Institutional Investors & Corporate Governance: International Evidence

NSE-ECGI ROUNDTABLE

13 November 2017

Mumbai, India

PEDRO MATOS

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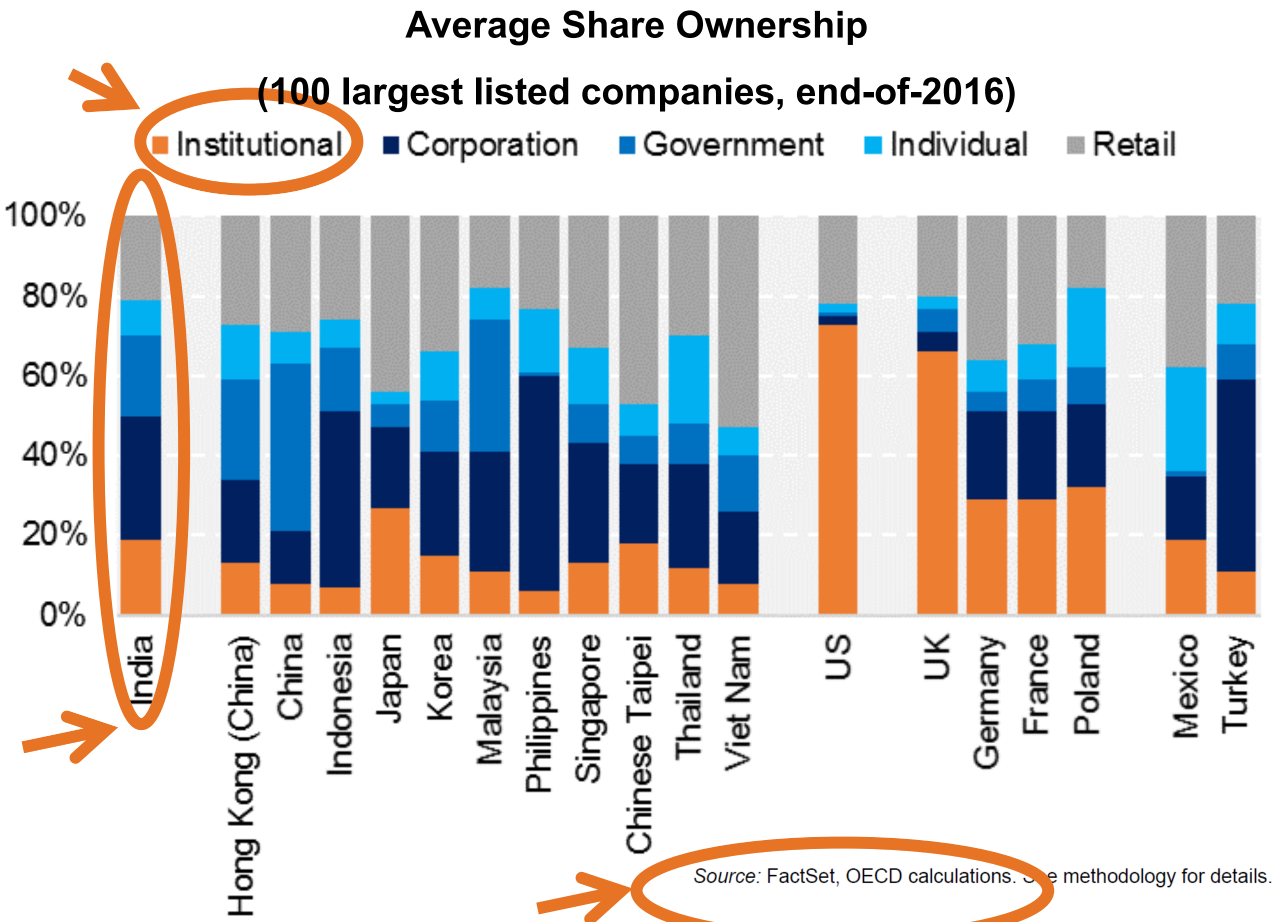
UNIVERSITY of VIRGINIA | DARDEN SCHOOL of BUSINESS

FOREIGN INSTITUTIONAL INVESTORS (“FPI”)

- Perception:
  - Foreign Direct Investment (FDI): take control of the company in which investment is made … long term and less fluctuating?
  - Foreign Portfolio Investment (FPI): minority investment in shares, etc. … speculative and unpredictable?

- Focus of my work: micro (not macro, as in balance of payments, etc.)
  - International evidence that FPI reduces cost of capital and it can play a value-increasing governance/monitoring role

OWNERSHIP STRUCTURE IN INDIA



MSCI

CORPORATE GOVERNANCE IN INDIA

February 2017

GOVERNANCE ISSUES:

Corporation [31%] : Foreign MNC is controller

-> RPTs and royalty payments (vs. dividends)

-> Control & squeeze out

Government [20%]: Controller is Indian State

-> RPTs and Weak governance protections

-> Executive turnover associated with government change

Individual/Family [9%]: Family conglomerates

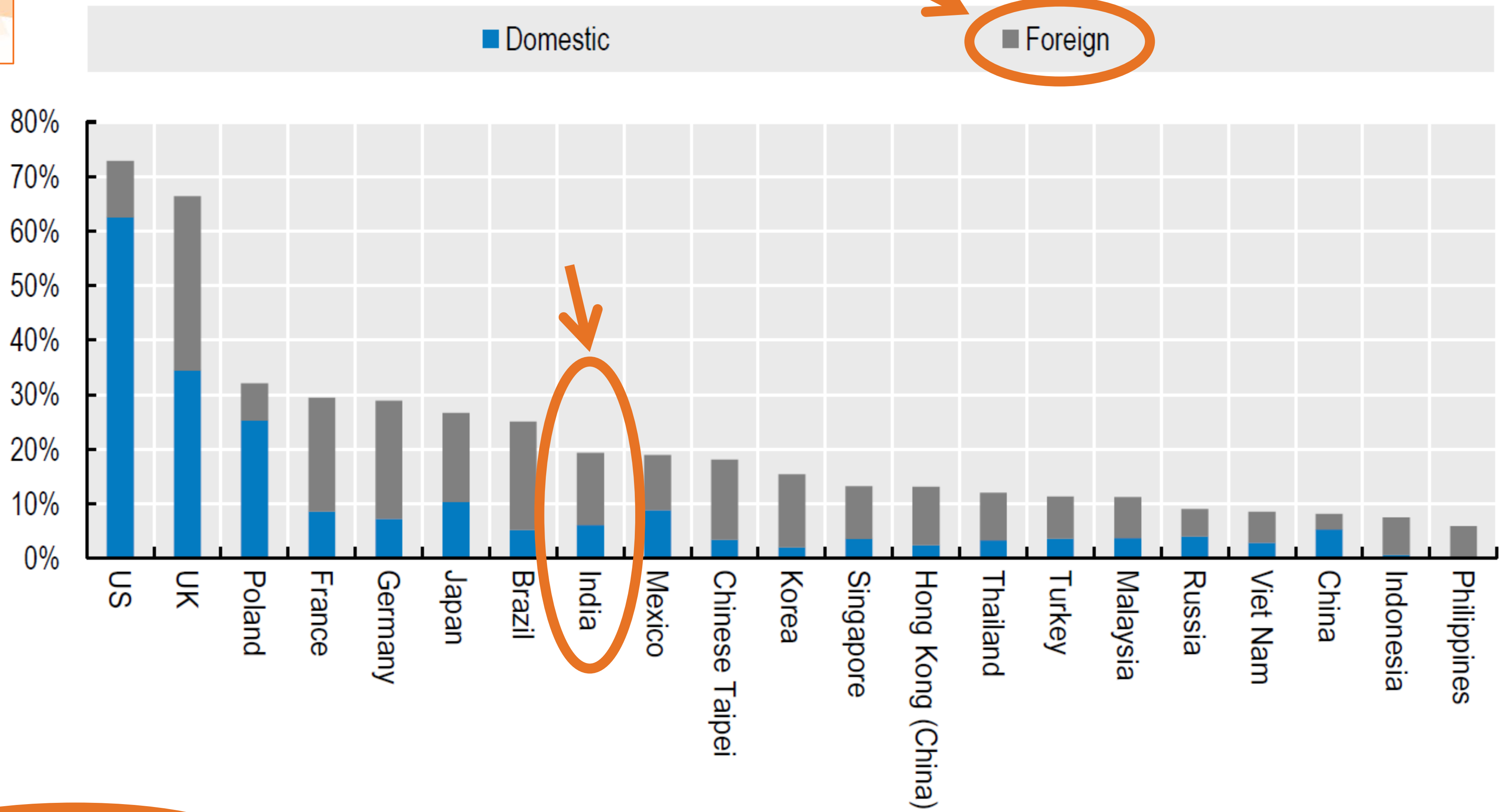
-> RPTs and family control & strength

-> Family disputes: Loss of strategic focus

Institutional [19%]

(FOREIGN) INSTITUTIONAL INVESTORS IN INDIA

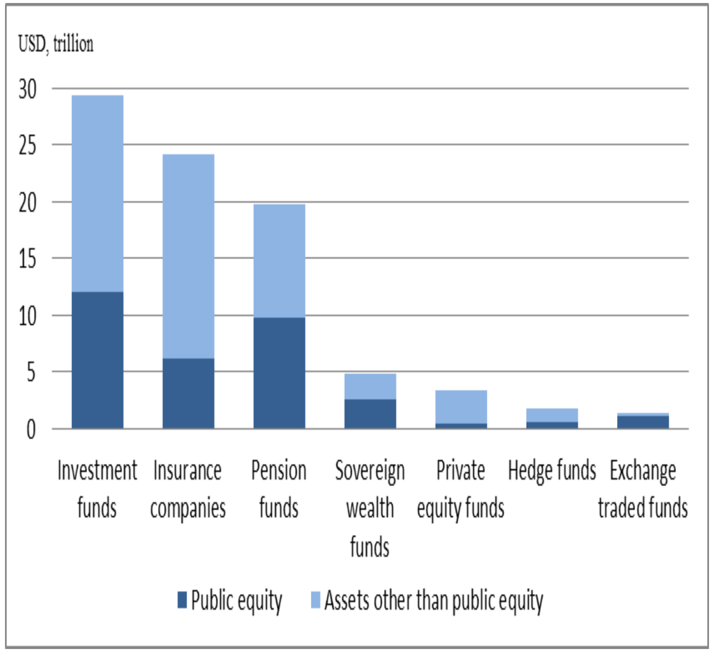
Figure 20. Institutional investors, domestic versus foreign, as of end 2016



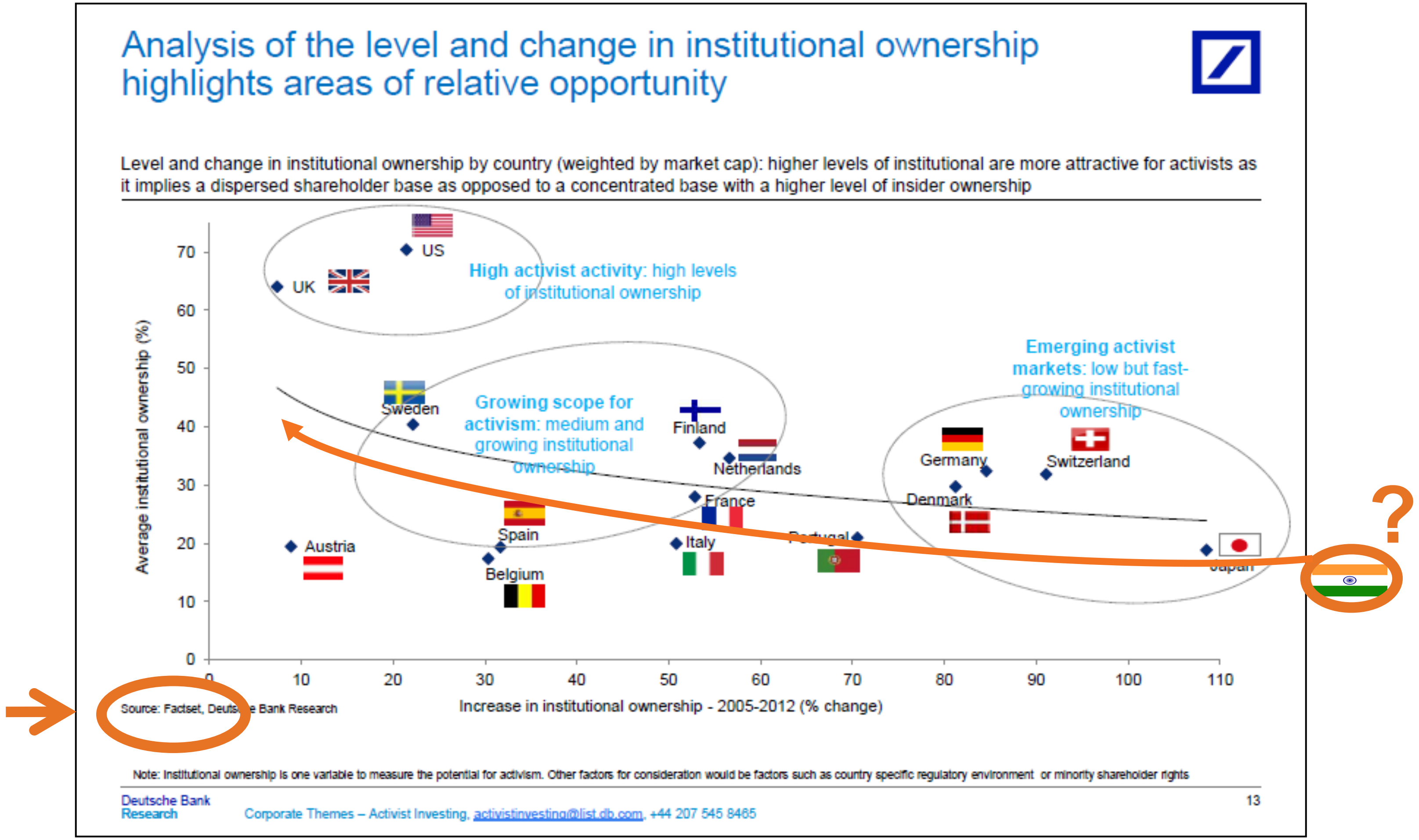
Source: FactSet, OECD calculations. See methodology for details.

THE INCREASING ROLE OF INSTITUTIONAL OWNERSHIP (IN ADVANCED ECONOMIES)

Institutional Investor Holdings = $28 Trillion in Public Equities [2011]



Source: OECD Institutional Investors Database, SWF Institute, IMF, Preqin, BlackRock, McKinsey Global Institute



Source: Deutsche Bank Research “Shareholder Activism: Battle for the Boardroom” [2014]

THE GOVERNANCE ROLE OF (FOREIGN) INSTITUTIONAL INVESTORS: THE THEORY

- In widely-held firms, investors may be disengaged and not push for shareholder value. Given the size of their holdings as a group, institutional owners can impact corporate governance:
  - through "voice" (voting their shares, using quiet diplomacy in persuading management, via confrontational proxy fights)
  - and/or by threatening to "exit" (selling and depressing stock prices)

- Special role played by foreign institutions (Foreign IO) since domestic institutions (Domestic IO) are more prone to be loyal to management due to "business ties" and other conflicts of interest

THE GOVERNANCE ROLE OF (FOREIGN) INSTITUTIONAL INVESTORS: INTERNATIONAL EVIDENCE

PERFORMANCE

P1: "THE COLORS OF INVESTORS' MONEY …"

JFE (2008)

GOVERNANCE

P3: "DOES GOVERNANCE TRAVEL AROUND THE WORLD? …"

JFE (2011)

LONG-TERM

P5: "ARE FOREIGN INVESTORS LOCUSTS? …"

JFE (2017)

M&As

P2: "SHAREHOLDERS AT THE GATE? …"

RFS (2010)

CEO PAY

P4: "ARE US CEOS PAID MORE? …"

RFS (2013)

INDIA?

IMPLICATIONS FOR INDIA

P1: THE COLORS OF INVESTORS' MONEY: THE ROLE OF INSTITUTIONAL INVESTORS AROUND THE WORLD WITH M. FERREIRA. *JOURNAL OF FINANCIAL ECONOMICS*, VOL. 88 (3), P. 499-533, (JUNE 2008)

DATA:

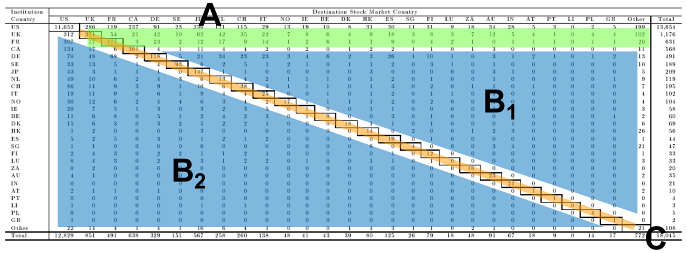
Novel dataset (FactSet/LionShares) of equity holdings: 27 countries, >5,000 institutions, >35,000 stocks, Period: 2000-05

. $ 18 trillion [Dec-2005]

. 38.5% of world market cap

. 49.9% of market float

Non-US firms (US$ 5.2 trillion): 3 investor groups with equal "pocket sizes" … by country of institution (rows) and stock (columns)



A — US$2 trillion from **U.S.-BASED Foreign** institutions

B_1 B_2 — US$1.7 trillion from **NON-U.S. Foreign** institutions

C — US$1.5 trillion from **DOMESTIC** institutions

RESULT #1:

Different Investor Preferences by **US-BASED** vs **NON-US Foreign** vs **DOMESTIC** Investors

➤ Firm-level characteristics:

Instl preferences (Gompers&Metrick(01)):
- + Firm Size (SIZE)
- + Past Return (RET)
- + "Value" Stocks (BM)
- + Turnover (TURN)
- + Investment Opportunities (INVOP)

"Prudent-man" Rules (Del Guercio(96)):
- + Dividends (DY)
- + Profitable (ROE)
- + Volatility (SIGMA)
- + MSCI Members (MSCI)

Governance Indicators (Gillan&Starks(04)):
- – Leverage (LEV)
- + Free-Cash-Flow (CASH)
- – Closely-Held Shares
- + ISS Governance Ranking

Visibility:
- + ADR Listing (ADR)
- + Nr of Analysts
- + Foreign Sales

➤ Country-level factors:

Investor Protection (LLSV(97)):
- + Legal = ANTI*RULE (LEGAL)
- + Disclosure quality (DISC)

Distance/Familiarity (Chan et al.(05)):
- – Geographical distance (DISTANCE)
- + English language (ENGLISH)

Size & Development of Market:
- + GDP per capita (GDP)
- + Stock Market Cap (MCAP)

RESULT #2:

Firms with higher foreign institutional ownership (Foreign IO) have
- ➤ Higher valuations (Tobin Q)
- ➤ Higher operating performance (ROA, Net Profit Margins, less CAPEX)

[Note: IV results]

INTERPRETATION:

Better performance suggest investors MONITORING (rather than just high stock prices dues to OVERVALUATION)

TAKEAWAY:

Performance increases due to increased shareholder pressure to perform

P2: SHAREHOLDERS AT THE GATE? INSTITUTIONAL INVESTORS AND CROSS-BORDER MERGERS AND ACQUISITIONS WITH M. FERREIRA AND M. MASSA.
***REVIEW OF FINANCIAL STUDIES*, VOL. 23 (2), P. 601-644, (FEBRUARY 2010)**

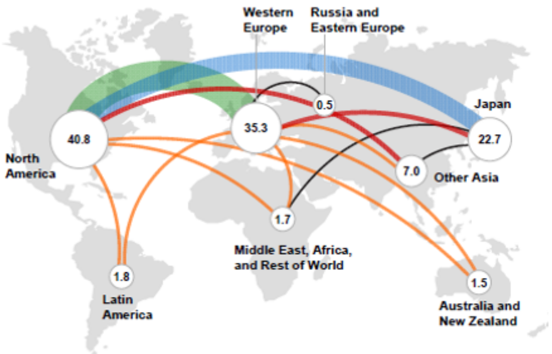
DATA:

Institutional holdings: FactSet/LionShares

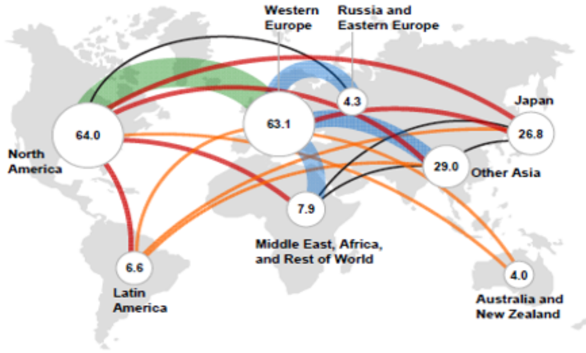
M&A Data: SDC (2000-05, completed, >50%)

Cross-border flows at peak levels ("Multipolar world"!):

- 1999:



-2009:



McKinsey Global Institute
Mapping global capital markets 2011

RESULT #1 & #2:

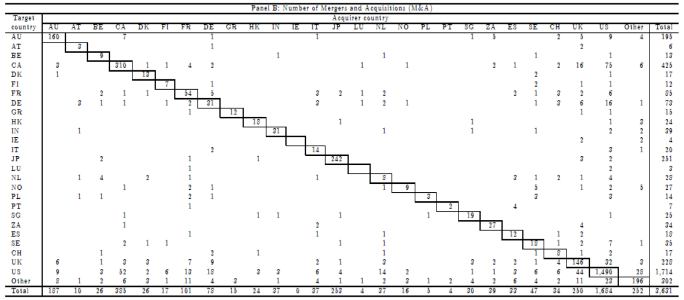
1) Country-level: Institutional Investors Increase % of Cross-Border M&A deals

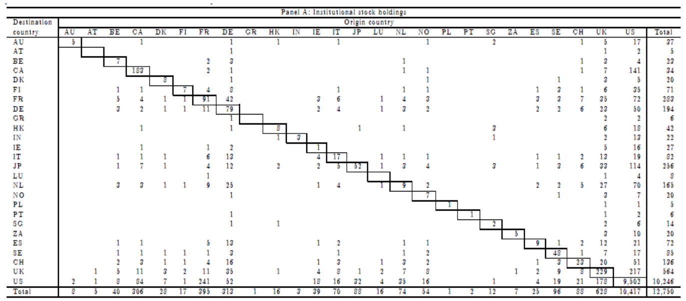
2) Country-pair level: Pairwise Cross-Border Flows Increase % of Cross-Border M&A deals

CROSS_BORDER(i,j)= # of deals target country *i*, bidder from *j*

IO(i,j) = % of country *i*'s Market Cap held by institutions from *j*

$$\boxed{\text{Cross-border M\&A}}_{i,j} = \alpha + \beta \boxed{\text{Institutional Ownership}}_{i,j} + \delta X_{i,j} + \varepsilon_{i,j}$$





RESULT #3:

2) Deal-level:

Prob(Deal is Cross-Border) ↑ with Foreign IO

Prob(Deal Success) ↑ with Foreign IO

Prob(Full Shares Acquired) ↑ with Foreign IO

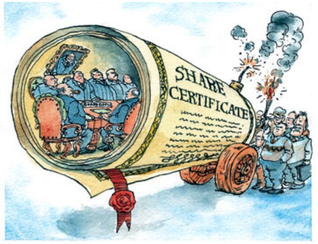
Combined (Announcement Return)CAR ↑ with Foreign IO

INTERPRETATION:

International institutional investors = shareholders at the "gates" that act as Trojan horses facilitating changes of control!

TAKEAWAY:

Increased likelihood of cross-border takeovers

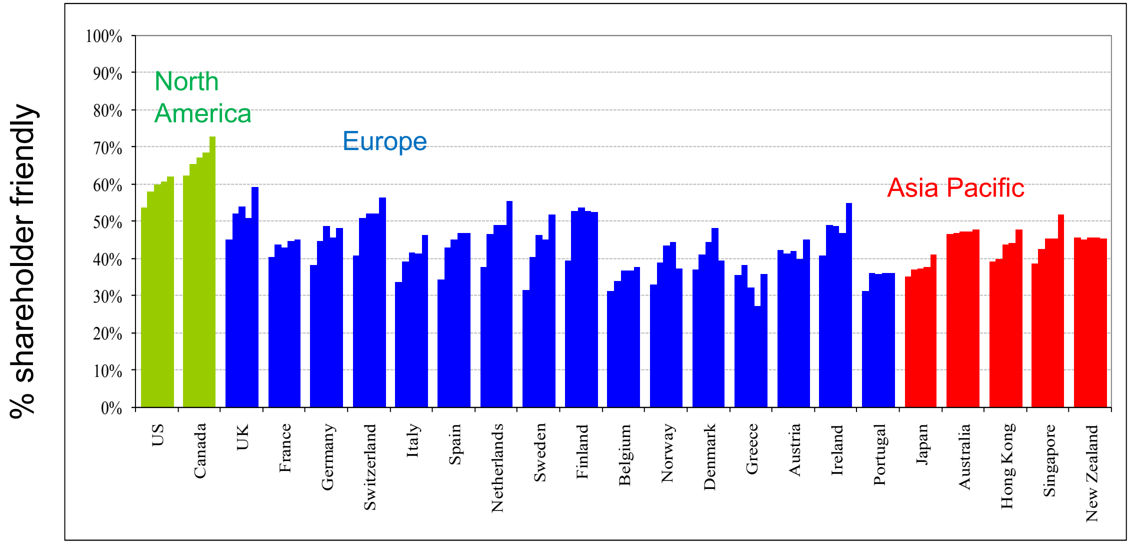


P3: DOES GOVERNANCE TRAVEL AROUND THE WORLD? EVIDENCE FROM INSTITUTIONAL INVESTORS WITH R. AGGARWAL, I. EREL AND M. FERREIRA. *JOURNAL OF FINANCIAL ECONOMICS*, VOL. 100 (1), P. 154-181, (APRIL 2011)

DATA:

Institutional holdings: FactSet/LionShares

ISS/RiskMetrics (2004-08): **Governance Index (*GOV_{41}*):** % of attributes that a firm satisfies, using minimally acceptable guidelines set by ISS. Board (24); Audit (3); Anti-takeover provisions (6); Compensation and ownership (8)



1,983 non-U.S. firms in **22 developed countries**

- Highest index (08): Canada (73%), U.S. (62%), U.K. (59%)
- Lowest index (08): Greece, Portugal (36%), Belgium (38%)
- Index has improved over time (yearly change 2.1%)

Data available at: http://faculty.msb.edu/aggarwal/governance_data.xls

RESULTS ON GOVERNANCE INDEX (GOV_{41}):

Outside the U.S., Foreign IO drive governance improvements

Changes in institutional ownership over time drive changes in governance (but not the opposite)

[Endogeneity: IV using MSCI dummy as instrument]

REAL OUTCOMES (NOT JUST "COMESTIC CHANGES"!):

Governance indexes criticized ("check-the-box", not good predictors of fraud, etc.) but evidence that institutions affects corporate governance outcomes:

- Higher CEO turnover-performance sensitivity in firms with higher institutional ownership

- Firm valuation goes up after institutional ownership increases (not the reverse)

INTERPRETATION:

International institutional investors lead to convergence in corporate governance practices worldwide

TAKEAWAY:

Adoption of more shareholder-centric (US-style) practices

P4: ARE US CEOS PAID MORE? NEW INTERNATIONAL EVIDENCE WITH N. FERNANDES, M. FERREIRA AND K. MURPHY. *THE REVIEW OF FINANCIAL STUDIES*, VOL. 26 (2), P. 323-367, (FEBRUARY 2013).

DATA:

Institutional holdings: FactSet/LionShares

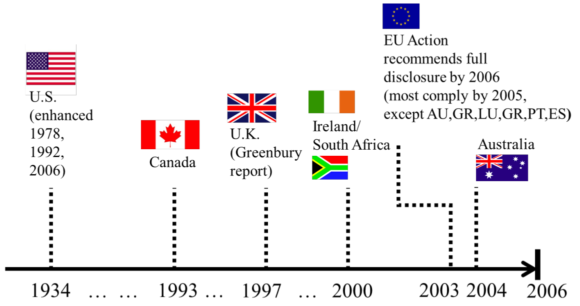
US firms: S&P's ExecuComp

Non-US firms: BoardEx [CEO pay + bios, boards] + Company Filings [annual reports, proxy statements, 20F forms …]

2006 (limited time-series: 2003-2008)

14 countries with mandated individual-level compensation disclosure

final sample = 3,263 CEOs



Country	Number of CEOs in Sample and Data Source: BoardEx & Exec	Corp. Filings	Total	% of Market Cap	CEO Pay ($ million): Mean	Median	Mean Composition of CEO Pay: Salary	Other	Bonuses	Stock & Options
Non-US	*1,251*	*364*	*1,615*	*83%*	*$2.8*	*$1.6*	*46%*	*8%*	*24%*	*22%*
US	1,648	0	1,648	90%	$5.5	$3.3	28%	6%	27%	39%

US Pay Premium ≈ 100% !

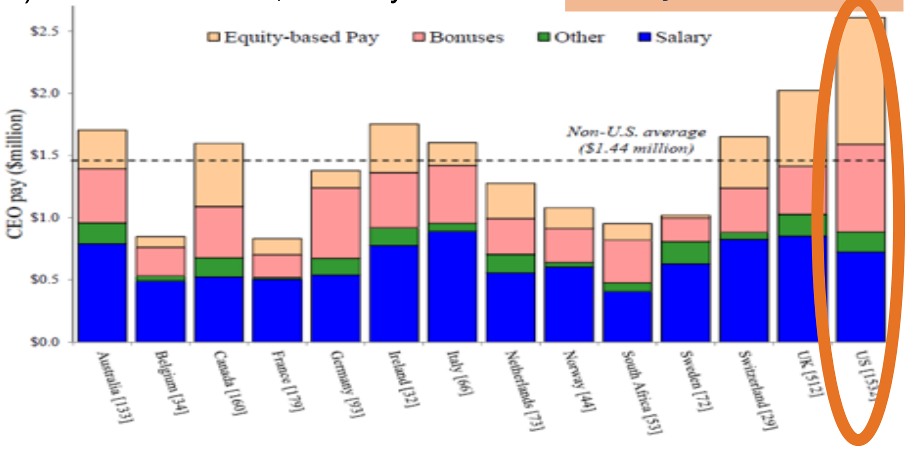
… but very different pay structure!

RESULT #1:

Predicted Level & Structure of CEO Pay ($1 billion sales)

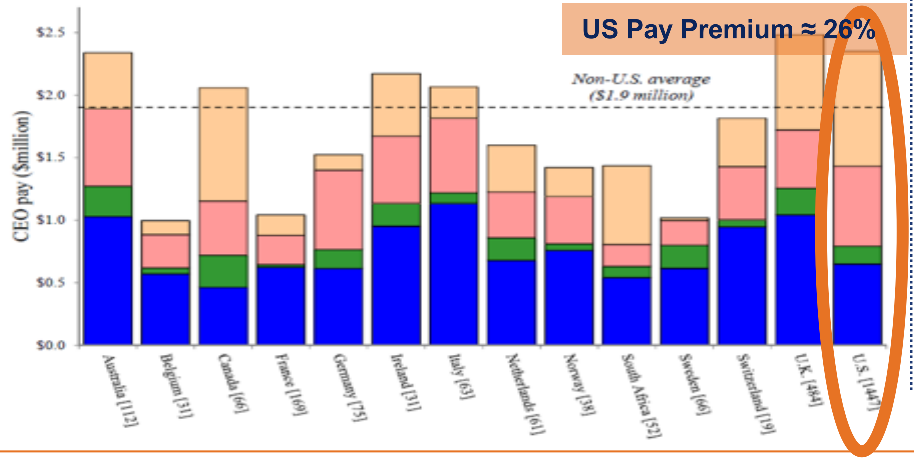
b) Control for sales, industry

US Pay Premium ≈ 79%



b) Control for sales, industry, ownership structure (Closely-Held, Foreign IO) and board independence

US Pay Premium ≈ 26%



RESULT #2:

Pay Gap smaller for Non-US firms with:
- Foreign investors (Foreign IO, MSCI, ADR)
- Foreign sales
- Foreign (US) acquisitions
- Board members with foreign (US) experience

INTERPRETATION:

Convergence towards US (incentive-based) pay among Non-US firms that are more "Internationalized" …almost "Law of One Price"?

TAKEAWAY:

Convergence to international (US) executive compensation practices

P4: ARE US CEOS PAID MORE? NEW INTERNATIONAL EVIDENCE WITH N. FERNANDES, M. FERREIRA AND K. MURPHY. *THE REVIEW OF FINANCIAL STUDIES*, VOL. 26 (2), P. 323-367, (FEBRUARY 2013).

PRESS COVERAGE – SAME EVIDENCE, BUT DIFFERENT CONCLUSIONS ☺ ?

MY OP-ED:

Forbes

LEADERSHIP | 3/13/2013 @ 11:20AM | 465 views

Do CEOs Make Much More In The U.S. Than Elsewhere?

This article is by Pedro Matos, an associate professor of business administration at the University of Virginia's Darden School of Business.

There has been a good deal of press coverage of the numbers of zeros in the paychecks of American chief executives. Many people, especially workers who have faced stagnant or lower wages in a tough economy, believe U.S. CEOs take home too much. This perception is usually supported with estimates by firms like Towers Watson, which conduct surveys showing that CEOs in the U.S. earn much more than their counterparts abroad. But is it true?

The difficulty in answering this question has come from a lack of good data on executive compensation across countries. But thanks to recently expanded disclosure rules, my co-authors and I were able to analyze data from more than 3,000 businesses across the U.S. and 13 other countries (mostly in Europe). In a recent paper we showed that the conventional wisdom that U.S. CEO pay is out-of-sync with the rest of the world is inaccurate or, at least, outdated.

ONE TYPE OF COVERAGE:

CNBC

The Myth of the Overpaid American CEO

John Carney | @carney
Published 3:31 PM ET Tue, 9 July 2013 | Updated 3:51 PM ET Tue, 9 July 2013

...

The fact is that U.S. companies are more likely to be owned by institutional owners and to have independent boards. These features of the American corporate ownership are closely linked to a larger fraction of compensation being paid in stock, for the very good reason that diversified institutional shareholders are interested in a rising stock market and want to provide incentives for stocks across the board to rise. Concentrated ownership—by families, by the government, by banks—is far more common outside the U.S. and apparently has an effect on how CEOs are paid.

Pedro Matos, an associate professor of business administration at the University of Virginia's Darden School of Business, was one of the authors of that study.

"In other words, the world is flat for CEOs, or nearly so," Matos wrote in Forbes earlier this year.

...

In other words, the American CEO's pay isn't some kind of group conspiracy or the result of a national delusion. It's largely in line with the rest of the world. Any marginal difference is better explained by actual performance and time spent at the company.

ANOTHER TYPE OF COVERAGE:

The Atlantic

U.S. Corporate Executives Aren't the Only Ones Making Tons of Money

CEO pay has been skyrocketing on both sides of the Atlantic. Now, a flurry of policies in the EU aims to put the massive earnings in check.

OLGA KHAZAN | MAR 19, 2013 | GLOBAL

FORTUNE

How to get paid like a U.S. CEO

July 5, 2011: 10:57 AM ET

While millions are still out of work, U.S. CEOs received a 28% pay raise this past year. A lot of factors are driving the increases. Job performance isn't one of them.

By Eleanor Bloxham, contributor

FORTUNE -- Did you get a decent raise last year? How about 28% without having to change jobs, vie for a promotion or outperform your peers?

If you were a CEO of an S&P 500 company last year and your pay *only* went up 28%, then sorry, but half your peers did better than you.

So with millions out of work, how do U.S. CEOs keep their pay rising in good times and bad? The short answer is an army of support and a few small distinctions.

Here's how it's done.

P5: ARE FOREIGN INVESTORS LOCUSTS? THE LONG-TERM EFFECTS OF FOREIGN INSTITUTIONAL OWNERSHIP WITH J. BENA , M. FERREIRA AND P. PIRES , *JOURNAL OF FINANCIAL ECONOMICS*, VOL. 126, PP. 122-146 (OCTOBER 2017)

MOTIVATION:

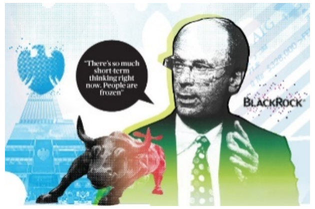
Foreign Institutional Investors:

Google Translate

"THE GREED OF BIG MONEY
Financial investors reach for German companies"

"We support those companies, who act in interest of their future and in the interest of their employees against irresponsible ***locust swarms****, who measure success in quarterly intervals, suck off substance and let companies die once they have eaten them away."*
Franz Müntefering, German SPD Chairman
(2005)

Long-term Institutional Investors:



"The effects of the ***short-termist phenomenon*** *are troubling (...) In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while* ***underinvesting in innovation, skilled workforces or essential CAPEX necessary to sustain long-term growth.****"*
Laurence Fink, CEO, BlackRock (2015)

P5: ARE FOREIGN INVESTORS LOCUSTS? THE LONG-TERM EFFECTS OF FOREIGN INSTITUTIONAL OWNERSHIP WITH J. BENA , M. FERREIRA AND P. PIRES , *JOURNAL OF FINANCIAL ECONOMICS*, VOL. 126, PP. 122-146 (OCTOBER 2017)

DATA:

Coloring by geographical region

Other

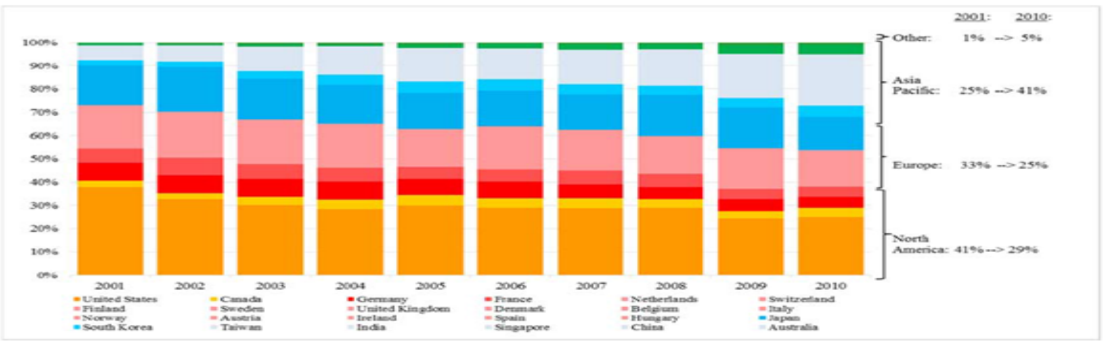
Asia-Pacific

Europe

North America

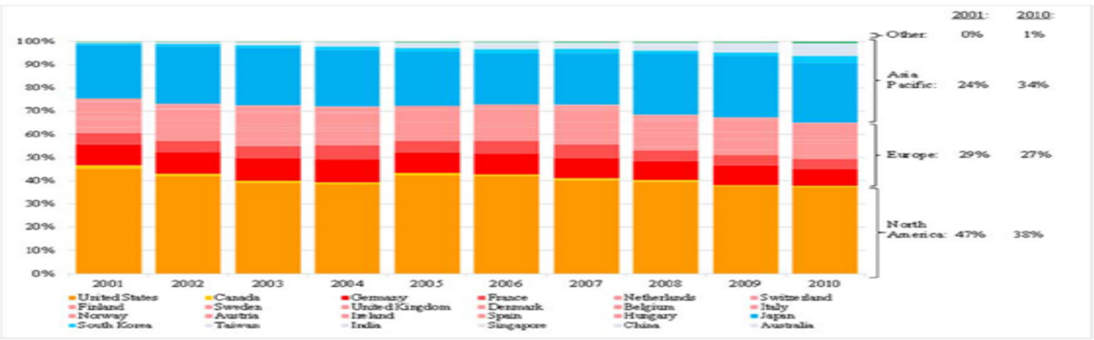
Physical Capital (CAPEX)

Panel A: Percent of Capital Expenditures



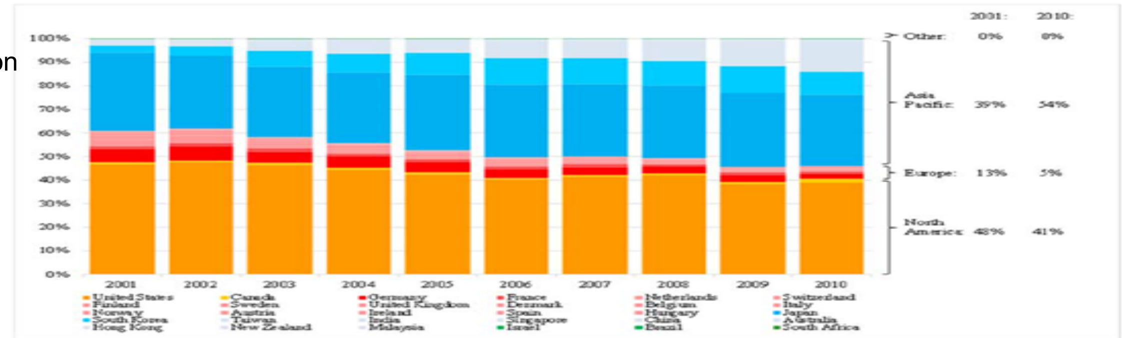
Intangible Capital (R&D)

Panel B: Percent of R&D Expenditures



Innovation Output = Patents

Panel C: Percent of Number of Patents



RESULT #2:

First stage: MSCI addition => +3% in Foreign IO

Second stage: +3% in Foreign IO is positively associated with ...
+0.3% long-term investment (CAPEX + R&D)
+12% employment
+11% innovation output (Patent counts)
IV and Diff-in-diff (additions) MSCI index suggest causal effect

Foreign IO positively linked to productivity and shareholder value

INTERPRETATION:

Common fear that foreign portfolio flows are "hot money" seeking short-term gains, with no concern for the long-term prospects of local firms … evidence above runs counter to these concerns: foreign institutional investors are NOT "locusts". Evidence in support of monitoring role of Foreign IO.

TAKEAWAY:

Can sustain long-term investing

TO RECAP …

- Globalization of firm's shareholder base can be a positive force!

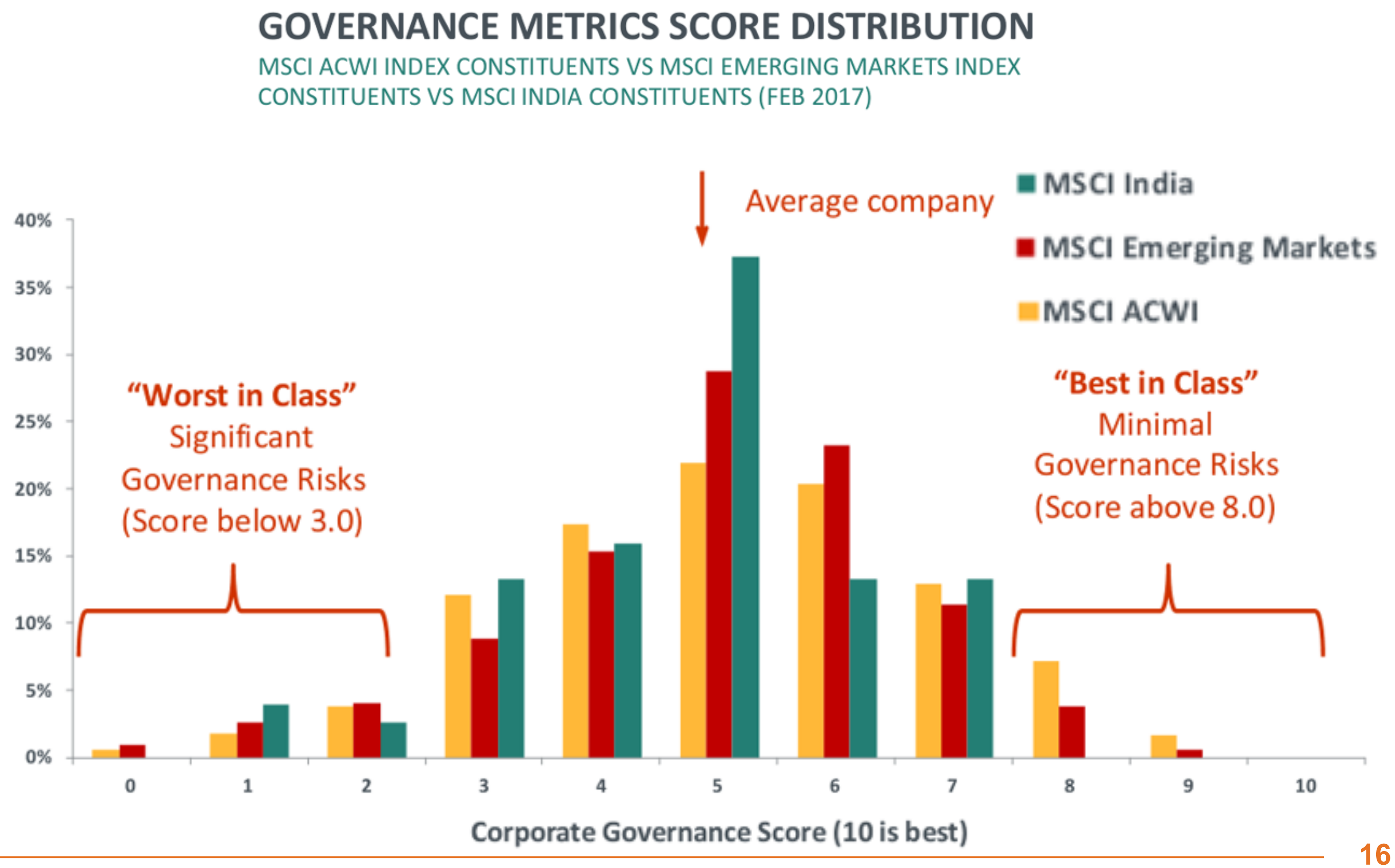
- Rise of Foreign Institutional Ownership on average leads to:
  - Performance: Increased shareholder pressure to perform
  - M&As: Increased likelihood of cross-border takeovers
  - Governance: Adoption of more shareholder-centric (US-style) practices
  - CEO Pay: Convergence to international (US) executive compensation practices
  - LT Investing: Can sustain long-term investing

BACK TO INDIA

- ## CORPORATE GOVERNANCE

MSCI

India underperforms.
Key areas of concern: audit committee composition, auditor report concerns, related party transactions, poor board attendance

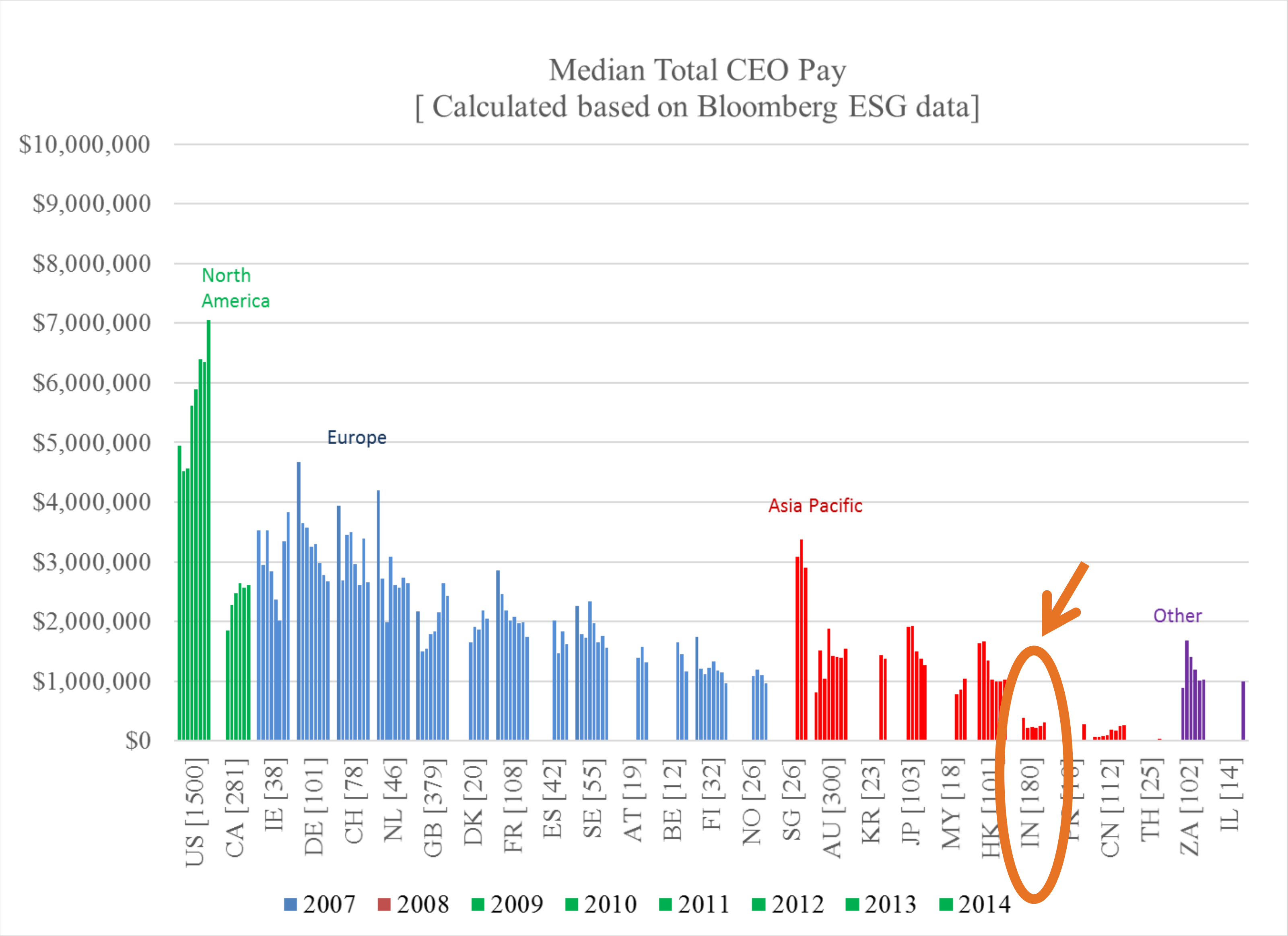


BACK TO INDIA (2)

- **CEO PAY**

“International Corporate Governance Spillovers …”, with R. Albuquerque, M. Ferreira and L. Marques (revise & resubmit)

Bloomberg



BACK TO INDIA (3)

- **LONG-TERM INVESTING**

The Economist

Globalisation

The fear factor

Why Asian firms need to take on the world

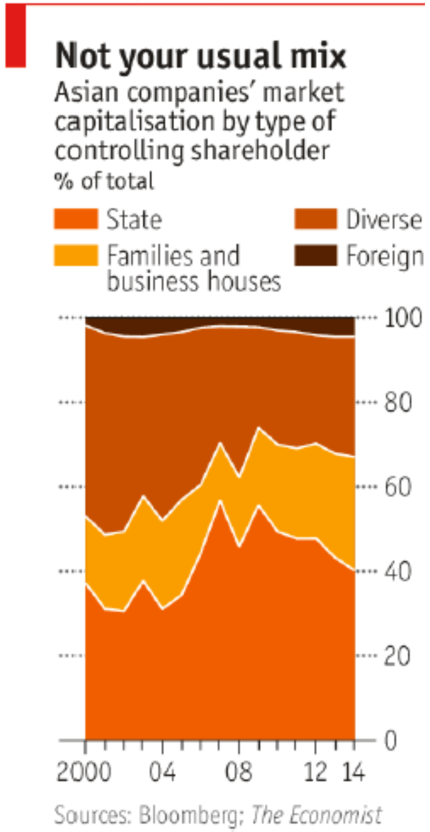
May 31st 2014 | From the print edition

Governance

Avoiding the dinosaur trap

State firms and family conglomerates are Asia's favourite kinds of companies. Both must change

May 31st 2014 | From the print edition



CONCLUSIONS

- Policy-making should be evidence-based! Support academic research on the Indian market!

"It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts."

The Adventures of Sherlock Holmes

"A Scandal in Bohemia"

- I look forward myself to learn more at ACGA in the next couple of days!

WEBLINKS TO PUBLICATIONS

P1: The Colors of Investors' Money: The Role of Institutional Investors Around the World with M. Ferreira, *Journal of Financial Economics*, Vol. 88 (3), p. 499-533, (June 2008)

P2: Shareholders at the Gate? Institutional Investors and Cross-Border Mergers and Acquisitions with M. Ferreira and M. Massa, *Review of Financial Studies*, Vol. 23 (2), p. 601-644, (February 2010)

P3: Does Governance Travel Around the World? Evidence from Institutional Investors with R. Aggarwal, I. Erel and M. Ferreira, *Journal of Financial Economics*, Vol. 100 (1), p. 154-181, (April 2011)

P4: Are US CEOs Paid More? New International Evidence with N. Fernandes, M. Ferreira and K. Murphy, *The Review of Financial Studies*, Vol. 26 (2), p. 323-367, (February 2013).

P5: Are Foreign Investors Locusts? The Long-Term Effects of Foreign Institutional Ownership with J. Bena , M. Ferreira and P. Pires, *Journal of Financial Economics* ,(forthcoming)


Thank you!
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