Foreign equity ownership, corporate governance and financial performance

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Abstract. *The increasing importance of the Foreign Direct Investment (FDI) is one of the most features of the world globalization. FDI is one of the key ways of economic development for emerging countries. It provides funding and expertise to help companies from the emerging markets to increase the international trading. The present research is conducted to assess the impact of foreign ownership, aiming to determine if foreign ownership improves corporate governance, firm performance and competitiveness and if foreign-owned entities over-perform domestic-owned companies. The empirical literature reveals mixed evidence. An increase in FDI has a positive effect on economic growth rates in financially developed countries but foreign ownership has either a negative or a small effect on firm performance in some emerging countries, like Croatia and the Taiwan. The main findings of the research support the view of a positive connection between FDI and firm performance. This suggests that FDI should be encouraged by policies regarding foreign ownership to enhance firm productivity and competitiveness in emerging markets.*

Keywords: *ownership; foreign equity ownership; corporate governance; financial performance.*

Introduction

Entity ownership, corporate governance and firm performance are key elements for economic growth in a globalized economy. To achieve sustainable economic growth, the emerging countries need large inflows of foreign investments. There are three main forms of foreign investments: portfolio investments, foreign loans and Foreign Direct Investments

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(FDI). According to the International Monetary Fund (IMF), FDI is one individual business that owns more than 10% from the capital of a foreign company and thus has important influence on the company's policies. FDI is one of the key channels and an important engine for economic growth, increasing the capital stock, creating employment and may bringing new technologies. Despite the fact that some researchers found no evidence of spillovers to the domestic economy due to FDI, most empirical studies have found evidence of increasing performance of the companies with foreign ownership.

Ownership structure

As according to the Oxford Dictionaries, ownership means the act, state or right of possessing something (Oxford Dictionaries, 2014). The business ownership structure has an important impact upon the liability of the owners, the continuity of it if one of the owners dies or withdraws the kind of managements control, the level of additional capital, and the amount of taxes (Douma et al., 2012, p. 642). There are six main forms and four main types of ownership. The most common forms of business ownership can be structured as follows: sole proprietorships, general partnerships, limited partnerships, corporations, limited liability companies and limited liability partnerships (Prescott, 2010, p. 30). As for the type of ownership, it can be: ownership concentration, public ownership, private ownership, foreign ownership (Aymen, 2014, p. 164). Business ownership structure can be represented by director ownership, foreign ownership and state ownership. Other important elements that have significantly positive impacts on profitability are the board size, board composition, management skill level, Chief Executive Officer (CEO) duality inside ownership, and family business (Abor & Biekpe, 2007, p. 288).

Foreign Direct Investment: definition and importance

Foreign Direct Investment (FDI) is a direct investment into production or business in a country by an individual or company based in another country. According to the World Bank, FDIs are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. FDI is one of the key ways of economic development

for emerging countries and it boosts corporate performance indicators (Jurajda & Stancík, 2012, p. 322). It is widely known that foreign direct investment is a way for improving corporate governance, firm performance and profitability (Aymen, 2014, p. 166). Among the effects of FDI can be mentioned: the transfer of new technologies and know-how, formation of human resources, integration in global markets, increase of competition, and firms' development and reorganization. Bokpin suggested that the more foreign owners a firm has the less the company discloses and the less a company discloses the more foreign share owners it attracts. At the same time he found a positive and statistically significant relationship between foreign share ownership and the market capitalization and insignificant relationship with Return on Equity (ROE) (Bokpin, 2009, p. 692).

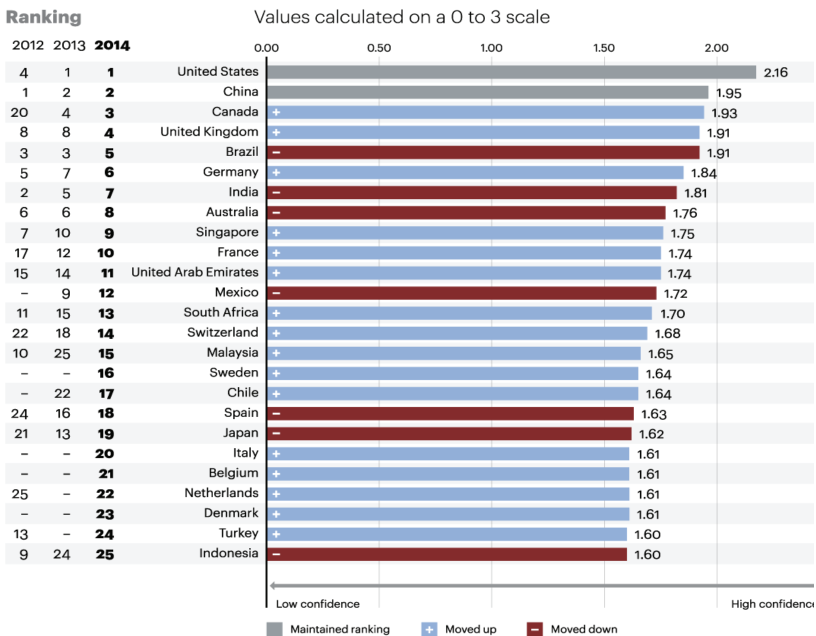

Figure 1. FDI confidence index, ranking and scores

Source: Foreign Direct Investment (FDI) Confidence Index®

Among the main determinants of FDI can be mentioned: proximity to markets or customers, skilled workforce availability, government support and lower costs (fDiIntelligence, 2014). Firms attracting foreign direct investment acquire sufficient internal funding and they do not need more debt financing to fund their capital expenditures compared to domestic firms. They found increased capital investment for the firms with foreign ownership than domestic ones (Gurunlu & Gursoy, 2010, pp. 21-29). Among the main determinants of FDI can be mentioned: proximity to markets or customers, skilled workforce availability, government support and lower costs (fDiIntelligence, 2014). In 2013, around 45% of FDI projects were driven by the access to domestic markets growth potential.

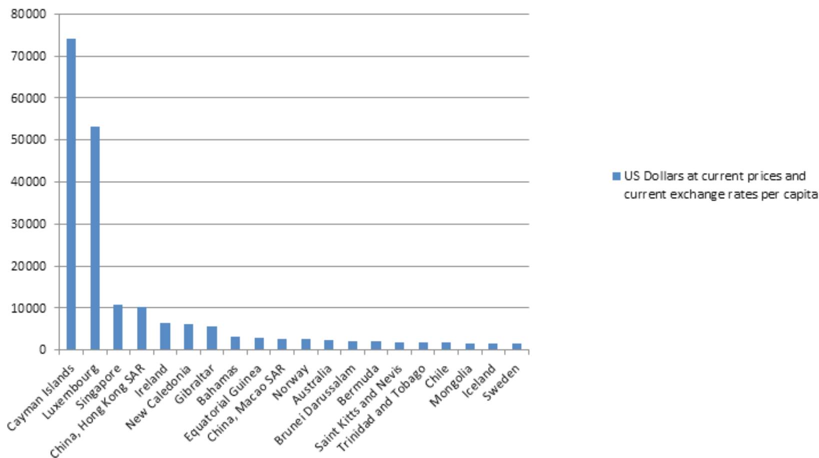

Figure 2. Inward FDI inflows by economy, 2012 – excluding British Virgin Islands (based on data provided by UNCTAD)

Studying the FDI inflows by economy, we observe that (Figure 2) Cayman Islands are placed on rank 2, after British Virgin Islands that have more than 81.82% of the world FDI inflows in 2012 (World Investment Report).

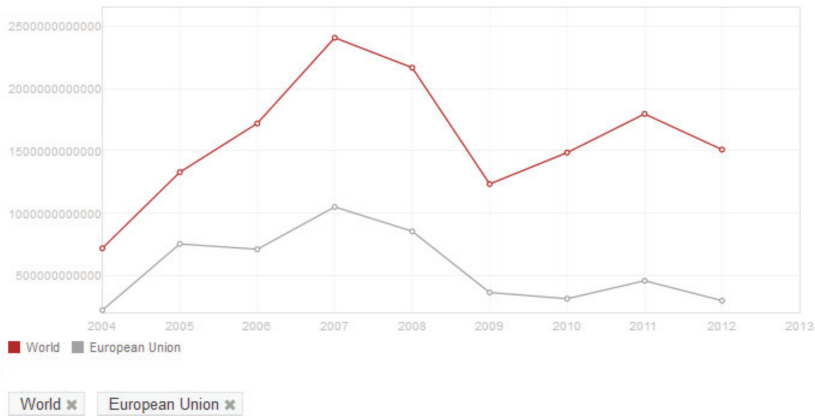

Figure 3. World and European Inward FDI flows (World Bank)

The European Union plays an important role in the global foreign direct investment (FDI), in terms of both inward and outward FDI (see Figure 3). This means that EU companies can compete in markets inside and outside the EU. The evolution European inward FDI flows follow the world trend, reaching a maximum in 2007. It was FDI inflows to the world and the EU were hit significantly by the global recession between 2008 and 2009. It recovered between 2010 and 2011, but the recovery lessened during 2012, meaning a reduced capability of European firms to invest abroad.

The impact of FDI and corporate governance on firm performance

Corporate performance can be measured by variables connected with productivity, profitability, growth and customer satisfaction (Barbosa & Louri, 2005). Firms are heterogeneous in terms of profitability due to differences in industry's characteristics, proprietary technology and managerial expertise, industry concentration that leads to larger profits, industry growth, and competitive environment. Among the elements that affect firms' performance can be mentioned: age, size and FDI. Older firms can obtain superior performance due to their previous learning process. Larger firms can exploit economies of scale and organize their activities efficiently but they must cope with the increased bureaucracy that prevents them from acquiring higher performance and profitability.

A main reason for investing in a company from emerging countries can be cheaper labor force and hence lower production costs. But foreign investors avoid investing in firms with poor corporate governance structures and inadequate disclosure practices. An improvement in the corporate governance system can facilitate capital mobility across countries (Cueto, 2009, p. 146; Bowman, 2012, p. 47).

Examining the impact of corporate governance on corporate performance Nazli (2010) found weak evidence that companies which adopted good governance practices performed better than others. But companies with a larger proportion of foreign ownership were found to be more profitable (Nazli, 2010, p. 117). Investigating a sample of 183 companies listed on the Amman Stock Exchange for the year 2010, Suwaidan, Abed and Al-Khoury (2013) showed that foreign owners play a very significant role in improving corporate governance and are likely to export their higher standards and apply them to firms in the host country. From the perspective of companies, foreign investor participation should improve the market value of their shares and thus lower their cost of capital. He found a positive relation between foreign share ownership and international audit firm, but debt ratio had no significant effect on foreign-Arab share ownership (Suwaidan et al., 2013, p. 21). Most studies indicate that foreign ownership has a positive effect on firm performance. Foreign ownership helps increase firm performance due to its monitoring role, foreign ownership has positive effect on firm performance because foreign investors possess better financial and technological resources and experience. Based on firms listed on Ho Chi Minh Stock Exchange between 2008 and 2011, Phung and Le (2013) found a negative impact of FDI on firm performance and a positive impact of FDI on capital structure. The reason for this result can be the lack of concentration of foreign ownership. As a result it cannot play a monitoring role in corporate governance and the investors cannot set out long-term goals for the company. As an example we can mention the case of Vietnam stock market where the foreign ownership is currently limited at 49% and it may not positively affect firm performance (Phung and Le, 2013, p. 56).

Studying 202 Ukrainian medium and large enterprises for the period 1998-2000, Akimova and Schwodiauer (2004) found the impact of foreign ownership on firm performance is non-linear, being positive

up to a specific level. Stake holding ownership by customers affects sale prices and performance negatively. Many conflicts may arise in the case of ownership shared between several individuals with different preferences about company goals. These conflicts affect the entity's performance. In developed market economies partnerships are mainly formed by family business or by owners that have similar tastes (Akimova & Schwodiauer, 2004, p. 36). Ownership concentration has a positive and significant effect of Jordanian banks' profitability while foreign ownership positively affects their operating efficiency. Foreign-owned banks tend to be more efficient and less risky than domestic banks. Foreign ownership, measured by proportion of shares held by foreign shareholders, brings more efficiency to bank operating and minimizes the total operating expenses (Al-Amarneh, 2014, p. 198). In Kenya foreign-owned banks had slightly better performance and they are more efficient than domestically-owned banks (Mang'Unyi, 2011, p. 2). The positive effect of ownership concentration on firm performance matters more in countries with weak investor protection. Yang found that foreign ownership in Taiwan has a positive impact on the privatized firms and their operating performance. Ownership concentration is negatively related to performance of privatized companies.

Studying the relationship between firm performance evaluated by means of Assets Growth and Return on Assets (ROA) and FDI, on a sample of more than 400 companies from Czech Republic, Cástek (2013) found a positive effect of FDI in small companies. The profitability was higher if the owners were present in the top management but the results were not conclusive in medium-sized and large companies (Cástek, 2013, p. 13). While traditional theories predict that firms from developed countries acquire capital from entities located in emerging countries, Anusha, Chen and Dominguez (2009), observed foreign acquisitions of US firms by entities from emerging markets, despite the input costs for investment. Among their motivations can be mentioned: access to the advanced technology and entering new markets. In the years following the acquisition, sales and employment decline while profitability rises, suggesting significant restructuring of the target firms (Anusha et al., 2009). Using a sample of 383 state-owned firms from Taiwan between 1991 and 2002, Chen found that foreign investment had a positive impact on the long-run stock performance of equity issuers, suggesting that higher foreign ownership

may increase the process of monitoring and reduce agency problems. It leads to better monitoring effects and thus increases firm performance. Studying 84 firms listed on Tehran Stock Exchange for a period of five years from 2007 to 2011, Moradi, Aldin, Heyrani and Iranmahd (2012) found that the percentage of institutional investors' ownership has a direct relationship with firm performance (Moradi et al., 2012, p. 91). Foreign ownership mitigates the agency problems of free cash flows and optimizes the use of corporate resources for equity-issuing firms (Chen et al., 2009). Using a data set of 434 foreign-invested firms in Poland, Hungary, Slovenia, Slovakia and Estonia, Filatotchev (2008) showed that foreign investors' ownership and control over strategic decisions are positively associated with export intensity, measured as the proportion of exports to total sales worsens (Filatotchev, 2008, p. 1145). Using a sample of 19 privatized firms from 1994 to 2005 in Taiwan Yang showed that ROS, ROA and ROE did not improve after privatization. The ownership concentration is negatively related to performance. Foreign ownership makes the performance of privatized firms increase because foreign institutions require a higher level of information (Yang, 2008, p. 10). Examining the role of FDI on firms' performance, Barbosa and Louri (2005) found that multinational Portuguese firms do not perform better than the domestic ones. FDI has a positive impact upon Greek entities' gross return on assets. When net profitability is taken into account, the level of FDI has no effect on Greek corporations (Barbosa & Louri, 2005, p. 49). Studying the firms listed on the Zagreb Stock Exchange in period 2003-2009, Dzanic (2012) shows a negative relationship between the presence of a large shareholder and Tobin's Q value of the company. Tobin's Q is calculated as the market value of the company divided by the replacement value of the firm's assets. High Tobin's Q implies that the stock is overvalued. Also, he found no evidence that foreign ownership is better domestic ownership, as it usually is in emerging economics. Despite the fact that different authors revealed the positive effect of foreign ownership on a firm's performance, the sample from Zagreb Stock Exchange - Croatia does not support this view. In the case of Croatian entities foreign ownership has either a negative or a small effect on firm performance (Dzanic, 2012, p. 44).

Taking into account the efficiency scores for measuring corporate performance, Huang et al. found a positive but weak effect of foreign ownership upon Taiwanese firms (Huang et al., 2007, pp. 143-144).

Bokpin (2011) shows that in Ghanaian entities foreign firms' appetite to accumulate more cash is more than twice local firms. Foreign investors would avoid firms with higher levels of insider ownership (Bokpin et al., 2011, p. 277). In India, where companies maintain their shareholding pattern over time and big corporate family prevails, ownership concentration increased the average company (Kaur & Gill, 2009, p. 25). The more activist of foreign investors focused on obtaining key shareholdings in the largest of Australian corporations. The ownership of Australian corporations has become more concentrated than before and more concentrated than in Canada. Also concentration in the hands of foreign finance capital has intensified (Murray & Peetz, 2013, p. 102).

Conclusions

FDI is an important engine for economic growth, increasing the capital stock, creating employment and bringing new technologies and skills, and technology, especially from industrialized to developing countries. Most studies indicate that foreign ownership has a positive effect on firm performance because foreign investors possess better financial and technological resources and experience. FDI can help entities from developing economies coping with informational barriers, improper management, lack of financing, higher risks and costs entering new markets. Foreign-owned firms can become more competitive, increase their profitability, shareholder's value, and can easier access, expand and integrate into new and global markets. At the same time, reduces the agency costs within a corporation, improves the activity of managers, increases the quality of their auditing and reporting systems and thus result in higher performance and profitability. Due to its monitoring role, foreign ownership helps increase firm performance, the capital stock and creates employment. Foreign investors can monitor more independently the company's ways of spending capital and its managerial activity. For the investors' point of view, FDI is associated with costs for acquiring information, monitoring and bonding expenses that tend to decrease the benefits of international diversification. Due to the negative effects of expanding their business operations and disclosure of entities' resources across different business segments, FDI is not perceived as value increasing. The empirical literature shows that FDI has a positive effect on the corporate governance, financial performance and the economic growth

rates. The impact of Foreign Direct Investment on domestic acquisitions is significant and positive only in low international trading companies. On the contrary, services and manufacturing industries that are competing in international markets record smaller influence of FDI on corporate performance, productivity, and level of employment. One of the main reasons is that they are very competitive because only the most productive firms are able to overcome the costs of entering the international markets. The competitive exporting markets force exporters to be more efficient (Kostevc, 2009). In Malaysia and Czech Republic, FDI has a statistically significant and positively associated with company performance. When certain groups or families, like in Asia or in Jordan, where the banking sector is essentially built upon family businesses, mainly control companies, FDI has a weak influence on company's performance. Also firms with higher foreign ownership do not change their benchmark after equity issues. In Portuguese firms there is no connection between foreign ownership and profitability. In Greek firms, foreignness has a positive effect in terms of gross measure of profitability (Barbosa & Louri, 2005). The non-linear effect of FDI on firm performance from the emerging countries is due to their different level of institutional environment that is still adverse to the foreign ownership.

This study is a systematic literature review that has shed some light and provides evidence of the importance of Foreign Direct Investment for the firm performance and productivity. As the results are mixed, further research is requested. It might be interesting to study the main determinants taken into consideration by the investors for their investment decisions: corporate governance, disclosure practices, the official language, the market size, new trade agreements, the political climate, and the economic and business risks, that are country specific.

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