

CORPORATE OWNERSHIP STRUCTURE AND FIRM PERFORMANCE IN SAUDI ARABIA¹

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Abstract

The empirical results of this study suggest that corporate ownership structure has a significant effect on firm performance. Previous studies focus solely on US firms. This study is based on all publicly traded firms on the Saudi stock market. More generalized insights into the relation between ownership structure and firm performance are obtained by examining the performance of Saudi firms using ROE as a proxy for firm performance. The results show that Government Ownership (GO) and Foreign Ownership (FO) have statistically significant impact on firm performance as measured by ROE.

Introduction

This paper examines the effect of corporate ownership structure and firm performance using ROE as a measure of performance. Following Jensen and Meckling [1976], interest in the relation between firm performance and the allocation of shares among shareholders has continued to evolve in the finance literature. According to Jensen and Meckling [1976], managers have the tendency to allocate firm's resources in their own best interests. This behavior may conflict with the interests of outside shareholders. As managers' equity ownership increases, however, their interests coincide more closely with those of outside shareholders, and hence the conflicts between managers and shareholders are likely to be resolved. Thus, management's equity ownership helps resolve the agency problems and improve the firm's performance. However, several studies suggest that management's ownership does not always have a positive effect on firm performance. Fama and Jensen [1983] demonstrate that managers who own enough stock to dominate the board of directors could expropriate corporate wealth. Large-block shareholder could, for example, pay himself an excessive salary, negotiate deals with other companies he controls, or invest in negative-net-present-value projects. Stulz [1988] explains how owning large blocks makes it easier for managers to be entrenched. Thus, greater stock ownership by managers increases the owner of the internal constituency, but decreases the power of the external constituency in influencing corporate performance.

Berle and Means [1968] argued that the separation of owner and manager found in the joint-stock firm form of corporation created situations where the interests of owners and managers

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might differ. The shareholder owner often held equity in a number of firms and chose not to take an active role in the management of any one firm but hire professional managers to direct firm activity. Because of their ability to diversify their overall financial risk through portfolio investments, the shareholder owner is likely to prefer that the individual firms take riskier actions that maximize their wealth. Thus, the separation of ownership and the diversification potential of owners create two problems. First, the interests of owners and managers will often tend to differ in terms of risks and benefits. Second, managers may possess information not readily available to owners and are in a position to use their control of information to justify or support actions that are in their interest but not the firm as a whole including shareholders.

The objective of this paper is to examine the effect of corporate ownership structure on firm performance. Specifically, this paper examines the effect of Government and Foreign Ownership on firm performance which has not been studied in extant literature. We seek to investigate the relation between ownership structure and firm performance using Saudi firms' sample. This research uses Saudi data which includes 67 firms, an emerging market in the Middle East instead of focusing on U.S. firms. We use return on equity as a measures of firm performance instead of short-term stock returns which are too volatile to be used as a reliable measure of corporate performance since long term returns will capture corporate performance more effectively. This paper is structured as follows. Section II reviews the previous literature. Section III describes the data and research methodology. Section IV presents the empirical results. Section V concludes the paper.

II Literature Review

Morch, Shieifer, and Vishny [1988], and McConnell and Servaes [1990], among others, empirically examine the effect of ownership structure on corporate performance. Morch, Shleifer, and Vishny [1988] estimate a piece-wise linear regression in which the dependent variable is Tobin's q ratio [1969] as a proxy for corporate performance, and the primary independent variable is the fraction of shares owned by corporate insiders. While these studies do not agree on details, they both report that the relationship between q ratio and the degree of insider ownership is not linear: in some range of insider ownership, q ratio is positively related to insider ownership, but in other range, a negative relationship is found. Thus, the results of these studies suggest that insider ownership does not always have a positive effect on corporate performance. Using a different methodology, McConnell and Servaes [1990] also demonstrate that q ratio is nonlinearly related to the degree of insider ownership. Interestingly, McConnell and Servaes show that q ratio is positively related to the degree of institutional ownership, indicating a positive effect of institutional ownership on corporate performance. They suggest that managers' entrenchment would be more difficult with the existence of institutional shareholders.

Jensen and Meckling [1976] in their seminal research on corporate governance triggered a large body of theoretical and empirical researches that are largely focused on U.S. based corporate governance in the 1980s. By the early 1990s, however, research on corporate governance focused primarily on other major world economies such as U.K., Germany and Japan. More recently, there has been an explosion of corporate governance research around the world.

Holderness [2003] surveys the U.S. evidence on equity ownership by officers and directors of a firm and block holders that own at least 5% of the firm's equity. He reports that the average inside ownership in publicly traded U.S. corporations is approximately 20%, varying from almost none in some firms to majority ownership by insiders. In another survey, Holderness [2003] examines the effects of management and blockholder equity ownership on corporate decisions and on firm value and finds opposing results about the effects. The U.S. evidence regarding the effects of ownership structure on corporate decisions and on firm value is mixed. Morck, Shleifer and Vishny [1988] and McConnell and Servaes [1990] find that the alignment effects of inside ownership dominate the entrenchment effects over some ranges of managerial ownership. However, as inside ownership increases beyond some level, the entrenchment effects of inside ownership dominate and higher inside ownership is associated with lower firm value. In contrast, Himmelberg, Hubbard and Palia [1999] use panel data and conclude that a large fraction of the cross-sectional variation in managerial ownership is endogenous. They suggest that managerial ownership and firm performance are determined by a common set of characteristics and, therefore, question the causal link from ownership to performance implied by previous studies.

Beginning in the late 1990s, studies of equity ownership concentration expanded to include countries from the emerging markets. This body of evidence reveals that concentrated ownership structures are more typical of ownership structures around the world than are the relatively diffused structures observed in large, publicly traded U.S. and U.K. firms. This generalization, however, masks important differences across countries with respect to the degree of ownership concentration and the identities of the blockholders. Faccio and Lang [2002] in their European studies conclude that listed firms are generally either widely held, which is more common in the U.K. and Ireland, or family owned which is more common in continental Europe. Xu and Wang [1997] document high ownership concentration in China, with ownership split relatively equally between the government, institutions, and domestic individuals. Valadares and Leal [2000] document high ownership concentration in Brazil; with the majority of blockholders being corporations or individuals.

Numerous other studies address the relationship between ownership structure and firm performance. Kang and Shivdasani [1995] find that Japanese firms with blockholders restructure more quickly following performance declines than do Japanese firms without blockholders. They point out, however, that the response comes less quickly in Japan than in the U.S. Gordon and Schmid [2000] document that firm performance in Germany is positively related to concentrated equity ownership. There are numerous potential types of large shareholders: other corporations, institutions, families and government. The evidence implies that the relation between large shareholders and value often depends on who the large shareholders are. Claessens, Djankov, Fan, and Lang [2000], for example, examine firms in nine East Asian countries and find that the impact of ownership varies according to the identity of the block holder. They conjecture that ownership by corporations is negatively related to performance, while ownership by the government is positively associated with performance. They find no relation between institutional ownership and firm performance. Gibson [2003] studies firms in eight emerging markets and reports that, while CEO turnover is likely for poorly performing firms in the sample

overall, there is no relation between CEO turnover and firm performance for the subset of firms that have a large domestic shareholder.

The evidence from around the world indicates that the relation between ownership structure and firm performance varies by block holder identity. Overall, however, this body of evidence suggests that there is a more significant relation between ownership structure and firm performance in U.S. firms. We are interested in finding whether or not ownership structure has a positive effect on firm performance in Saudi Arabia.

III Data and Research Methodology

The sample data on stock ownership is obtained from the 2003 Bakheet Financial Advisors and 2003 Saudi Stock Market Guide published by the Saudi American Bank (SAMBA) consisting of the 67 Saudi firms. We checked the same data from other sources including 2002 Middle East Economic Digest (MEED) to verify the information on the 67 Saudi firms. We selected and classified the firms as Government-Controlled (GO), Foreign-Controlled (FO), Owner-Controlled (OC) or Manager-Controlled. GO, FO and OC status was assigned to firms if the largest shareholder owned 20% or more of the voting common stock. Conversely, MC status was assigned to firms if no single holding of stock is greater than 5% of the outstanding common stock. This control criterion was used by Berle and Means [1968], Elliot [1972], Karnerschen [1968], Lerner [1966] and Sorenson [1974]. The return on equity during a 2-year period [2001-2002] is adopted as the appropriate measure of a firm's performance. The effect of ownership structure on performance was evaluated through regression methodology. We adopt a regression approach to control for other potentially influencing factors.

We used cross-sectional data for a two-year period (2001 through 2002) to examine the relationship between ownership structure and firm performance. We consider this time period to be sufficient in length to enable us identify the relationship between ownership control and the firms' financial characteristics. In fact, this shorter test period minimizes measurement errors over longer periods due to changing firm risk and common stock ownership positions in Saudi Arabia.

IV Empirical Results

We adopt ROE as a measure of firm performance since ROE is the accounting ratio often used to measure the effective performance of management. In order to assess the impact of corporate ownership structure on firm performance; we use the following regression model:

$$ROE = \alpha + \beta_1 GO + \beta_2 FO + e \dots \dots \dots 1$$

ROE = Return on Equity

GO = Government Ownership

FO = Foreign Ownership

**Table 1: Effect of Corporate Ownership Structure on Firm Performance:
Regression Results**

2001	$ROE = \alpha + \beta_1 GO + \beta_2 FO + e$ F-value = 7.18 Sig. = 0.002 R₂=18% $ROE = .0291 + .140(GO) + .441 (FO)$ t-values (2.282) (3.260)
2002	F-value = 8.351 Sig. = .001 R₂=20.2% $ROE = 0.02926 + 0.07521(GO) + .214(FO)$ t-values (2.463) (3.218)

This model is estimated using two series of cross-sectional data for 2001-2002 in order to assess the consistency of the results across these two sub-periods. The results of estimating equation (1) are summarized in Table 1. These results based on 2001 data reveal that the model is statistically significant at .002 level (F-value= 7.18). Both GO and FO have statistical significant impact on ROE at .026 and .002 level of significance respectively. The analyses of 2002 data reveals that GO and FO have statistical significant impact on ROE at .016 and .002 level of significance respectively. These results are consistent across the two test periods. The model suggests that corporate ownership structure has strong effect on firm performance in Saudi Arabia.

The results suggest that FO has positive effect on firm performance possibly due to the managerial efficiency and technical skills as well as the state of technology that foreign owners bring to their work environment. Given that the Saudi Government is contemplating to join WTO in the near future, the results imply that Government policies with regards to foreign direct investment should be further relaxed to attract foreign investors into the Country. These changes in the private sector would promote efficiency and contribute to growth in the economy. The positive impact of GO on Saudi firm performance may indicate that firms in which government have ownership enjoy natural or legalized monopolistic powers. Additionally, government often instructs their agencies to procure their needs from firms in which the government has ownership.

V Conclusions

Does corporate ownership structure (GO and FO) impact firm performance? The answer to this question is yes based on the statistical results of this study. The positive impact of FO on performance is not too surprising since the foreign owners employ efficient management practices and use state of the art technology, both of which enhance performance. The implications of the results suggest that FO and GO have positive impact on the ROE and hence the firm performance. In contrast, the positive impact of GO on performance is somewhat surprising. This can be partly explained by the monopolistic nature of the sectors in which the government has stake. To develop more generalized insights into the effect of corporate

ownership structure on firm performance, we need to expand the domain of the study into the Gulf Cooperation Council (GCC) nations.

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