Value co-creation : Conceptualization, theory of nested states, measurement, and implications

Abstract

CEO compensation has been the focus of intensive academic and popular debate. However, majority of the research has focused on the diversified ownership setting of the U.S. and the U.K. In this thesis, we address several issues relating to compensation in a concentrated ownership setting using the example of India. In the first chapter, we examine the impact of economic, board and ownership factors on the level of CEO compensation in India and how this impact varies for promoter and professional CEOs. Only six studies have been conducted on this issue in India and most of them are in the pre-corporate governance reform period when disclosure of CEO compensation was not mandatory. We collect remuneration and detailed board structure data from annual reports for 200 Indian firms for the post-reform period of 2004-2010. We find evidence for compensation being determined by firm size and firm performance. While accounting return dominates in the case of promoter CEOs, growth opportunities are important in the case of professional CEOs. Independent directors and institutional owners impact compensation particularly in the case of promoter CEOs. Looking at the impact of different types of institutional investors, we find mutual funds are passive institutional investors on the issue of compensation providing further evidence for the current public debate on their ineffectiveness in voting on corporate resolutions. We find promoter CEOs being awarded higher pay than professional CEOs and also find a premium pay for CEOs of firms belonging to business groups. In the second chapter, we measure the level of pay performance sensitivity for CEOs in India and test for the presence of reward for luck. Pay performance sensitivity varies in different institutional contexts and while it has been extensively studied in diversified ownership settings, studies on pay performance sensitivity in concentrated ownership are few. Our study is the first to address this issue in India. We find that for a Rs. 1000 change in shareholder wealth, CEO compensation changes by 11 paisa approximately. For promoter CEOs, ownership is the key source of wealth sensitivity to firm performance. The estimate for sensitivity from ownership ranges between a change in CEO wealth of Rs.16 to Rs 391 for a Rs. 1000 change in shareholder wealth. We also measure the impact of risk on pay performance sensitivity and find CEO compensation sensitivity to stock return to be inversely related to riskiness. We test whether CEOs in India are rewarded for that part of firm performance which is attributable to market and industry factors (luck) and is beyond the influence of the CEO. We find evidence for reward for luck. We also find evidence for asymmetry in reward for luck i.e. the CEO is rewarded more for good luck than penalized for bad luck. In the third chapter, we examine why promoter CEOs in India are paid higher compensation than professional CEOs and whether the existing theory of expropriation is the correct explanation for this phenomenon. We compare CEO compensation for promoter and professional CEOs by examining the components of the compensation, compensation's sensitivity to firm performance and the source of sensitivity to performance. When we decompose total compensation into fixed and variable components, we find an explanation for difference in compensation between professional and promoter CEOs. It is not the case that promoter CEOs are paid higher fixed compensation than professional CEOs. Instead, the higher total compensation for promoter CEOs arises from higher sensitivity of their compensation to firm performance. Interestingly, this higher sensitivity is due to a higher reward for skill rather than a higher reward for luck or a more asymmetric reward for luck. Thus, our findings do not support the existing opinion of promoters using compensation as an expropriation device. In the fourth chapter, we test the existing theory that CEO compensation is used as a means of tunneling in business groups often at the cost of dividends resulting in lower dividends than otherwise. We do not find any evidence for this theory in the case of India. Instead, the strategic choice of business groups to engage in higher value addition activities in comparison to stand-alone firms is the cause of the difference in compensation plans between business groups and stand-alone firms. We measure the impact of extent of value creation on CEO compensation and find that it is positively related to CEO compensation in the case of business groups. Thus, we provide evidence supporting the view that strategic choice should be included when testing corporate governance mechanisms.

Keywords: CEO Compensation, Pay Performance Sensitivity, Family Firms, Business Groups, Tunneling, Ownership Incentives, Agency, Managerial Power, Reward for Luck, Reward for Skill