Relationship Between Foreign Equity Ownership And Firm Performance

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INTRODUCTION

Various studies have been conducted in the past to study the impact of foreign capital both - at the country level and the firm level. These studies, however, provide different results. The focus of the present research paper is to study the relationship between *'Foreign Equity Ownership'* in a firm and the *'Performance'* of the firm. For this purpose, an attempt has been made in this paper to ascertain the components of foreign equity ownership appearing in the share capital of sample companies and also to study the association between those components and various performance aspects of the companies in the light of empirical findings of earlier studies.

LITERATURE REVIEW

Earlier and recent empirical studies concluded that foreign ownership has positive influence on the firm's performance. Goethals and Ooghe (1997) conducted a study to investigate the performance between domestic Belgian firms and Belgian firms taken over by foreigners. They calculated 28 financial ratios for both foreign and domestic firms and concluded that firms with foreign ownership performed better than their domestically owned counterparts. Grant (1987) and Qian (1998) assessed the relationship between the return performance and multiple explanatory factors per se multi-nationality. Grant's study to investigate firm's performance revealed that profitability for the 304 largest UK manufacturing firms drawn from *'The Times 500'* list of Britain's largest companies was positively correlated to their level of multi-nationality. Qian included in his analysis the 164 largest US industrial corporations on the Fortune 500 listings. He found that the return performance is different due to differences in the level of foreign involvement. Most importantly, multi-nationality has a significant impact on the performance of MNEs. Besides, Liu et al. (2000) looked at the issue from a different angle and examined the intra-industry productivity spillovers from FDI on the manufacturing sector in the UK. Their findings indicate that FDI existence has a positive spillover on the productivity of UK owned firms. Neeta (2008) pointed out the importance of foreign capital in strengthening and improving the functioning of domestic capital markets. Nidheesh (2008) examined the costs and benefits of foreign investment in India and pointed out that foreign capital inflows reduce the required rate of return for equity, enhance stock prices, and foster investment by Indian firms in the country. Moreover, the author asserted that the presence of foreign capital in the domestic capital markets often leads to vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value. Some conflicting results with respect to the aforementioned findings also appear in the concerned literature. For instance, Kim and Lyn (1990) made a research to evaluate the performance of MNEs operating in the United States of America (USA). They took as a sample, 54 large foreign corporations operating in the USA. The results indicated that a foreign-owned firm operating in the USA is less profitable than randomly selected domestically owned U.S. corporations. Another research conducted by Dauma et al. (2006) in a developing economy tested foreign ownership effects on the performance of 1005 Indians firms in 1999 and 2000. They observed that foreign ownership positively affects firm performance. Akimova and Schwödiauer (2004) examined the impact of ownership structure on corporate governance and performance of privatized corporations in the Ukrainian transition economy. Their analysis revealed that there are significant ownership effects on firm performance, but that are mainly non-linear in nature. In other words, its effect is positive within the lower range, but is negative from the point that closes to majority ownership. With this backdrop, the present paper examines the effect of foreign ownership on the performance of Indian listed companies having foreign equity and evaluates whether the findings are compatible with earlier studies.

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SCOPE OF THE RESEARCH

The scope of this research is limited to the components of equity share capital of sample companies that represent foreign equity ownership. The following have been identified as the components of foreign equity ownership in a company:

1) Direct Investment by Non-resident Indians/Foreign Individuals/Foreign Nationals, Foreign institutions, etc. in the equity shares of Indian companies;

2) Indirect Investment by Non-resident Indians/Foreign Individuals/Foreign Nationals, Foreign institutions etc. in Indian companies through American Depository Receipts (ADRs) and Global Depository Receipts (GDRs).

OBJECTIVE OF THE STUDY

The objective of the present study is to investigate the association, if any, between the components of foreign equity ownership and various performance aspects of Indian companies chosen as the sample. Performance aspects shall include the *'Management Effectiveness', 'Capital Structure', 'Cost of Capital',* and *'Financial Performance'* of sample companies.

LIMITATIONS OF THE STUDY

The findings of the study have to be considered in the light of the following inadvertent limitations :

1) Most of the variables (i.e. ratios) used in the study were calculated based upon the *'accounting approach'*, as distinct to the *'cash approach'*. Hence, they might be affected by taxation, depreciation methods, etc.

2) The data used in this study was taken from a digital database. The data might have suffered from some limitations that are inherent in the database.

HYPOTHESES TO BE TESTED

Keeping in mind the objective of the research, the following Null (Ho) & Alternate (Ha) hypotheses were formulated :

☸ **Ho: There is no significant relationship between Foreign Equity Ownership and Performance Variable of sample Indian companies.**

☸ **Ha: There is a significant relationship between Foreign Equity Ownership and Performance Variable of sample Indian companies.**

DATA AND RESEARCH METHODOLOGY

☸ **Data Collection :** Necessary information pertaining to the financials of sample companies was gathered from *CapitaLine Plus*, a digital database maintained by the company-Capital Market Publishers India Pvt. Ltd.

☸ **Sample Description :** The study specifically focuses on Reliance Industries Ltd. (RIL), known for its aggressive & path-breaking corporate strategies, apart from being the largest private sector company of India; and Tata Steel Ltd. (Tata Steel), known for its relatively conservative and cautious business approach, apart from belonging to one of the oldest business houses of India. Though the components of foreign equity ownership present in these companies do not form a strategic proportion, it would still be interesting to examine whether the said components bear any significant relationship with different performance related aspects of these premier companies of India which, of late, have been otherwise active in the area of overseas investment.

☸ **Period of the Study :** The period of the study was from April 1, 2000 to March 31, 2011 (eleven financial years).

☸ **Research Methodology :** The step-wise research methodology employed in this study is enumerated hereunder :

a) Technique Used For The Analysis : All the four aspects of sample companies mentioned earlier were captured by employing the technique of *'Financial Ratio Analysis'*. Suitable ratios corresponding to each aspect of inquiry were chosen on the basis of survey of related books (I. M. Pandey, 2010; Subramanyam and Wild, 2009) & research papers (Beaver, 1966; Goethals and Ooghe, 1997). The ratios so selected comprised of the Variables of the Study.

b) Variables of the Study: The variables of the present study are as follows:

1) Percentage (%) holding of Non- Resident Indians/Foreign Individuals/Foreign Nationals, Foreign Institutions etc. in the issued and paid-up equity share capital of the sample companies either directly or by way of ADRs & GDRs : This was used as a variable for capturing the aspect of *'foreign equity ownership'* in sample companies.

2) Return On Shareholders' Equity (ROE) And Return On Assets (ROA) : For capturing the aspect of *'Management effectiveness'* of sample firms.

3) Debt-Equity Ratio (D/E ratio) : For capturing the aspect of *'Capital Structure'* of sample firms.

4) Cost of Debt Capital : For capturing the aspect of *'Cost of Capital'* of sample firms.

5) Cash Earnings Per Share (CEPS) : For capturing the aspect of *' Financial Performance'* of sample firms.

c) Statistical Tests Used For Hypotheses Testing : As all the variables of the present study are numeric in nature, the statistical test used herein for hypothesis testing is *'Bivariate Correlation'*, measured by Karl Pearson's Coefficient of Correlation (r). If the observed p-value (2-tailed) of the coefficient of correlation for any pair of observations is more than the chosen level of significance, which is 0.05 (i.e. 5%) in the present case as per the prevalent practices, the null hypothesis is accepted, that is, the relationship is insignificant. Otherwise, the alternative hypothesis is accepted, that is, the relationship is significant. The necessary statistical analyses were performed using SPSS. The results and findings have been discussed in the next section.

FINDINGS AND ANALYSIS

As highlighted earlier, the association between foreign equity ownership and various performance aspects of sample companies was examined in the present study. Findings related to the same are as follows :

(a) Relationship Between Foreign Equity Ownership & Management Effectiveness : The relationship between Foreign Equity Ownership & Management Effectiveness of sample companies has been studied on the basis of correlation between the % holding of all foreign equity components in the paid-up share capital of the sample companies and the ROE & ROA of the companies. Table 1 shows the results obtained for each sample company after running the Bivariate Correlation Test between % foreign equity holding and ROE as well as ROA of the companies.

Table 1: Empirical Results of Hypothesis Testing For Relationship Between % Foreign Equity Holding And Management Effectiveness of RIL & Tata Steel

	Results obtained for RIL		Results obtained for Tata Steel	
Correlation between →	**% holding of Foreign Equity and ROE**	**% holding of Foreign Equity and ROA**	**% holding of Foreign Equity and ROE**	**% holding of Foreign Equity and ROA**
Pearson's Coefficient of Correlation (r)	r = 0.284	r = - 0.019	r = - 0.339	r = - 0.175
Observed significance level	p-value = 0.397	p-value = 0.956	p-value = 0.308	p-value=0.607
Applicable Null Hypothesis (Ho)	No significant relationship between % Foreign Equity and ROE	No significant relationship between % Foreign Equity and ROA	No significant relationship between % Foreign Equity and ROE	No significant relationship between % Foreign Equity and ROA
Status of Ho	**Accepted**	**Accepted**	**Accepted**	**Accepted**

Sources: Capitaline Plus & SPSS

Major Observations From The Table 1 are as follows :

❆ As evident from the Table 1, the coefficient of correlation between % Foreign Equity and ROE of RIL is positive, but is very low. An increase in Foreign Equity may lead to an increase in the ROE of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

❆ Likewise, the coefficient of correlation between % Foreign Equity and ROA of the company is interestingly negative, but negligible. An increase in Foreign Equity may lead to a negligible decrease in the ROA of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

☸ In the case of Tata Steel, the coefficient of correlation between % Foreign Equity and ROE of the company is negative and very low. An increase in Foreign Equity may lead to a decrease in the ROE of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

☸ Likewise, the coefficient of correlation between % Foreign Equity and ROA of the company is also negative and very low. An increase in Foreign Equity may lead to a decrease in the ROA of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

☸ *After running the Bivariate Correlation Test, it was found that both the hypotheses framed for each company were accepted. Thus, no significant relationship exists between % Foreign Equity and Management Effectiveness of the sample companies.*

(b) Relationship Between Foreign Equity Ownership & Capital Structure : The relationship between Foreign Equity Ownership & Capital Structure of sample companies has been studied on the basis of correlation between the % holding of all foreign equity ownership components in the paid-up share capital of sample companies and the DE ratio of the companies. Table 2 shows the results obtained for each sample company after running the Bivariate Correlation Test between % Foreign Equity and DE ratio of the companies.

Table 2 : Empirical Results of Hypothesis Testing For Relationship Between % Foreign Equity And Capital Structure of RIL & Tata Steel

	Results obtained for RIL	Results obtained for Tata Steel
Correlation between →	**% holding of Foreign Equity and DE Ratio**	**% holding of Foreign Equity and DE Ratio**
Pearson's Coefficient of Correlation (r)	r = 0.503	r = 0.009
Observed significance level	p-value = 0.114	p-value = 0.980
Applicable Null Hypothesis (Ho)	No significant relationship between % Foreign Equity and DE ratio	No significant relationship between % Foreign Equity and DE ratio
Status of Ho	**Accepted**	**Accepted**
Sources: Capitaline Plus & SPSS		

Major Observations From The Table 2

☸ As is evident from the Table 2, the coefficient of correlation between % Foreign Equity and DE ratio of RIL is positive and moderately high. An increase in Foreign Equity may lead to an increase in the DE ratio of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

☸ In the case of Tata Steel, the coefficient of correlation between % Foreign Equity and DE ratio of the company, though positive, is almost zero. An increase in Foreign Equity may lead to an increase in the DE ratio of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

☸ *After running the Bivariate Correlation Test, it was found that the hypothesis framed for each company was accepted. Thus, no significant relationship exists between % Foreign Equity and Capital Structure of the sample companies.*

(c) Relationship Between Foreign Equity & Cost Of Capital : The relationship between Foreign Equity & Cost of Capital of sample companies has been studied on the basis of correlation between the % holding of all Foreign Equity components in the paid-up share capital of sample companies and the cost of debt capital of the companies. The Table 3 shows the results obtained for each sample company after running the Bivariate Correlation Test between % Foreign Equity and Cost of Debt of the companies.

Table 3: Empirical Results of Hypothesis Testing For Relationship Between % Foreign Equity And The Cost of Capital of RIL & Tata Steel		
	Results obtained for RIL	**Results obtained for Tata Steel**
Correlation between →	**% holding of Foreign Equity and Cost of Debt**	**% holding of Foreign Equity and Cost of Debt**
Pearson's Coefficient of Correlation (r)	r = 0.736	r = 0.307
Observed significance level	p-value = 0.010	p-value = 0.358
Applicable Null Hypothesis (Ho)	No significant relationship between % Foreign Equity and Cost of debt	No significant relationship between % Foreign Equity and Cost of debt
Status of Ho	**Rejected**	**Accepted**
Sources: Capitaline Plus & SPSS		

Major Observations From The Table 3 :

☸ As is evident from the Table 3, the coefficient of correlation between % Foreign Equity and Cost of Debt of RIL is positive and high. An increase in Foreign Equity may lead to an increase in the cost of debt of the company and vice-versa. Moreover, the correlation is interestingly significant as the significance value of 'r' is less than the chosen level of significance (i.e. p-value <0.05).

☸ In the case of Tata Steel, the coefficient of correlation between % Foreign Equity and Cost of Debt of the company is also positive, but very low. An increase in Foreign Equity may lead to an increase in the cost of debt of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. p-value >0.05) .

☸ *After running the Bivariate Correlation Test, it was found that the hypothesis framed for RIL was rejected, whereas for Tata Steel , it was accepted. Thus, the relationship between % Foreign Equity and Cost of Capital is significant in the case of RIL, and insignificant in the case of Tata Steel.*

(d) Relationship Between Foreign Equity & Financial Performance : The relationship between Foreign Equity & Financial Performance of sample companies has been studied on the basis of correlation between the % holding of all Foreign Equity components in the paid-up share capital of sample companies and the CEPS of the companies. The Table 4 shows the results obtained for each sample company after running the Bivariate Correlation Test between % Foreign Equity and CEPS of the companies.

Table 4: Empirical Results Of Hypothesis Testing For Relationship Between % Foreign Equity And Financial Performance Of RIL & Tata Steel		
	Results Obtained For RIL	**Results Obtained For Tata Steel**
Correlation between →	**% holding of Foreign Equity and CEPS**	**% holding of Foreign Equity and CEPS**
Pearson's Coefficient of Correlation (r)	r = - 0.621	r = 0.123
Observed significance level	p-value = 0.041	p-value = 0.719
Applicable Null Hypothesis (Ho)	No significant relationship between % Foreign Equity and CEPS	No significant relationship between % Foreign Equity and CEPS
Status of Ho	**Rejected**	**Accepted**
Sources: Capitaline Plus & SPSS		

Major Observations From The Table 4 :

☸ As is evident from the Table 4, the coefficient of correlation between % Foreign Equity and CEPS of RIL is negative and moderately high. An increase in Foreign Equity may lead to a decrease in the CEPS of the company and vice-versa. Moreover, the correlation is interestingly significant as the significance value of 'r' is less than the chosen level of significance (i.e. p-value <0.05).

☸ In the case of Tata Steel, the coefficient of correlation between % Foreign Equity and CEPS of the company is interestingly positive, but very low. An increase in Foreign Equity may lead to an increase in the CEPS of the company and vice-versa. However, the correlation is insignificant as the significance value of 'r' is more than the chosen level of significance (i.e. *p*-value >0.05).

☸ *After running the Bivariate Correlation Test, it was found that the hypothesis framed for RIL was rejected, whereas for Tata Steel it was accepted. Thus, the relationship between % Foreign Equity and Financial Performance is significant in the case of RIL and is insignificant in the case of Tata Steel.*

(d) Overall Findings of The Relationship Between Foreign Equity Ownership And Performance of RIL And Tata Steel : The Table 5 presents the overall findings of the association between Foreign Equity Ownership and the Performance of RIL and Tata Steel.

Table 5 : Overall Findings of The Association Between Foreign Equity Ownership And Performance of RIL And Tata Steel

Correlation between % holding of Foreign Equity Ownership and (↓)	Results obtained for RIL	Results obtained for Tata Steel
(A) Management Effectiveness:		
o Return on Equity	No significant correlation	No significant correlation
o Return on Assets	No significant correlation	No significant correlation
(B) Capital:		
o Debt-equity ratio	No significant correlation	No significant correlation
(C) Cost of Capital		
o Cost of Debt	Positive, High, and Significant	No significant correlation
(D) Financial Performance		
o Cash Earnings Per Share	Negative, Moderately High, and Significant	No significant correlation

Sources: See Tables 1 to 4

As is evident from the Table 5, *an insignificant association* was found to exist between Foreign Equity Ownership and Management Effectiveness as well as Capital Structure of RIL. However, *significant positive association* was found to exist between Foreign Equity Ownership and Cost of Capital of RIL. Furthermore, *significant negative association* was found to exist between Foreign Equity Ownership and Financial Performance of RIL. In both the cases, the degree of relationship was found to be high. In the case of Tata Steel, insignificant relationship was found to exist between Foreign Equity Ownership And Management Effectiveness, Capital Structure, Cost Of Capital, and Financial Performance of the company.

CONCLUSION

Based upon the findings and observations made during the study, the following are the points which lead to conclude the present study:

☸ As per the findings of the study, it was found that the average % holding of Foreign Equity components in RIL for the period 2001 to 2011 was around 6%. It peaked to 9.38% for the year ending March 31, 2005. This finding is interesting in the sense that as per the definition of Foreign Direct Investment (FDI) enunciated by the International Monetary Fund and the Organization for Economic Cooperation & Development (OECD) , the threshold value for foreign equity ownership to be taken as evidence of direct investment relationship (i.e. FDI) is 10%. Thus, foreign equity ownership in RIL, the biggest private sector company of India, nearly entered the ambit of FDI in the recent past.

☸ As observed in the study of association, positive, high and significant correlation exists between the components of Foreign Equity and the Cost of Debt of RIL. The square of the coefficient of correlation (i.e. r^2, known as the coefficient of determination), comes out to be around 0.54. *Accordingly, it can be inferred that 54% of the variation in the Cost of Capital of RIL can be attributed to the presence of Foreign Equity Ownership in the company.*

☸ Negative, moderate and significant correlation exists between the components of Foreign Equity and the CEPS of RIL. The coefficient of determination in this case comes out to be around 0.39 or 39%, thereby inferring that *39% of the variation in the financial performance of RIL can be attributed to the presence of Foreign Equity components in the company*. Thus, the presence of Foreign Equity Ownership in RIL, as measured by CEPS, has a negative bearing on its financial performance . This inference is in alignment to the inference established for the Cost of Debt Capital of RIL, wherein an increase in Foreign Equity Ownership leads to an increase in the cost of capital of RIL. This, in turn, results in lesser earnings available to the company's equity shareholders and, therefore, lowers the CEPS of the company.

☸ Presence of Foreign Equity Ownership in RIL has no bearing on the Management Effectiveness and Capital Structure of the company. This indicates the robustness of the aforesaid aspects of RIL towards Foreign Equity Ownership.

☸ The average % holding of Foreign Equity Ownership in Tata Steel for the period 2001 to 2011 has been around 0.6%, *nearly one-tenth of the same in RIL*. This shows the basic difference between the approach of RIL and Tata Steel towards foreign investment in the company. While RIL has always taken the lead to recognize and avail opportunities, Tata Steel has been relatively conservative in its approach.

☸ As observed in the study of association, the presence of Foreign Equity Ownership in Tata Steel has no bearing on its Management Effectiveness, Capital Structure, Cost of Capital, and Financial Performance of the company. This indicates the relative robustness of the aforesaid aspects of Tata Steel 's Foreign Equity Ownership.

☸ On the basis of the overall findings in the study of the relationship between Foreign Equity Ownership and company performance, it can be inferred that the presence of Foreign Equity Ownership has no significant association with the *'Management Effectiveness'*, and *'Capital Structure'* of sample companies. For the other aspects of *'Cost of Capital'* and *'Financial Performance',* inferences are mixed on account of significant association for RIL and insignificant association for Tata Steel. India, being one among the world's fastest-growing major economies, at present, needs foreign capital to boost infrastructure and sustain economic growth at its near-double-digit targets. However, the findings of the present study point towards the fact that the impact of foreign capital by way of Foreign Equity Ownership in Indian companies is not positive as may have been perceived at the time of its inception. Though the empirical analysis considered only two Indian companies as sample, the study did not examine the impact of Foreign Equity Ownership on the *'providers'* of foreign capital, who are usually from developed economies around the globe, and it can be inferred on the basis of literature survey and available evidence that the favourable impact of Foreign Equity Ownership has always tilted towards the *'providers'* of foreign capital in contrast to the recipient firms. These findings, thus, have important implications not only for Indian companies, but also for domestic companies operating in other emerging economies of the world and looking forward to Foreign Equity Ownership for seeking *'favorable turnaround'*.

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