Performance of Indian business groups : Diversification and tunneling effects

Abstract

Business group is a collection of legally independent firms (publicly or privately traded) doing business in different markets under common administrative or financial control with the group-firms (firms affiliated to the business groups) being linked by multiple ties through which they co-ordinate to achieve mutual objectives (Granovetter (1995), Leff (1978)). Business groups are expected to exist in emerging economies such as India because they are considered as responses to economic problems of such developing markets (Khanna and Palepu (1997)). However, there are benefits as well as costs associated with such governance structures. This doctoral dissertation proposes to examine empirically the performance of Indian business groups. In particular, I examine the performance of business groups and its interplay with diversification strategies and ownership structures.

Chapter 1 discusses the theoretical foundations of business groups. In economies with missing market institutions and ineffective mechanisms to enforce contracts, the transaction costs of economic exchange is high. In order to reduce transaction costs, theories (such as Coase (1937), Williamson (1989), Granovetter (1995)) suggest that firms are organized into governance structures such as business groups which act as substitute to the missing intermediaries in capital, labour and product markets. Business groups create value by spreading the costs of organizing such internal structures across several lines of business (Khanna and Palepu (1997)). Group diversification is beneficial and diversified business groups add value by replicating the functions of missing institutions in emerging markets (Khanna and Palepu (2000a)).

Theories (such as La Porta, Silanes, and Shleifer (1998), (1999)) also suggest that a consequence of weak contract enforcement mechanisms in emerging economies is the presence of concentrated ownership structure of family-run business groups. The nature of concentrated ownership structure affects the agency relationships in a business group. In emerging economies with weak corporate governance laws and ineffective law enforcement mechanisms, agency problems exist between the controlling shareholders and the minority shareholders (Claessens and Fan (2002)). Business group is regarded as a device for the controlling shareholders to expropriate the wealth of minority shareholders if the interests of the minority shareholders are not protected (Dharwadkar, George, and Brandes (2000)). Some anecdotal evidences in support of these theoretical foundations are also provided in Chapter 1.

In emerging economies with missing and under-developed market institutions, vertical integration and diversification is necessary to secure access to intermediate products and services, leading to the emergence of business groups with diversified business portfolios (Khanna and Palepu (1997)). Chapter 2 tries to analyze a longitudinal data sample of affiliated and unaffiliated firms in India for the years 2001-2007 to understand the effect of corporate diversification on performance. Chapter

2 analyzes the role of different diversification strategies such as related and unrelated diversification on business group performance. The empirical analysis shows that performance of business groups (or group-firms in relation to standalone firms) has a quadratic relationship with group diversification and such a relationship is more due to related diversification strategy of business groups. Performance of business groups increases with increase in group diversification beyond a threshold level of diversification.

Business groups in India have a very high concentrated ownership structure of investors. The minority investors fear expropriation by the controlling investors. The paper by Bertrand, Mehta, and Mullainathan (2002) had shown the presence of expropriation in the form of tunneling resources from group-firms with low cash flow rights to group-firms with high cash flow rights for a sample of firms for the period 1989-1999. In Chapter 3 , the methodology developed by Bertrand et al. (2002) is used to test the evidence of tunneling for a longitudinal sample of group-firms for the period 2001-2007. Year 2001 marks the beginning of Corporate Governance reforms in India. The reforms are aimed to protect the interests of the minority shareholders and restrict expropriation by the majority shareholders. The empirical analysis in Chapter 3 finds some evidence that the tunneling activity in business groups for the years 2001-2007 might have reduced showing that the corporate governance reforms in India might have been effective.