The Managing Agency System

A Reply to R K Hazari

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That the managing agency itself does not hold a large percentage of the equity capital of the managed company is neither here nor there. What is relevant is that it is an instrument of control and is in many ways, as is argued below, a pretty good instrument.

In the ultimate analysis, the strength or weakness of a company is not technical but financial; and one of the most important services that the managing agents perform is to provide the managed company an access to the capital market which it would not have otherwise.

Hazari also finds the managing agency system expensive. This is the fundamental difference between private sector and public sector management. In the public sector the belief is that personal incentive is not necessary for encouraging efficiency, while the private sector attaches the greatest importance to incentive. It is probably true that management costs more in the private sector, but on the whole it would appear that the private sector also finds itself better rewarded for its expense,

WHILE I have nothing hut admiration for Dr R K Hazari's painstaking and well-informed article on the managing agency system, (Annual Number, February 1964) on careful reading, I am left with a suspicion that, like some intelligent Martian watching chess, he has understood all the moves, but has failed to comprehend the inter-relation of one move to another which makes the game possible. He has condemned the managing agency system on the grounds that it is irrational and expensive; nor does he see in the system any of the advantages that, according to him, are claimed for it. He says that managing agency agreements do not appear to be generally necessary for the purpose of exercising control over the management of public Companies; the total controlling blocks of most groups are sufficiently large to control a Company without, the further burden of managing agency system. He further argues that the managing agency Company contributes little to the share capital of the managed Company, and is normally just a nominal Company that has nothing specific to do except provide part-time management.

Substantial Holding Unnecessary

No one can deny (indeed he has proved this without a shadow of doubt) that the managing agency Company does not normally hold a large percentage of equity capital of the managed Company; but. whoever said that it should ? Managing agency Companies are basically nominal Companies which are not expected to hold a large percentage of shares of the managed Company. This is not to say, however, that the managing agency system is not necessary for controlling a Company. The mere fact that the shares are held not by managing agents but by associates of the managing agents does not make managing agents redundant. The managing agent is really the effective paint of integration for the controlling block so that it can effectively pool its resources to control the Company through a single agency, The controlling block consists normally of shares held by individuals, trusts other Companies all of whom have got together to form a 'new Company which they can only control provided they have an instrument of control. The instrument of control can either be a Managing Director or a managing agent or secretaries and treasurers, but an instrument of control is essential to persuade those who intend to put in the major portion of capital to float a Company. The fact that the managing agency itself does not hold shares of the managed Company is neither here nor there. What is relevant is that it is an instrument of control, and is in many ways, as will be argued below, a pretty good instrument.

Hazari maintains that the elimination of managing agency system from certain industries will not affect control: of course, il will not affect ultimate control that lies not with managers but with owners. But. what does he suggest should be the instrument of control ? How would substantial owners haw a say in the Company they own ? Besides, what assurance does the investing public have that a particular controlling group will not pull out of a Company whenever it wants to ? Even Hazari does concede that the investing public evaluates the group to which the Company belongs before investing. As for his statement 'the investing public generally evaluates the performance and prospects of individual Companies', all one can wonder is in which hot-house has he found that sort of investor ? Of course, it is true that, once the Company becomes well-established, the investors do look at the Company's performance; but in all initial investment, the crucial thing is the group to which the Company belongs, and the one way of making sure that the controlling group does not leave the investor high and dry is by giving the group control over management so that the controlling group is made responsible for the performance of the Company

Makes Collective Control Possible

One of the greatest advantages of a managing agency system is that it enables more than one individual to control a particular Company. As Hazari has pointed out. quite frequently, more than one family is part of a controlling block and it is reasonable, therefore, that each family and even each member within a family who has a substantial holding in the controlling block should have some say in the affairs of the Company. This does not necessarily lead, as Hazari implies, to confusion; everyone does not intervene in the affairs of the Company. The closest analogy that can be given to the managing agency system is the cabinet system where one or two men hold the executive power in a particular sphere of activity, but responsibility is taken by the entire cabinet for a decision. In the same way, normally the managing agency has one or two active Directors, but the responsibility is taken by the entire group.

It is perfectly true that a Board of Directors could play exactly the same role, but, at least in the system as it exists to-day in India, the Board of Directors normally consists of a few members from the managing agents and a large number from outside who have little financial stake in the Company but whose guidance and presence is of value for publicity which enables a Company to raise additional finance on the strength of their name. I am not for a moment suggesting that this method of working is in any way superior to having only working Directors in the Company, but neither has Hazari said anything to prove that it is inferior. The present system has, at least, one advantage : in an economy where raising capital is no easy task, having Directors who may have little interest in the Company, but who have a reputation of worthiness in the capital market, is useful for fund raising, and useful for the investo as a corrective to any excesses that the managing group may indulge in.

Value of Family Control

Hazari has criticised the concept of stability inherent in a managing agency system on the grounds that all it leads to is a perpetuation of family control; he claims that the system confers a birth-right on the managing agency family, which he dislikes — presumably as irrational. The value or otherwise of a hereditary system of management is eertainly not debated by him; he has assumed that the perpetuation of family control is bad. He may be right, but equally he may be wrong. There are obvious advantages in meritocracy but the value of a family tradition in business is often far more important. The name of Mafat. lal or Tata is not influenced by the particular Mafatlal or Tata incharge, but by the tradition that has been handed down from generation to generation.

While traditional ideas max not be useful in the day-to-day technical affairs of the Company, it is invaluable in financial matters. It is, here, in fact, that the real strength of the managing agency system lies. In the last analysis, the strength or weakness of a Company is not technical but financial, and one of the most important services that the managing agents perform is to provide the managed Company an access to the capital market which it would not have otherwise. There is no doubt, for instance, that, whereas there might be some reluctance to lend to a particular Company, the reluctance is diminished considerably if the managing agents provide the guarantee.

Hazari may think banks pretty 'silly' to insist on the kind of guarantees they do insist upon, and he may consider the guarantees pretty 'meaningless' as the guarantee cannot be honoured by any managing agent; but it is here that he is acting like the intelligent Martian. With his research, he should be aware that the value of the managing agents' guarantee is not in the resources that the managing agents have, but in their reputation. If a Tata-managed Company, for instance, failed on any single guarantee, they would not only cease to function for that Company, but their entire base would give way within twenty-four hours. Their high reputation in the capital market makes their guarantee worth more than the guarantee of a high-asset Company like TISCO.

This Is Finance !

If this is irrational, if this is not as it should be, if this is meaningless, all one can say to Hazari is that this is finance. Financial institutions very often, perhaps too often, rely more on reputation than on assets. This may not be sound logic, but, as an excellent American banker once told me, 'the greatest asset is sound and honest management; other assets can be liquidated, this cannot'. Many economists have unsuccessfully tried to understand finance, perhaps their failure is attributable more to their inability to see the simple propositions on which it stands. Finance is, of course, complex — if it was not so, there would be many more millionaires — but its basic tenets are simple and really quite sound.

Finally, Hazari finds the managing agency system 'expensive.' He has, of course, not disclosed what he considers expensive. These definitions are no doubt merely terminological; yet, one can presume what he means is that the work put in by managing agents is not commensurate with the commissions given to them. All one can say to him is that it depends on the point of view you take as an investor. Being in the private sector, I take the view that, if the managing agents make a profit, they are welcome to ten per cent of it; there does seem to be a case for removing the minimum remuneration, but I cannot see why there should not be an incentive for managing agents to make a profit for the Company. I suppose this is the fundamental difference between public sector and private sector management; in the public sector, the belief is that personal incentive is not necessary for encouraging efficiency while the private sector thinks that it is and, if the managers do earn a thumping commission by making a thumping profit, good luck to them.

Anyway, there is no evidence to suggest that Indian companies pay any higher for management than British or foreign Companies for exactly similar service. Some of the Manager Agreements of other countries may surprise even Hazari, It is probably true that management costs more in private rather than public sector, but, on the whole, I think the private sector finds itself more rewarded for its expense !