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Ownership structure and firm's financial performance: Sri Lankan evidence

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Abstract

Financial performance is vital importance for every organization, and it is affected by many factors. The ownership structure is one of the main determinants that influence the firm's financial performance. Many researchers have given the importance of company's ownership structure in corporate governance mechanisms, whereas studies on ownership structure and financial performance of firms have yielded non-conclusive empirical findings. Limited studies have observed, explored, and quantified in Sri Lanka. Further, extant studies have not examined the impact of ownership structure with ownership identity on financial performance. Hence, the purpose of this study is to investigate the relationship between ownership structure and financial performance and then examine the impact of ownership structure on the financial performance of companies listed on the Colombo Stock Exchange. Based on the ownership diversification, three sectors were selected as the population and 24 companies were selected as the sample as per the availability of information. Data collection period was 2015-2019. This study reveals that institutional ownership and foreign ownership are significantly and positively correlated with financial performance, while individual ownership and ownership concentration are negatively correlated with financial performance. Further, ownership concentration has a significant impact on company's financial performance, and the ownership identity has no significant impact on company's financial performance. These findings may help investors and policymakers to make decisions regarding ownership structure.

Keywords: *Foreign ownership, individual ownership, institutional ownership, ownership concentration, ownership structure.*

1. Introduction

Different parties who have invested in shares of a listed company are known as owners of that company, and they are also known as shareholders of that particular company. Various types of owners can be found in nationally as well as internationally, and they are further categorized as foreign ownership, government ownership, institutional ownership, and individual ownership (Connelly, Hoskisson & Tih, 2010). Primarily, these owners' concern is to reap the benefits from firm profits or maximize their wealth. To achieve these objectives, owners appoint management, and then agency conflict occurs (Jensen & Meckling, 1976). The term ownership structure can be defined by using two applied dimensions: ownership concentration and owner identity. Ownership concentration is a measurement of the degree of concentration of voting right in listed corporations, and it is measured by using the voting right of the largest shareholders. The Ownership Identity can be identified as a measure of the extent to which members of the organization identify themselves as genuine owners of the company. Ownership structure influences a company in various aspects, and Jensen and Meckling (1976) found that ownership structure has a significant impact on corporate governance mechanisms because they determine the incentives of managers and thereby the economic efficiency of the corporations they manage. Thus, various indications from previous studies can be found that ownership structure is directly or indirectly related to financial performance, but rare to find consistent conclusions among these two.

The relationship between ownership structure and firms' financial performance is still a debatable problem in the finance literature. Some previous literature stated that there is an inverse relationship between shareholdings and firm performance (Ganguli & Agrawal, 2008) while other researchers emphasize that the ownership structure of a corporation should be thought of as an endogenous outcome of decisions that reflect the influence of shareholders and of trading on the market for shares (Demsetz,1983).

In 1970, almost all Sri Lankan enterprises were state-owned enterprises, but with the introduction of the open economy policy, privatization and restructuring of state-owned enterprises, the ownership switched from public to private, and ultimately this ownership has ended up with some concentrated family owners and individuals. In the late 1970s, the Sri Lankan government started free trade zones to attract new business and this was results in increased foreign ownership gradually. Therefore, at present various types of owners can be found in Sri Lankan companies. This motives to investigate how ownership structure affect firm's financial performance and what kind of relationship between ownership structure and financial performance in Sri Lankan firm.

Many research studies with contradictory results can be found in the literature which investigates the relationship between ownership structure and financial performance, but it is rare to find a study that considers the impact of ownership structure with ownership identity on financial performance. Therefore, this study sought to investigate whether there is a relationship between ownership structure and financial performance through investigating the pattern and variation of the ownership structure of listed firms in Sri Lanka and their financial performance while investigating the impact of ownership structure on the financial performance of that same sample of the study.

Empirical significance and application significance were clearly mentioned under the introduction section as sub section in order to ensure the significance of this study. Second section demonstrates previous research studies on the same research area that providing a theoretical and empirical evidences derived from past literature. Third section depicts statistical results generated by the data analysis and it discusses the results critically. Finally conclusion section summarizes whole paper while emphasizing key points of this research study.

1.1 Empirical significance

Jensen and Meckling (1976) indicate that it is very important for having an acceptable ownership structure in corporate governance because it affects to determine the economic efficiency of the corporations. Since the Sri Lankan listed companies are having dispersed and concentrated ownership, it is very important to know about how the ownership structure affects the company's financial performance in order to maximize the shareholder wealth. Most of the studies in Sri Lankan context were considered only the ownership concentration for investigating the relationship between ownership structure and firm financial performance. There was also a lack of research that considers the two concepts of ownership structure when investigating the relationship between ownership structure and firm's financial performance. Therefore, this study considered ownership structure, including both ownership concentration and owner identity, to investigate the relationship between ownership structure and firm financial performance.

1.2 Application significance

This study was conducted in the context of the Colombo Stock Exchange (CSE) and a variety of ownership structures can be found in these listed companies. Therefore, this study covers three sectors (Diversified, Telecommunication, Healthcare,) for the period of 2015-2019 in order to identify the relationship between ownership structure and financial performance.

However, the connection between ownership structure and financial performance is an ongoing debate in the corporate finance literature; therefore the study motives to identify the significance of the ownership structure on financial performance. Ultimately, the study examines the impact of ownership concentration and ownership identity on the financial performance of companies listed in CSE.

2. Literature review

2.1 Theoretical review

Agency Theory: An agency is any relationship between two parties in which those two parties represent the role of agent and principal. In order to maximize the wealth of the principles, owners hire agents to perform day to day transactions and services on behalf of them. Further, they delegate decision making authority to agents while maintaining a certain level of trust and confidence (Shapiro, 2005). But in practice, when one party is expected to act in the best interests of the other, a conflict of interest might be occurring, which is known as an agency problem. Typically, the cause of agency problem can be identified as the convergence of interest between the principal and the agent. There are three types of agency problems in an

organization known as Principal-Agent Problem, Principal–Principal Problem, and Principal–Creditor Problem (Dharwadkar, Gerorge, & Brandes, 2000). When identifying the impact of ownership structure on firm's financial performance, agency theory takes an important place because the conflict of interest between owners and managers can directly affect the firm's financial performance.

Ownership Structure: Ownership is the state of exclusive rights and control over property such as land or real estate or intellectual property. Ownership structure defines how this ownership and control of a company is distributed (Jensen & Meckling, 1976).

Ownership concentration is an amount of stock that is owned by investors; they might be individual, institutional or foreign investors. Investors who have owned more than 5 percent of equity ownership within a particular organization will be able to influence and control the firm's management. Therefore, a higher level of ownership concentration denotes a higher level of investor's monitoring power over a firm's managerial decisions in order to protect their investments. A low level of ownership concentration indicates a weaker governance power because investors with fewer ownership interests have little incentive to pay attention to the strategic decisions of the firm.

Ownership can be identified as a measure of the extent to which members of the organization identify themselves as genuine owners of the company.

2.2 Empirical review

Ownership Concentration

Warrad, Alnimer, and Almahamid (2013) examined the relationship between ownership concentration and business performance of non-financial businesses listed on the stock exchange of Jordan for the period of 1994-2005.Two different group assessment criteria are determined for this study, and those criteria are accounting and market. According to accounting criteria, the ownership structure does not have a significant impact on business performance, however, market criterions determined that ownership structure affects business performance significantly. Similarly, Zeckhauser and Pound (1990) investigate the impact of large outside shareholders on corporate performance and corporate financial policy. This study employs a sample of firms from 22 industries to test whether the presence of large shareholders is associated with systematic differences in expected earnings growth, dividend payout ratios, or leverage ratios. Overall, they have found that eleven industries with a relatively open information structure, large shareholders are associated with significantly higher expected earnings growth rates.

Thomsen and Pedersen (1999) suggest that after controlling for other variables, ownership concentration has a positive relation with market-to-book value of equity as well as the ROA. They took a sample of 435 from the largest European companies, and they find that ownership identity has important implications for corporate strategy and performance.

Manawaduge and De Zoysa (2013) present ownership of companies in Sri Lanka is highly concentrated, with a presence of controlling shareholders in most enterprises. Further results suggest that concentrated ownership has a significant positive relationship with firm performance while confirming the same conclusion drawn by Chandrasena and Kulathunga

(2014). In contrast, Demsetz (1983) indicates that ownership concentration is a factor that balances the costs and benefits of ownership. This argument is supported by a paper that argues the ownership structure varies systematically in ways that are consistent with value maximization. It considered variables that are significant in explaining the variation in ownership structure for 511 corporations such as firm size, instability of profit rate, whether or not the firm is a regulated utility or financial institution, and whether or not the firm is in the mass media or sports industry and also found the relationship between ownership concentration and accounting profitability is not significant when controlling other variables that are related to financial performance (Demsetz & Lehn, 1985). Thomsen and Pedersen (1999) also report the same results that examining the causes and effects of ownership concentration among the largest companies in twelve European countries, and it found that ownership concentration has an insignificant effect on accounting profitability.

Individual Ownership

According to Thomsen and Pedersen (2000) there is no effect on financial performance when the ownership is highly concentrated in one owner. Similarly, Lauterbach and Vaninsky, (1999) suggest that family owner-managed firms appear less efficient in generating profits, whereas firms owned by business concerns and managed by non-owners perform better. Therefore, these findings suggest that the modern form of business organization, which have an open corporation with disperse ownership and non-owner managers, promotes performance. In the contrary, Manawaduge and De Zoysa (2013) suggest that there is a significant positive relationship between individual ownership and return on assets (ROA) through an examination of the impact of ownership structure and concentration on firm performance in Sri Lanka. The overall results of the study provide more proof for a strong positive relationship between ownership concentration and accounting performance measures. Therefore, it suggests that a greater concentration of ownership causes better performance of an organization. As opposed to the previously mentioned study, Chandrasena and Kulathunga (2014) found a significant negative relationship between individual ownership and firm performance. In this study, researchers have considered seventy-six (76) non-financial companies that are listed in CSE during the period of 2008 to 2014 as a sample. Concentrated ownership too has a significant positive relationship with firm performance, supporting the well-known agency theory propositions.

Foreign Ownership

Gurbuz and Aybars (2010) have used a sample of 205 non-financial listed companies covering the 3-year time period from 2005-2007 and employed panel data analysis to identify the impact of foreign ownership on the firm's financial performance. In terms of operating profitability, the results indicated that minority foreign-owned companies perform better than domestic ones and also the overall results of this study provide evidence that confirms foreign ownership improves the financial performance of companies in Turkey up to some certain level, beyond which additional ownership by the foreigners does not add to firm profitability. Confirming the results of the previous study, Bilyk (2009) investigated the effects of foreign ownership on the performance of Ukrainian manufacturing companies, and the results provide evidence that foreign ownership positively affects the firm's financial performance. In addition, these arguments were supported by an investigation done by Balagobei and

Velnampy (2017) that suggests ownership concentration and foreign ownership structure are significantly and positively correlated with the financial performance of listed beverage food and tobacco companies. Further, it suggests that institutional ownership does not significantly correlated with financial performance. It is also providing evidence that there is a significant impact of foreign ownership on the financial performance of the company.

When referring literature it is very clear that many research studies show contradictory results which investigate the relationship between ownership structure and financial performance. Some research studies indicate positive relation while others show negative relation. Moreover, it is rare to find a study that considers the impact of ownership structure with ownership identity on financial performance. Thus researchers were able to discover the literature gap by exploring various research papers relevant to this study. Therefore, this study aims to investigate whether there is a relationship between ownership structure and financial performance of listed firms in Sri Lanka while investigating the impact of ownership structure on the financial performance for the same sample of this study.

3. Results and discussion

To identify the relationship between ownership structure and firm's financial performance influence, three sectors were selected as the population and whole population was considered as the sample, but 24 companies were selected for the sample as per the availability of information for the period of 2015-2019. Three sectors have been selected for this study, namely Diversified Holdings, Telecommunication and Healthcare as these sectors record highest foreign and domestic shares. Data were collected through annual reports of each company which were downloaded through CSE website.

In the data screening and cleaning stage, the researcher identified the data on institutional ownership and foreign ownership follows a normal distribution, but it is non-normal for financial performance, institutional ownership, and ownership concentration. Then few outliers were detected and winsorized at a 5 percent significant level to remove the outliers.

3.1 Conceptualization

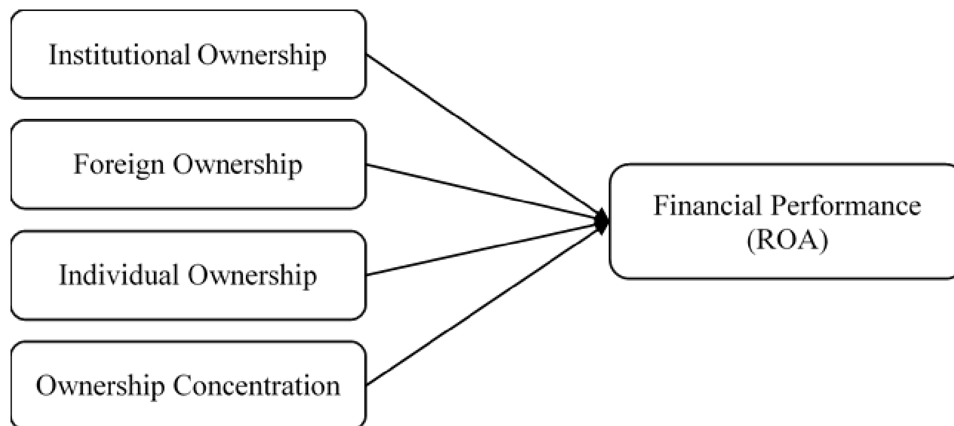

Figure 1 Conceptualization of variables

Source: Authors constructed.

In this research, the researcher has used five variables consist of one dependent variable (financial performance, which is measured by ROA) and four independent variables (institutional ownership, foreign ownership, individual ownership, and ownership concentration).

3.2 Operationalization of variables

Table 1
Operationalization of variables

Variable		Indicator	Measurement	References
Dependent Variable	Financial performance	ROA	Net profit after tax / Total Assets	Mirza and Javed (2013)
Independent Variable	Ownership Concentration	Concentration Ownership (CON)	(percentage of sum of shares controlled by each of the top 5 shareholders)	Manawaduge and De Zoysa (2013)
	Institutional ownership		Percentage of shares held by institutional shareholders	Chandrasena and Kulathunga (2014)
	Foreign ownership		Percentage of shares held by foreigners	Chandrasena and Kulathunga (2014)
	Individual ownership		Percentage of shares held by individual shareholders	Chandrasena and Kulathunga (2014)

Source: Authors constructed.

3.3 Hypotheses development

H_1: There is a significant relationship between institutional ownership and firm's financial performance.

H_2: There is a significant relationship between foreign ownership and firm's financial performance.

H_3: There is a significant relationship between individual ownership and firm's financial performance.

H_4: There is a significant relationship between ownership concentration and firm's financial performance.

3.4 Correlation analysis

To examine the relationship between dependent variable and independent variables Pearson Correlation was used and Table 2 depicts the directions of relationships between two types of variables of this study.

Table 2
Correlation analysis

	Financial performance	Institutional Ownership	Foreign Ownership	Individual Ownership	Ownership Concentration
Financial performance	1				
Institutional Ownership	0.3689*** (0.0002)	1			
Foreign Ownership	0.4660*** (0.0000)	0.1065 0.3045	1		
Individual Ownership	-0.4771** 0.0000	-0.9975** 0.0000	-0.4581** 0.0000	1	
Ownership Concentration	-0.1902** 0.0448	0.0775 0.4581	-0.0165 0.8745	-0.1677 0.1163	1

** Correlation is significant at the 0.05 level*
*p<0.05**
*p<0.01,***

Source: STATA Output.

From Table 2, it is apparent that there exists a significant positive relationship between institutional ownership and the dependent variable (financial performance) of the study. This shows that when an organization is owned by another institution, the profitability and operating efficiency of the firm can be improved.

Similarly, the relationship between foreign ownership and the dependent variable has a significant positive relationship at a significant level of 5 percent. Further, there is a significant negative relationship between foreign ownership and individual ownership with a correlation coefficient value of -0.4581.

In the contrary, Table 2 presents a significant negative relationship between the individual ownership and dependent variable. This shows that when an organization is owned by individuals, the profitability and operating efficiency of the firm difficult to improved.

The concentrated ownership also illustrates a significant negative relationship with ROA. This means that when the ownership is concentrated, the financial performance of an organization is difficult to improve. This is in line with the agency theory, which suggests that concentrated ownership may cause to raise agency costs within an organization.

The significant positive relationship between concentrated ownership and institutional ownership structure represents that the ownership of most Sri Lankan firms are concentrated by the existence of a large shareholding owned by institutional owners.

There was a lack of research, such as Thomsen and Pedersen (2000) suggest that there is no relationship between individual ownership and financial performance. However, the findings of this study suggest that individual ownership has a negative relationship with financial performance, which is not consistent with the findings of Manawaduge and De Zoysa (2013). Moreover, findings of this study which despite the findings of Bhattacharya and Graham (2007), Chen and Chen (2007), and Tamimi (2011) and consistent with the findings of Welch (2003), Herdjiono and Sari (2017) and Gurbuz and Aybars (2010), suggest that there is a positive relationship between institutional ownership and financial performance as well as between foreign ownership and financial performance. Further, the findings of current study

consists of the findings of Demsetz (1983) and Pedersen and Thomsen (1999), which shows that ownership concentration has a negative relationship with firm financial performance.

3.5 Regression analysis

In order to determine the most suitable model (Fixed Effect Model or Random Effect Model) to run the panel regression analysis, the researcher conducted a test called Hausman Test (not tabulated) where the null hypothesis is that the preferred model is random effects vs the alternative the fixed effects.

After estimating the Hausman Test, it was revealed that Random Effect Model was the most fitted model where prob > Chi^2 is 0.64 (Prob > Chi^2 > 0.05). Then panel regression analysis were done and results were depicted in Table 3.

As per the Table 3 R Squared value of 0.3497 denotes that 34.97 percent of the observed variability in ROA can be explained by the differences in variables, namely institutional ownership, foreign ownership, individual ownership, and ownership concentration.

Table 3
Regression analysis

Financial performance	Coef.	Std. Err.	Z	P>|z|	[95 % Conf. Interval]	
Institutional Ownership	0.001322	0.001147	1.15	0.249	-0.0009256	0.0035705
Foreign Ownership	0.000315	0.000239	1.32	0.187	-0.000152	0.0007827
Individual Ownership	0.000882	0.0011348	0.78	0.437	-0.0013422	0.0031062
Ownership Concentration	-0.00077	0.000325	-2.38	0.017	-0.0014113	-0.0001362
_cons	-0.02606	0.115948	-0.22	0.822	-0.2533100	0.2011994
sigma_u	*0.022224*	*R^2=0.3497*				
sigma_e	*0.017153*					
Rho	*0.626686*					

The remaining 65.03 percent is not explained by the explanatory variables of this model, which means that the remaining 65.03 percent of the variance in ROA is related to other variables that have not been depicted in this model.

According to the two tail p values which present in Table 3 at a 95 percent confidence level, all three variables that represent owner identity have no any significant impact on the company's financial performance since all three variables' p values are more than 0.05. Contrary to these results, ownership concentration has a significant impact on financial performance by having p-value of 0.017 which is less than 0.05 percent.

In summary, ownership concentration has a significant impact on the company's financial performance and the rest part of the ownership structure which means the ownership identity (institutional ownership, foreign ownership, and individual ownership) has no impact on the company's financial performance.

These results are consistent with the findings of Chandrasena and Kulathunga (2014) and Pathirawasam and Wickremasinghe (2012), who suggest that ownership concentration has a significant impact on firm's financial performance.

4. Conclusion

The statistical evidence of this study depict that the higher potion of ownership structure in Sri Lankan firms which included in selected sample, represents by the ownership concentration, and it has a negative relationship with financial performance. Its reveal that ownership of selected firms is concentrated by the existence of a large shareholding owned by individual owners, and these owners have an ability to influence on financial performance which means, ownership concentration has an impact on company's financial performance as well as there is a negative relationship between ownership concentration and company's financial performance in selected 24 listed companies. This may cause the rise an interest conflict between owners as well as between owners and managers. Therefore, organizations should have established proper corporate governance mechanisms to prevent or minimize the situation of occurring higher agency costs within an organization.

Institutional ownership, foreign ownership, and individual ownership were considering as the components of ownership identity and each and every ownership category was separately analyzed in order to identify the relationship between ownership identity and firm's financial performance.

The statistical evidence show that institutional ownership and foreign ownership has a significant positive relationship with financial performance while individual owners have a significant negative relationship with financial performance as well as the ability of these owners to impact or influence the financial performance is very low, which means ownership identity has no any significant impact on firm's financial performance.

The study selected both the components of ownership structure to identify the impact between ownership structure and firm's financial performance. With the results of this study, it seems to be that, the ability or power to influence financial performance is with the owners who have hold the highest number of shares of an organization, which means the owners who are highly concentrated can impact on firm's financial performance. On the other hand, it can be illustrated as a matter of fact that ownership identity cannot impact on financial performance only the ownership concentration can impact on firm's financial performance.

As the limitations of this study it can be mentioned that the current research study is consisted only with four independent variables. Thus, it can be recommended that future research studies can be conducted by employing new variables such as directors' ownership as well as including some control variables which affects to the financial performance. Further, current study considered only three sectors and future research studies can be expanded by taking more than three sectors.

Future studies may employ alternative firm performance measures (i.e., Earning per Share, Stock Return) to see how results may be sensitive to performance variable selection when examining the ownership – firm performance relationship and affirm the empirical findings

obtained by the present study. It might be informative to replicate the estimates using a bigger sample so that the results could be generalized.

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