Title: Corporate governance quality, ownership concentration and the cost of equity capital

Urooj Istaqlal
College Of Management Sciences
PAF KIET

Introduction & Background:

- Corporate Governance Framework.
- Agency Cost.
- Regulatory Bodies.
- Ownership Structure.
- Cost of capital.

Problem Statement:

- According to Jensen and Meckling, 1976, Agency theory conjectures that in majority firms, shareholders hand over most control to managers, which in actual establishing an agency relationship.
- Williamson, 1985 examines that managers have enormous control over the company but they be inclined to be opportunistic and involved in value destroying activities that are against to interest of shareholders'.
- "Corporate Governance risk" which arises from a poor governance system can affect firms' Cost of Equity capital (Ashbaugh- Skaife et al., 2005; Cheng et al., 2006; Chen et al., 2003).

Research Objective:

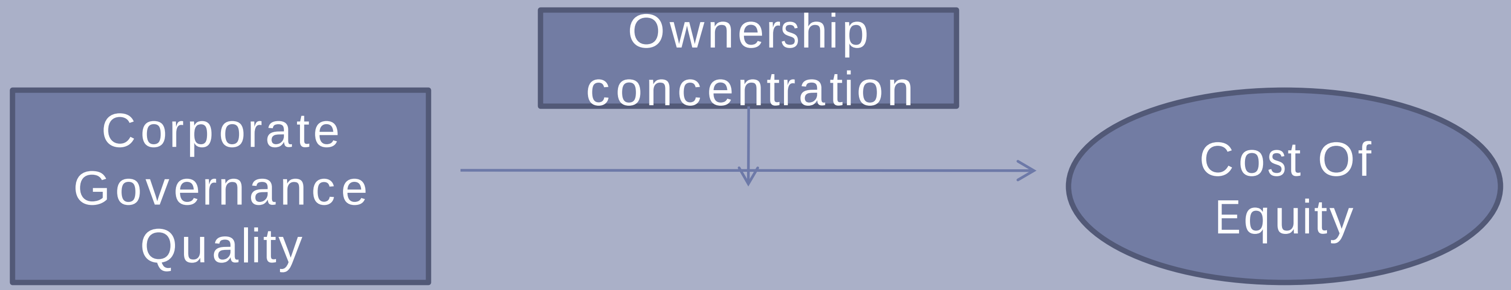
The objective of this study is to examine relationship between Corporate Governance has any effect on Cost of Equity in Pakistani listed corporations. This research also aims to identify Corporate Governance practice that significantly reduces Cost of Equity.

Research Contribution:

This study contributes to academia and industry practice in different ways.

- This study emphasize that Corporate Governance is a fundamental factor with respect to investor's viewpoint. Investors appreciate a sound Corporate Governance practices to shield their interest, the finding suggests that high quality Corporate Governance results in significant economic profits by lowering Cost of Equity, and thus access to capital becomes easier. High liquidity flow in the capital market increases chances for development in a emerging Market.
- Last, the Researchers can use Corporate Governance index consist a of quality measures attributes, is a valid instrument use to assess firm's Corporate Governance.

Conceptual Framework:



Variables:

Ke = Cost of Equity

CGI = Corporate Governance Index ,

CGC1 –CGC5= Corporate Governance Sub Categories

OWN.C= Ownership Concentration.

Control Variables: TA= Firm Size, LEV=Leverage, ROA= Return on Asset.

Research Hypothesis:

- **H1**: Companies with Quality Corporate Governance practices have a reduced Cost of Equity.

- **H2: The Relationship between** Quality Corporate Governance and cost of Equity is affected by different levels of ownership concentration.

Methodology:

Data and Discussion:

- This Paper analyzes relationship between Corporate Governance, ownership structure and Cost of Equity for 110 non-financial companies listed in Pakistan Stock Exchange.

Statistical Techniques and Models:

- Descriptive Statistics
- Correlation Analysis
- Panel Data Regression Model

Variables and Measurement:

- The Cost of Equity capital has been calculated using CAPM approach,

  $Ke = Rf + \beta(Rm - Rf)$

  Where Ke = Cost of Equity, Rf = risk free rate, Rm = market rate and β = beta.

- To investigate the relationship between Corporate Governance and Cost of Equity, we use a broad Corporate Governance index which provides a ample information regarding firm-level Corporate Governance for stated sample of Pakistani listed firms. This methodology has recently Used by (Black et al., 2006, Klapper and Love, 2004, Drobetz et al., 2004, Beiner et al., 2003, love and rachinsky, 2007). The CGI is a composite of various attributes, which includes 5 broad categories or sub indices: Disclosure, Board Composition and Functioning, Ownership and Control Structure, Shareholder Rights and Compensation Policies.

  CGC-1= OWNERSHIP AND CONTROL, CGC-2= BOARD COMPOSITION AND FUNCTIONING, CGC-3= COMPENSATION POLICIES, CGC-4= SHAREHOLDER RIGHTS, and CGC5= DISCLOSURE.

Econometric Specification:

Cost of Equity = f { *CGI* , Control variables}

$$Ke_{it} = \propto_1 + \beta_1 CGI + \beta_2 OWN.C + \beta_3 Fsize + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \mu_{it}$$

Main Findings:

- The results of model equation, panel data is used, where the Cost of Equity capital (Ke) is regressed against Corporate Governance Index (CGI) using each of five Corporate Governance sub categories CGC 1-5. The following firm-specific controls variables are included in Equation (2): firm size (F.SIZE), leverage (LEV), Return on Asset (ROA).

- Since good Corporate Governance practices are anticipated to decrease agency cost and bankruptcy risk which lower the firm's cost of capital, CGI should be negatively correlated with Ke. In this model, the coefficient for CGC-1 (Ownership and Control Structure), the CGI, is negative and statistically significant at the 1% level. In model, using each of 5 Corporate Governance sub categories CGC 1-5 individually, a negative relationship between CGI and Ke is reported, except for the shareholder CGC-4 (Shareholder Rights). The results appear to be stronger in statistical terms, for the CGC-2 (Board Composition and Functioning) and the CGC-4 (Disclosure).

- For different levels of ownership concentration (majority shareholders owning at least5%; 10%; 20%, and 25%). The variable of interest is the coefficient of the CGC 1-5. Results shows the following: first, the relation between corporate governance and a firm performance, be it ROA, is positive and statistically significant at the 1% level for holding percentages that are at least 5% and 10%. Secondly and most importantly, the magnitude of such a relationship, (the CGC 1-5 coefficient), decreases with the increase in the percentage of concentrated ownership. This result, along with the insignificant CGC 1-5 coefficients in, where ownership concentration is very high, i.e. at least 20% and 25%, provide new evidence on the relation between good governance and Cost of equity, and simply imply that the value addition of good governance is not necessarily maintained at high levels of ownership concentration.

Main Findings:

- Overall, the results suggest that the Cost of Equity decreases as Corporate Governance quality improve. This is mostly true when Pakistani firms comprises of effective boards and disclose better information. The negative relationship found between the CGC-4 (Disclosure) and Cost of Equity. The results show that the Cost of Equity decreases with firm size but increases with leverage. Though, the coefficients for LEV and ROA are not significant. The results are supporting the finding of (Bhattarcharya and Daouk, 2002; Ashbaugh et al., 2004; Cheng et al., 2006).
- In model equation results suggests that firms with sound Corporate Governance, in terms of high firm transparency and better disclosure, have lower cost of equity. Quality Corporate Governance will reduced information asymmetry and the uncertainty in future and support quality accounting information and reporting standards. As a result, firms which exhibit low risk profile should have lower Cost of Equity. We find strong evidence that the Cost of Equity is diminishing with the quality of Corporate Governance and this is consistent with previous studies findings.

Conclusion:

In this study examines the influence of corporate governance quality on the cost of equity of listed firms from Pakistan . Also finds how the relationship is affected by firm-level ownership concentration. Our results indicate that corporate governance quality has a negative influence on the cost of equity capital in Pakistan. Further we find that high firm-level ownership concentration tends to diminish the quality of corporate governance. Thus, corporate governance quality and low firm-level ownership concentration complement one another in lowering the cost of equity. Overall, our findings are consistent with the previous literature and suggest that seasoned investors have a preference for investing in firms with sound corporate governance practices and moderate levels of ownership concentration.

Recommendation:

- Because no research is close to perfection, we think that some limitations exist, the future research may shed light on other emerging economies with similar ownership structure, and investigate the relationship between the corporate governance mechanism and cost of equity . Researchers may examine how adopting such governance mechanism may preferred by corporations with different ownership structure, and hence examine their impact on corporate performance.
- This research was limited to 110 non financial firm listed in PSX, there is need for more extensive study which includes all non financial firms and some more variables to reduce the bias which is associated with generalization of findings.

Thanks for your attention!

Any questions?