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Investor Protection and external Financing: Empirical evidence from non-financial sector of Pakistan

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Abstract

Study was aimed to check the impact of investor protection on external financing. It is argued that in developing economies like Pakistan companies with foreign ownership have an advantage in their access to external finance comparatively access of domestic owned corporations. To find out the relationship, data of 62 non financial companies for the period of 2002-2006 was evaluated using applied fixed effect model. Study found a significant positive relationship between investor protection and external financing. In other words we can say, economies where strong investor protection is available to investors, companies enjoy good external financing. Overall, the result of this study concludes that good practices and measures of investor protection have positive influence on external financing. Hence, good practices, rules and regulations and proper policies for investors attracts foreign investors.

Keywords: investor protection, external finance, non-financial sector, Pakistan

1. Introduction

We are living in the most modernized society, ever since the birth of this world. Today's business has got the globalize recognition. Reason being, to do business has become easy. People who have money and want to invest have got the option to invest any where in the world and can earn the profit. At one side where this most modernized form of business has created opportunities has created the conflicts on the other side. As stated by [1]agency theory "When investment is of one party and being managed by the other party a relationship of principal and agent becomes in existence. According to the human psyche each one could have their own interests hence can create the conflict. Agency theory resolved the problem of one party that is by motivating agents can pursue to work in the interest of managers. Motivation could be in the form of financial or non financial benefits.

The interests of other party can only be secured by giving them the protection through law. As much investors would be secure more they would be willing to invest in the market and the markets would be established but the regions where Investors are not that much protected and even if laws are present to secure the investors but their enforcement is weak the markets doesn't flourish and ownerships becomes concentrated amongst few people.

Burkart and Panunzi (2006) securitize the hypothesis of La Porta et al. (1998) that concentrated ownership is substitute for weak shareholder protection. They are of the view that on the one hand, more monitoring or better legal protection reduce the risk of expropriation by the managers and on the other hand, more shareholder control deprive the manager of his private benefits, therefore reducing managerial initiative. Managerial initiative is essential for creating shareholder valuation. Therefore, it is better to restrict monitoring by the control shareholder or through a bonus to manager when legal protection curtails private benefit extraction.

Thus the assumption of substitute or compliment for the relation of monitoring and law is decisive with respect to the shape of relationship between law and ownership concentration.
In the view of Shleifer and Vishny (1997) many countries do not protect minority investors, and thus have large investors in form of families and financial institutions. This type of governance structure may control managers, potential minority investors remain unprotected and unwilling to reinvest. Perhaps for this reason many countries in the world have underdeveloped financial markets. In their early work La Porta et al (1998)argue that corporations in countries with weak law and enforcement face the cost of heavily concentrated ownership and it becomes difficult to raise the equity finance.

In gauging the impact of the law on corporate governance Pistor et al (2002) maintain the focus on external finance. In their view the protection of minority shareholders from block-holders is equally important for the development of equity markets as the protection against management. The ability of managers to take operational decisions in the face of stakeholder resistance may also influence the confidence of investors and the development of external finance**.**

"When investor rights such as the voting rights of shareholders and the reorganization and liquidation rights of the creditors are extensive and well enforced by regulators or courts, investors are willing to finance firms. In contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well.

[1]Agency Theory: Agency theory is the hypothesis that attempts to explain elements of organizational behavior through an understanding of the relationship between principals (such as shareholders) and agents (such as company managers and accountants). A conflict may exist between the actions undertaken by agents in furtherance of their own self interest, and those required to promote the interests of the principals. (OT 2000) lesson notes of ICMAP students of strategic Financial Management published by: PBP.com.pk.

As absent effectively enforced rights, the insiders would not have much of a reason to repay the creditors or to distribute profits to shareholders, and external financing mechanism would tend to break down"(La Porta et al, 2002).Here a question rises that how does better protection of outside investors (both shareholders and creditors) promote financial market development?

The answer of this question was concluded by (La Porta et al, 1999) who argued that when the rights of investors are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. By limiting expropriation, the law raises the price that securities fetch in the marketplace. In turn, this enables more entrepreneurs to finance their investments externally, leading to the expansion of financial markets.This study has also been conducted with the objective to find out that whether investor protection motivates investors to invest or not as far as Pakistani corporate culture is concerned.

Our empirical analysis base on the where "investor protection" refers collectively to those features of the legal, institutional and regulatory environment and characteristics of firms or projects that facilitates financial contracting between inside owners (mangers) and outside owners.Influence of investor protection on the ability of firms to raise external finance through either debt or equity using company data from 100 firms from the different sectors of Pakistan's economy both at firm level and aggregate level.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1996),henceforth LLSV (1996)),They conjectured that the differences in the nature and effectiveness of financial systems around the world can be traced in part to the differences in investor protections against expropriation by insiders, as reflected by legal rules and the quality of their enforcement. They presented evidence indicating that legal rules protecting investors and the quality of their enforcement differ greatly and systematically across countries. In particular, these rules vary systematically by legal origin, which is either English, French, German, or Scandinavian. English law is common law, made by judges and subsequently incorporated into legislature. French, German, and Scandinavian laws, in contrast, are part of the scholar and legislator-made civil law tradition, common law countries provide companies with better access to equity finance than civil law countries, and particularly French civil law countries. They found finally that Common law countries have a higher outsider-held capitalization of the largest companies than does any other group, with the difference being most pronounced for the Scandinavian and the French origin.

We assumed as defined by the La Porta et al (1998) that Pakistan belong to the common law origin. As results of La Porta (1997) show that civil law, and particularly French civil law, countries, have both the weakest investor protections and the least developed capital markets, especially as compared to common law countries. Thus common law countries have better protection of minority shareholders. Therefore, are in better position to raise external finance and have developed financial market.

In this context we tested the proposition whether belong to a particular origin with strong investor protection have strongly impact raising external finance for a specific county like Pakistan in our analysis. In this chapter as extension of previous chapter we provide an attempt to applying the propositions of LLSV (1997) for Pakistan economy both at aggregate level and firm level.

In Pakistan for the security of investors different rules are prevailing. First of all any business cannot register itself without getting approval of Securities and exchange commission of Pakistan (SECP) which is actually governed by Companies Ordinance 1984. After getting registered if company desire to get its share traded in a proper market that is secondary market it has to follow certain rules of Stock exchange. In March 2002, SECP also announced a Code of Corporate Governance to ensure the interest of all stake holders.These available laws in Pakistan helped us to calculate the investor protections over time in which rights of creditors and shareholders that the "law and finance" literature considers relevant. All of this discussion is actually relevant to the governance issues that arise among shareholders, creditors, labor, and managers. Here by using the word governance issue means that to which extent the government provides protection to shareholders, creditors, and labor through legal rights included in the laws prevailing in country. Embedded in the discussion of the best corporate governance practices is the fact that the governance mechanisms selected might require a plausible commitment by the government and the courts to provide enforcement of rights disputes amongst stake holders.

The study is very important because Pakistan has recently introduced Code of Corporate Governance and is moving towards best governance strategies. By the application of which investors would get more protected. In this current scenario where government is trying to make investors confident whether there would be any of its impact on the generation of finances. This is the core objective of the study which would be helpful for the policy makers and investors as well. To do so we have emphasized on empirical contribution that is concentrated mainly on firm-level panel data because of the availability of firm level panel data. Moreover, with firm level panel data we can examine how availability of external finance varies across firms.

The study has been organized as Section 1 introduces the theme and presents literature review of the paper. Section 2 describes the data and some of the measurement issues. In Section 3 we have presented our model and present a prelude analysis of the data, and in particular demonstrate the basic findings of the effect of investor protection on External Finance. Section 4 concludes the study.

2. Data and Methodology

In this paper our objective is to investigate the impact of investor protection on external financing. Beside investor protection, here we use sales, total assets of the firm and return on assets as independent variables.Annual data was collected from 2002-2006for 62 firms (a total of 325 observations) from different sectors of Pakistan including Auto industries, cement, fertilizer, food, glass and ceramics, pharmaceuticals, sugar and textile.To analyze the data we appliedfixed effect model following equation is estimated as:

$$ExtFin_{i,t} = \alpha + \beta_1\, IP_{i.t} + \beta_2\, TA_{i,t} + \beta_3\, ROA_{i,t} + \beta_3\, Sale_{i,t} + \varepsilon_{i,t} \ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Where ExtFinrepresents the external financing, IP denoted for investor protection which is our dependent variable, TA is firm's total assets, ROA represents the return on assets and finally sales volume of the specific firm, i,t represent the firm and time period and $\varepsilon_{i,t}$ is error term of the equation. We estimate the two models, in first model sale was not included as independent variable however in subsequent model it was included as independent variable. Instrument

variables were also used with their first lag while the lag of dependent variable was two, because the frequency of data was annual and the literature suggests that one or two lags are appropriate for the annual data.

It was observed that investors protection have positive impact on external financing, because investors put their money where they estimate the lower probability of risk. Here, the risk we mean regulation and policies of the corporations regarding the external party financers. In addition to investor protection total assets with log values and return on total assets also considered as explanatory variables, these might attract the external financing as the financial position of the company shows the positive image to all the stakeholders especiallyto existing and potential debtors and creditors.The fact behind measuring financial position of the companies by these parties varies from their objectives.We also taken the annual sales volume of our sampled firms, the idea behind including the sales volume in this empirical analysis was that the sale is the most important component for every business because a lot of things are dependent on sales even the business is said to be going concern if generates sufficient revenues otherwise the business does not remain profitable, companies becomes bankrupts, they have to face the situation of financial distress and nothing left for the shareholders and for other external financers.

The financers'gave more importance towards the volume of the sales of the firms to which they are going to finance. Soas an important indicator that can affect the decision of external financers we included theper annumsales volume of the understudy firms. By providing sufficient justifications of the variables of concerns which are included in this study now we will discuss the methodology used to achieve the objectives of this empirical research.Thus to account for cross-firm variations in investor protection and other indicators we estimate the two models within the framework of fixed effect model by keeping the effect of firms specific characteristics fixed.

Given that the model predicts the possible effect of investor protection among a set of different variables on external financing. Here we did not take into consideration the foreign firms because these firms have the benefits and more chances of external funds as compared to domestic firms. Hence we examine whethervariations in firm specific requirement of external finance is associated with level of corporate governance and rules and regulations differences across firms.

3. Results and Discussions

To finding out the differences in the quality of corporate governance at firm level in firm's financial requirements of a cross section of companies we regress external financing on the investor protection, return on total assets and sales volume of the companies. And the results of the analysis are depicted in table-1.

Table-1

	Model I		Model II	
	Coefficient	**t-Statistic**	**Coefficient**	**t-Statistic**
Constant	-7878.69	-1.23	4345.20	0.56
IP	11753.94	1.24	7296.80	0.64
TA	156.22	1.16		
ROA	-278.94	0.62	314.94	0.49
Sale			33.57	0.22
Dependent variable	ExtFin		ExtFin	

*,** denotes the level of significance at 1 and 5% respectively

The results indicate that investor protection has positive association with external financing. This suggest that firm which needs more financing must ensure and take steps for investor protection. Thus with good practice of investor protection, it is ultimately the financial markets which rewards good measures of investor protections and punishes bad ones. However among all the variables which are under consideration investor protection shows higher t-statistics around (1.24) in our first model while remaining indicators does not found to statistically significant and have the lesser values of t-statistics. In case of model two where we drop the total assets and as a result inclusion of sales become possible. This model was remained quite different with respect to t-values comparatively lesser from earlier model, t-values of all the variables including investor protection in spite of having higher coefficient does not fall within the statistically significance range. However in first model investor protection have greatest t-value having higher coefficient showing positive association as discussed earlier.

4. Conclusion

Economic researchers investigated how the various micro- and macro-economic factors affect the external financing for developed economies but very little work has been done in case of developing economies. In this study we make an attempt to fill up this gap by studying 62 firms listed on Karachi Stock Exchange representative of all non-financial major sectors of Pakistan. To address this issue we estimated two models. Our result suggests that good practices and measures of investor protection have positive influence on external financing. Hence, good practices, rules and regulations and proper policies for investors are attractive for the investors. Where the bad and sufficient rules and regulation and policies effect the decision of investor and force them to think about next alternate.In this paper we applied the simple model to determine the determinants of external finance, and the results shows that better provisions and policies for external financers generate and attracts more funds and vice versa. As a result profit, market capitalization and revenues increases.In addition, our results add an important link in the description of the consequences of weak legal environmentof the company’s external finance and corporate evaluation.Future research might be conducted in weak legal regime countries like Pakistan, it is extremely crucial to investigate the firm’s legal environment and corporate governance policies in this regard.

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