The Impact of Foreign Ownership on Firm Value

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외국인 소유지분이 기업가치에 미치는 영향

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요 약

After the year of 2000, compositions of stock holders in domestic firms are rapidly changing. In domestic stock market, the proportion of market value held by foreign investors reaches over 40%. There are several blue chip companies among those where foreign investors hold more than 50% of the stocks. There are still hot debates going on about whether the increase in the number of foreign investors contributes to domestic companies. This research attempted to determine foreign ownership increases enhance firm value empirically. It has been shown that foreign ownership variable has significant positive impact on Tobin's Q of firm value variable. The result suggests that foreign ownership increases in domestic corporations positively contribute to firm value, as they monitor and keep the management transparent as an institutional investor, and they work to soothe agency problems by the managements or the large stock holders.

Ⅰ. Introduction

There are hot debates going on about whether the increase in the number of foreign investors contributes to domestic companies, and how. Those who view it positively claim that it improves firm value, by keeping the management transparent, while also serving as a brake on the management if it gets out of hand. Those who frown on it see it as a minus to firm value, as foreign investors use capital on buying treasury stocks or increasing dividend, and may try to merger domestic companies.

This research analyzes whether the increase in foreign investments improve values of the firms. Foreign investors, who grew large in number after the Korean currency crisis, are evaluated to have contributed to liquidity of stock market and changed the governance structure of domestic firms. Moreover, an increase in needs of domestic stocks strengthened international competitiveness of domestic firms by reducing capital cost, and therefore, contributing to the development of domestic capital market and national economy. However, foreign investments tend to focus on indirect investing on securities, and fund managers decide whether they will purchase domestic stocks. Fund managers' performances depend on the stock market indexes, and they are evaluated among themselves in order to determine their compensations. Foreign fund managers have an incentive to sell their stocks if the firms does not reach expected yield in a short period of time. Therefore, they tend to stick with myopic short term investments, and focus on allocating corporate cash flows and dividend increase and stock repurchase, while shunning the firms' research efforts or facility investments for long term growth. In some cases, foreign investments in stock market are conceived as detrimental by a few hedge funds.

Ⅱ. Literature Survey

In the past literature, an analysis of causality between foreign investors as institutional investors and firms' returns has been debated. Many researches on foreign ownership and corporate performances are done in relation with the causation between ownership structure or governance structure, and corporate performances. These researches assume that in terms of agency theory, ownership and governance structure decides corporate performance. Whether it is institutional investors or foreign investors, and or whether certain shareholder groups actively play in the management or not, corporate performance will improve with a monitoring function. Researches in this field point to institutional investors as those with capability to monitor firms. In accordance

[Table 1] The Impact of Foreign Ownership on Firm Value (1)

-Instrument Variable Regression-

	Manuf.	Ele. Gas Water	Constr.	Sale	Trans.	Others	Total
Foreign	0.05 (8.44)**	0.002 (0.08)	0.004 (0.86)	0.07 (3.49)**	0.04 (1.71)	0.07 (0.49)	0.05 (9.18)**
Sales	0.04 (3.64)**	0.02 (1.28)	0.02 (2.02)*	0.08 (2.21)*	0.10 (1.32)	0.12 (0.88)	0.03 (3.01)**
RnD_K	0.16 (1.77)	6.06 (1.73)	0.17 (0.68)	2.51 (1.69)	0.24 (0.18)	0.34 (0.61)	0.45 (5.08)**
Adv_K	0.19 (1.74)	1.74 (0.32)	0.09 (0.76)	0.19 (1.65)	6.07 (1.33)	0.22 (0.14)	0.02 (0.43)
CapEx_K	0.01 (2.13)*	0.02 (1.14)	0.001 (0.24)	0.0009 (0.22)	0.03 (0.21)	0.11 (2.63)*	0.01 (5.27)**
Y_Sales	0.02 (4.15)**	0.19 (0.79)	0.002 (0.66)	0.33 (2.35)*	0.58 (0.99)	0.0002 (0.04)	0.002 (2.36)*
K_Sales	0.13 (2.71)**	0.03 (2.99)**	0.007 (1.70)	0.03 (0.35)	0.007 (0.08)	0.01 (0.30)	0.03 (4.04)**
Lever	0.32 (6.39)**	0.31 (3.27)**	0.34 (5.74)**	0.33 (1.55)	0.20 (0.57)	1.58 (1.42)	0.39 (8.33)**
Growth	0.01 (0.45)	0.23 (1.08)	0.006 (0.83)	4.8E 7 (0.00)	0.14 (2.37)	0.10 (0.85)	0.0005 (0.01)
Year99	0.01 (0.38)	0.01 (0.41)	0.04 (1.58)	0.02 (0.15)	0.18 (1.24)	0.15 (0.21)	0.01 (0.59)
Year00	0.06 (1.91)	0.08 (2.73)	0.06 (2.44)	0.006 (0.04)	0.001 (0.01)	1.06 (1.59)	0.06 (2.03)
Year01	0.05 (1.83)	0.07 (2.27)	0.06 (2.32)	0.13 (087)	0.04 (0.30)	0.11 (0.17)	0.06 (2.15)
Year02	0.11 (3.54)	0.08 (2.78)	0.09 (3.38)	0.04 (0.29)	0.08 (0.52)	0.56 (0.87)	0.12 (3.72)
Year03	0.08 (2.71)	0.05 (1.50)	0.09 (3.39)	0.07 (0.45)	0.06 (0.41)	0.57 (0.91)	0.10 (3.12)
Const.	2.63 (9.52)	0.64 (1.13)	0.77 (2.80)	3.46 (4.09)	3.67 (2.22)	0.19 (0.06)	2.43 (9.90)
Adj.R^2	0.22	0.37	0.47	0.17	0.35	0.47	0.21
F	44.63	7.58	13.21	4.06	4.67	3.86	54.73
N	2.065 (77.3%)	27 (1.0%)	191 (7.1%)	205 (7.6%)	93 (3.4%)	45 (1.6%)	2669 (100%)

Note: Ratio = foreign ownership ratio (The portion of foreigners' ownership of total number of common stocks outstanding, Foreign = log(Ratio/(1 Ratio)), Tobins_Q = Market value of assets/ Book value of assets, Sales = log(total sales), RnD_K = R&D expenses/ Tangible assets, Avd_K = Advertising expenses/ Tangible assets, CapEx_K = Capital expenses/ Tangible assets, Y_Sales = Operating profit/ Total sales, K_Sales = Tangible assets/ Total sales, Lever = Book value of debt/ Market value of asset, Growth = Average growth rate of total sales over the past 3 years.

Asterisks * and ** indicate significances at the 5% level and at the 1% level.

with the efficient monitoring hypothesis, McConnell and Servaes [1] found that shareholdings of institutional investors are in a positive close relationship with Tobin's Q, corporate performance index. Chaganti and Damanpour [2] found that institutional inverstors' share holdings have positive impact on capital yield. Meanwhile, Pound [3] found that institutional investors tend to vote in favor of the management at shareholders' meetings, and claimed they are not being efficient monitors. Afterwards, Khanna and Palepu [4] found a direct causal relationship between foreign investors' shareholdings and firm value, by analyzing the relationship between foreign ownership and corporate performance. In domestic literature, Kim Yong Sook and Lee Jae Chun [5] examined the empirical relationship between ownership structure and firm value and found that the larger the proportion of institutional investors' shareholdings, the higher firm value. Recently, Park Hun Joon, Shin Hyun Han, and Choi Whan Soo [6] found that the larger foreign investors' shareholdings, the lower agency cost such as perk expenses. Kang Sin Ae and Min Sang Ki [7] conducted a panel data analysis by subdividing the total sample for the period from 2001 to 2008 into several panel data subsamples. They found the positive correlation coefficient estimates between foreign investors in the low-level panel sample and enterprise values. Cho Jung Il and Byun Jong Cook [8] run a OLS regression on the foreign investors' data from 2000 to 2007 and found a highly positive correlation between foreign investor and enterprise value.

Ⅲ. Methodology

Our sample includes the firms listed on the Korea Stock Exchange.. The sample excludes financial institutions and communication companies since these firms are regulated during the sample period, and their business styles may differ from those of other firms. Stock price, stock returns, and market returns data are from Korea Information Service (KIS) database. Accounting data are from Korea Listed Companies Association (KLCA) database, and the financial variables are calculated.

We estimate an instrumental variable (IV) regression model. It corrects the endogeneity problem in which foreign ownership variable is used as an explanatory variable.

$$\text{Tobins\_Q} = \beta_0 + \beta_1\ \text{Foreign} + \beta_2\ \text{Sales} + \beta_3\ \text{RnD\_K} + \beta_4\ \text{Adv\_K} + \beta_5\ \text{CapEx\_K} + \beta_6\ \text{Y\_Sales} + \beta_7\ \text{K\_Sales} + \beta_8\ \text{Lever} + \beta_9\ \text{Growth} + \beta_{99\ 03}\ \text{Yearly\_Dummies}$$

Tobins_Q is a proxy variable for firm value, which is scaled by market value of assets to book value of assets. Explanatory variables are chosen, considering the test models of Himmelberg, Hubbard, Palia [4], Dahlquist and Robertsson [5], Habib and Ljungqvist [9].

Foreign investors may induce greater monitoring through the participation in the board of directors and mitigate the incentives for management to take value-destroying projects. The testable hypothesis is as follows.

(Hypothesis): *Foreign ownerships increase corporate performances and value of the firm.*

Ⅳ. Empirical Results

Table 1 shows how foreign ownership variable affects firm value by adjusting endogeneity problem of foreign ownership variable, using instrumental variables. Foreign ownership's influence has been estimated, declaring Tobin's Q as dependent variables, total sales as controlling variable Sales, RnD_K (research and development expenses), Adv_K (advertising expenses), CapEx_K (capital expenses), Y_Sales (operating profits), K_Sales (tangible assets), Lever (debt ratio), and Growth (growth rate). Market value of common stocks Ln_MktCap, and ownership ratio of the largest sharesolders, Largest, have been used as instrumental variables of foreign ownership ratio variables. In Table 1, in the manufacturing sector, which takes 77.3% of the whole industry, the coefficient estimate of foreign ownership variable Foreign, in relation to the proxy variable of firm value, Tobin's Q, is 0.05, and at 1% level, it was statistically very significant. This is evidence that shows as foreign ownership rises, Tobin's Q also rises, supporting the efficient monitoring hypothesis on foreign investors.

In addition,,an analysis has been applied to include Foreign2 variable, a squared value of Foreign, by studying relationship between foreign ownership ratio variable, and firm value variable, and by considering nonlinearities possibility. The coefficient estimate of foreign ownership variable Foreign, in relation to Tobin's Q, is still 0.05, which is statistically very significant at 1% level, but the coefficient estimate of Foreign2 was not significant and is not different from zero statistically. In Table 1 controlled variables such as Sales(total sales), CapEx_K(capital expenses), Y_Sales(operating profits), K_Sales(tangible assets), and Lever(debt ratio) show significant coefficient estimates, but such was not the case with RnD_K(research and development expenses), Adv_K(adverting expenses), and Growth(growth rate).

V. Conclusions

This paper empirically analyzes whether foreign investments improve firm value. A regression analysis has been done to determine whether foreign investors positively affect firm value by using instrumental variable on foreign ownership. It was shown that foreign ownership variable has a consistently positive impact on Tobin's Q of firm value variable. Therefore it is interpreted that foreign investments in domestic firms contribute to monitoring functions as institutional investors, soothe the agency problems by management or the largest shareholders, and finally, contribute to improvement of firm value.

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