Foreign Institutional Investors, Controlling Shareholders and Market Timing

Evidence from India

Bindal, Haque, Saurabh

December 16, 2016
Motivation

FIIs as sophisticated investors (Ferreira and Matos, 2008)
Exporting good governance (Aggarwal, Erel, Ferreira, Matos, 2011)
What about emerging markets?
Twin agency problems (Stulz, 2005)
Study interaction of FIIs with controlling shareholders in emerging markets
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- Study interaction of FII with controlling shareholders in emerging markets
Research Question

Do information barriers make FIIs susceptible to market timing by corporate insiders in Emerging Markets?

Do financial markets overestimate the gains from FII shareholding?

Highlight the role of information asymmetry in emerging markets and its implication for efficient allocation of foreign investments.
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- Do financial markets overestimate the gains from FII shareholding?
- Highlight the role of information asymmetry in emerging markets and its implication for efficient allocation of foreign investments
Main Findings

- FII make poor investment choices, extrapolating from past performance.
- Information asymmetry leads to opportunistic market timing by controlling shareholders.
- Disconnect between short-run market reaction and long-term performance.
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- Disconnect between short-run market reaction and long-term performance
Institutional Background

Regulations governing FII shareholding in Indian firms

▶ Initial limit of 24% on aggregate FII ownership
▶ Individual FII cannot own more than 10% of the firm
▶ Firms can raise the limit on aggregate FII stockholding through board approval, a subsequent shareholder vote and final approval from the central bank (RBI)
▶ RBI monitors FII stockholding and imposes restrictions (Trigger) when such holdings reach within 2% of the existing ceiling or prohibits further purchase (Bans) when the holdings reach the statutory ceiling
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Event Timeline

- FII buys and sells stocks
- RBI Monitors the total holding

- RBI issues a trigger
- FII can buy with RBI approval
- RBI issues a ban
- FII cannot buy any more shares

FII Holding →

Firm proposes to increase FII limit → Board meets and approves FII limit increase → Shareholders vote on the proposal → RBI reviews and approves limit increase → RBI notifies the investors via press release

Event Date → Event Date →
Empirical Design

Y_{it} = \beta_{\text{FIILimit}}{it} + \gamma^\prime X_{it} + \alpha_i + \eta_t + \epsilon_{it} (1)
Empirical Design

- Event study
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  - Board approval dates

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- Event study
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- Long-run stock performance following FII Limit increase (BHAR)
- Panel regression with year and firm fixed effects
  - Standard errors are clustered by firm

\[ Y_{it} = \beta FII Limit_{it} + \gamma' X_{it} + \alpha_i + \eta_t + \epsilon_{it} \]  (1)
Data

Event dates (1998-2015) collected from the Reserve Bank of India (RBI) website

FII limit increases (FIILimit)

Shareholding data scraped from Stock Exchanges

Indian companies are required to submit quarterly shareholding pattern to the stock exchanges

Collected data on promoters stake, FII shareholding and other institutional investor holdings

Stock returns and Firm characteristics

Compustat Global - Daily security file, annual fundamental file

Prowess - Board related measures, acquisitions
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<tr>
<th>Variable</th>
<th>FII Limit Firm</th>
<th>Typical Firm</th>
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<tr>
<td>Assets</td>
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<td>Capital Expenditure (%)</td>
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<td>Cash (%)</td>
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<td>ROA (%)</td>
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<td>Dividend Payers (%)</td>
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## Ownership Changes

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Short run effect of FII limit increase
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- RBI Approval

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Trends

Short-run market reaction is positive but stocks of FII-limited firms strongly underperform in the long run.

- Signaling: Inconsistent
- Market timing by controlling shareholders: Supportive

Examine trends in firms' operating performance around the FII limit increase.

- Market Cap
- ROA (Industry-adjusted)
- EBITDA (Industry-adjusted)
Trends

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- Mean and median tests
Market Capitalization
Return on Assets

![Industry Adjusted ROA Graph](image)

- **Others**
- **FIILimit**
Do controlling shareholders exploit information advantage and stock misvaluation to engage in acquisition activity?

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<th>Outside Group</th>
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FII Limit and Acquisitions

Do controlling shareholders exploit information advantage and stock misvaluation to engage in acquisition activity?
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Use overpriced stock as currency to acquire real assets

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Conclusion

Document opportunistic market timing behavior by informed, controlling shareholders (promoters)

Poor investment choices by FIIs and failure to improve firm value and governance in the context of emerging markets

Information asymmetry and ownership structure has tremendous implications for foreign investments in emerging markets

Study also raises questions on relying on short-run event studies, especially in markets characterized by opaque firm-specific information
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- Study also raises questions on relying on short-run event studies, especially in markets characterized by opaque firm-specific information