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# Board Characteristics, Ownership Structure and the Market for Corporate Control in India

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## 1. Executive Summary

This study examines the effect of board characteristics and ownership structure of a target firm on (1) the likelihood of it getting acquired, (2) the likelihood of its majority acquisition (that is, acquisition of more than 50 percentage points of shares of target company) and (3) the impact on shareholders' wealth (that is, the unexpected change in stock price of the target firm in the event of an announcement that it is being acquired). Various attributes such as board size, proportion of independent directors (board composition) and duality (a concept of CEO and chairman being the same person) have been used to measure board characteristics. Promoters' ownership and institutional ownership have been used to measure the ownership structure of a target firm. The results show that while size of the board of the target firm as well as institutional ownership are found to have a positive relationship with the likelihood of it getting acquired, promoters' ownership has an inverted U-shaped relationship with the probability of acquisition implying that firms with very low and very high promoters' ownership are less likely to get acquired. On the other hand, duality of the target firm has a negative relationship with the probability of it getting acquired. The promoters' ownership of the target has a U-shaped relationship with the probability of majority acquisition. Finally, the board characteristics and ownership structures do not have a significant relationship with the target firm's shareholders' wealth.

## 2. Research Questions

In this study, we analyze the effect of board characteristics and ownership structures on various aspects of the likelihood of a firm getting acquired. For the analysis,

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1 The author is at Indian Institute of Management, Tiruchirappalli, India. This is a non-technical summary of the working paper (WP) with the same title under the NSE-IGIDR Corporate Governance Research Initiative (2013-14). Please refer to the original WP for further details, especially references.

we use attributes of the target firm such as board size, proportion of independent directors, and duality (a board is said to have duality, when the same individual is both the Chairman of the Board and the CEO of the company; duality is essentially a representation of the concentration of power inside the board) to measure the board characteristics. Promoters' ownership and institutional ownership are used to measure the effect of ownership structure of a target firm. Finally, to assess the impact on the wealth of shareholders, we use abnormal returns to a target firm's shareholder at the time of the acquisition announcement.

Promoters are the founders (or initial investors) of the company. Independent directors who do not have any relation (material or financial) with the company are supposed to look after the interests of non-promoter shareholders. If a firm is not performing well, it should be taken over for a better and efficient management. Therefore, we expect a positive relationship between the proportion of independent directors in a target firm and the likelihood of its takeover if the target firm is not performing well. However, theoretically, the relationship is not clear if the performance of the target firm is good because there could also be strategic reasons for a firm getting acquired rather than inefficient management. For a good performing target firm, the independent directors should accept the deal as long as it is beneficial/value adding to its shareholders, especially minority shareholders. A priori, it is difficult to assess whether the prospective deal is beneficial for its minority shareholders. The problem becomes more severe if insiders (promoters) are appointed as either CEO or Chairman of the board. If there is a duality, the CEO/chairman exercises higher power in the corporate policy decisions since he/she holds dual position. Typically, the management (as represented by CEO) of the target firm is opposed to its takeover because of the fear of loss of power in the event of acquisition. But how successful the CEO is in thwarting a takeover bid depends on his or her power. In case of duality, the CEO comes to acquire a higher concentration of power in corporate policy making and hence, is more likely to successfully stall a takeover bid. In other words, theoretically, one would expect duality to reduce the likelihood of a takeover.

## 3. Important results and their interpretation

The results suggest that board size has a positive effect on the likelihood of acquisition implying that companies with larger board size are more likely to be acquired. There may be more diverse views in a large board as compared to a small board. Since, the final decision of acquisition needs to be taken by the board of directors of the company, it is important to note that the larger boards do not prohibit the acquisition. In fact, they enhance the chance of firm's acquisition. There is a view that larger boards are less effective due to coordination issues and free-riding of some directors. Our results do not support the argument of coordination problems in a larger board; in fact it is the other way round. The presence of more independent directors does not change the prospect of a firm getting acquired either in a positive or in a negative direction. Further, results show that duality in the target firm reduces the likelihood of acquisition. It means that duality, which represents the concentration of power inside the board with the Chairman and CEO is influential in key decision making and also that the Chairman is unwilling to relinquish power.

The results of effect of ownership structure illustrate that promoters' ownership has an inverted U-shaped relationship with the probability of acquisition of that firm; i.e., there exist critical threshold values of promoter ownership below and above which firms are less likely to get acquired. Institutional ownership has a positive and significant effect on the likelihood of a firm getting acquired, particularly when the target firm is not performing well. Institutional investors typically monitor the performance of the company more closely (than non-institutional investors) and attempt to prevent the promoters to expropriate benefits from the other shareholders. Faced with (a) weaker incentive to retain control and (b) pressure from institutional investors, the promoters of target firms with high institutional holding are less likely to resist a takeover bid. Besides, in such target firms, there may be less information asymmetry as institutional shareholders are generally the more informed investors.

The board size and composition of a target firm does not have any effect on the likelihood of its majority acquisition. Duality does not have any effect on the likelihood of majority acquisition among all the acquisitions. Interestingly, the promoters' ownership has a U-shaped relationship on the likelihood of majority acquisition. The results illustrate that the majority acquisition can happen either at a very low or high level of promoters' ownership in the target firm. This relationship is in complete contrast to the results of the likelihood of all the acquisitions where there was an inverted U-shaped relationship. It means that for a majority acquisition to happen, either promoters’ ownership has to be very low or promoters will have to agree to sell their shares if they have high ownership. The first half of the relationship tells us that promoters usually do not encourage a majority acquisition since this will transfer control of the firm to its new owner/s. In the second half, the positive relationship can be explained by the fact that promoters with very high ownership are selling their stakes in these firms (i.e. majority acquisition will not be possible without promoters selling their stakes since they have very high ownership in the firm). The toehold (acquirer’s ownership in the target before acquisition) has a positive impact on the likelihood of majority acquisition. It means that the firms are more likely to acquire majority control in the target if they already had an ownership in the target before acquisition. This is perhaps because acquirers will be more confident of acquiring a majority control if they have some ownership in the target.

Finally, it is surprising that neither board size nor board composition (proportion of independent directors and duality) of the target firm has any significant relationship with abnormal returns (the proxy for shareholder wealth). Ownership structures (promoters and institutional ownership) are also found to have no significant relationship with abnormal returns. These results are baffling since, as already explained theoretically and empirically, these variables have significant effect on the likelihood of acquisition as well as acquisition of majority ownership. These results call for further examination of the relationship between board structure and firm performance in emerging markets.

The results of this study are expected to provide some guidance to regulatory agencies about the future directions of capital market regulatory framework, especially with respect to corporate governance and takeover regulations in India.