employs data covering the period of 1 year which is insufficient.