TUNNELING AND PROPPING: INDIAN EVIDENCE

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A THESIS
SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE FELLOW PROGRAMME IN MANAGEMENT
INDIAN INSTITUTE OF MANAGEMENT
INDORE

By

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March, 2017

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Abstract

Business groups (*BGs*) is one of the most dominant and prevailed organizational structures in emerging economies like India. The Business group is a set of legally independent firms tied through various formal and informal ways (Granovetter, 1995; Khanna and Yafeh, 2007). *BGs* was known as controlling minority structures wherein, the separation between ownership & control prevails through structural devices like pyramids, cross-shareholdings and dual class shares (Bebchuk et al., 2000). While there have been several critiques for *BGs* like crony capitalism, taking tax advantages, and political linkages, the demand for corporate control in groups is still pervasive. Such contradiction creates a 'Business Group Puzzle' and has been addressed by researchers through different lenses and perspectives. Our study is an effort in this direction.

Theoretical literature suggests the direct and indirect control of the controlling owners in a group. The controlling owners' willingness to maintain control for large private benefits causes the expropriation of minority shareholders. This is known as Principal-principal agency problem (Dharwadkar et al., 2000). The conflict further increases due to the asymmetry of information, development of the internal capital market and easy access to external finance. When the control motivation works in a manner that causes moral hazard problem and the interplay between external-internal markets, the resource transfer activity in a listed firm expropriates minority shareholders. This resource transfer activity is known as Tunneling. Tunneling is the transfer of resources from low-cash-flow-right to high-cash-flow-right firms (Bertrand et al., 2002). Propping happens when a firm is in financial difficulty and receives resources from a firm with high cash flow right, i.e., negative tunneling (Friedman et al., 2003). The market views such activities and reacts accordingly. Here, the monitoring role of controlling owner, the board of directors, quality and reputation of auditors' assume importance. When efficient monitoring mechanism by the board and auditors is present, it limits the minority shareholders expropriation caused by the collusion between owners and managers. Tunneling and Propping is one form of such expropriation that causes the diversion of resources to related parties of these insiders. To examine the role of these insiders (internal governance mechanism), a corporate governance index is used in the study based on the lines of Black et al. (2015) and Sarkar et al. (2012). The

role of efficient monitoring mechanism is crucial because its absence may aggravate the expropriation through increased Tunneling and Propping.

Our research considers this framework and provides evidence of Tunneling and Propping in *BGs* in India. We consider the direct and indirect methods of detecting Tunneling and Propping which still is not addressed for *BGs* in India. The Indirect method approach considers the earnings announcement effect. Under this, it is evident that when a firm of the group announces its earnings, a positive return of other non-announcing firms confirms the Propping hypothesis. Here, a negative impact of corporate governance mechanism is evident for the positive returns relationship between announcing and non-announcing firms. When considering the direct method approach, Related Party Transactions (*RPTs*) used as a proxy for the detection of Tunneling and Propping activity. The result suggests that large firms have the high amount of *RPTs* with Tunneling effect and the market penalizes them. Corporate governance mechanism plays a deterring role to Tunneling. Finally, when controlling owner has institution-driven motivations other than business transactions, the relationship between Tunneling and Propping is found to exist.

This work is comprehensive in its nature when considering the Tunneling and Propping activities in India. This study can be a guide to the investors planning to invest in group firms. From the investment point of view, findings of this study broaden investors' horizon as they are now more capable of analyzing various activities happening between group enterprises and its implications on their investment. We emphasize that, in certain cases, the firms with improved corporate governance system are less likely involve in activities that may expropriate the investors hard earned money. Policy makers and regulatory bodies may use this as a reference when formulating policies and regulations to protect the rights of shareholders.

Keywords Business groups, Ownership and control, Tunneling and Propping, Related Party Transactions, Performance.

Contents

List of Figures

List of Appendix

List of Tables