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Governance and firm value: The effect of a recession

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ABSTRACT

This paper examines the relationship between the firm's governance structure and its value during different economic conditions. We show that both relative industry turnover and CEO entrenchment increase during economic downturns. We also find that relative industry turnover and managerial entrenchment have opposite impacts on the value of the firm throughout the recessionary period. While industry turnover leads to an appreciation in firm value, managerial entrenchment reduces shareholders' wealth. The negative impact of managerial entrenchment on firm value, however, outweighs the positive impact of industry turnover. Accordingly, we propose that a recession provides managers with a good opportunity to camouflage their behavior and extract more private benefits and, thus, blame the poor performance on bad economic conditions.

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1. Introduction

Economic conditions may have a substantive influence on the soundness of the firm's governance structure and characteristics. This paper examines the impact of business cycle changes on the relation between corporate governance and firm value.

Few studies explore the consequences of the macroeconomic environment on the firm's value and characteristics. Philippon (2006) presents a theoretical model to demonstrate that firms with a bad governance structure have a higher response to aggregate shocks than firms with a good governance structure. Korajczyk and Levy (2003) suggest that the timing of debt issuance is significantly affected by macroeconomic conditions. Hackbarth et al. (2006) show that capital structure and credit risk are highly influenced by economic conditions. Oxelheim et al. (2008) propose that the impact of macroeconomic fluctuations on performance and compensation have a negative effect on the ability of managerial compensation to align the interests of managers and shareholders. Mac an Bhaird (2013) examine the attributes, pre and post the financial crisis, of firms requesting external financing. Enqvist et al. (2014) study the effect of macroeconomic conditions on the association between working capital management and firm profitability. Dimitras et al. (2015) investigate the impact of a recession on earnings management manipulation in European countries. Dimic et al. (2016) study the impact of macroeconomic elements on the stock-bond interdependence in emerging markets. Jin and An (2016) suggest that stock market volatility would be more affected if the financial crisis had happened today rather than the 2007–2009 period. Rao-Nicholson et al. (2016) propose that, relative to the pre and post crisis eras, mergers and acquisitions concluded during the crisis period achieve superior profitability.

This paper adds to the existing literature by investigating the relation between market conditions and corporate governance. We show that the firm's governance structure is vulnerable to fluctuations in the business cycle. Moreover, we

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examine the impact of the macroeconomic environment on the relation between the firm's governance structure and its value.

We suggest that CEO turnover increases during a recession. Our results support this hypothesis by showing that relative industry turnover increases during bad economic conditions. Due to the increase in managerial turnover throughout a recession, CEOs are subject to increased industry pressure. This is anticipated to have a positive influence on the manager's effort and behavior. In that sense, industry turnover seems to act as a control mechanism against swings in macroeconomic conditions.

We also investigate whether managerial entrenchment is affected by changes in the business cycle. Managers are said to be entrenched when they have power and control over the firm such that they are able to pursue their own private benefits and interests instead of maximizing the shareholders' wealth. We propose that the recession provides managers with a good opportunity to camouflage their behavior and extract more private benefits and, thus, blame the poor performance on the recession. The Entrenchment Index (E-index) constructed by Bebchuk et al. (2009) is used to measure managerial entrenchment. The results demonstrate that managers are more entrenched during economic downturns. That is, bad economic conditions amplify the manager's influence and authority within the firm. Consequently, agency problems are expected to be more pronounced during economic downturns.

In addition, this study investigates the impact of turnover and entrenchment on the value of the firm under different macroeconomic conditions. During economic downturns, the results demonstrate a direct association between turnover and firm value. Moreover, during a recession, we show that the increase in turnover, or excess turnover,[1] has a positive influence on the value of the firm. We also highlight a negative association between managerial entrenchment and firm performance. Furthermore, we propose that the effect of entrenchment on firm value is sensitive to macroeconomic changes. Our findings show that, during bad economic conditions, the increase in entrenchment, or excess entrenchment,[2] has a converse effect on firm value. The results also suggest that, during economic downturns, the negative impact of entrenchment on firm value outweighs the positive impact of turnover.

The findings of this paper suggest that agency problems may rise during recessionary periods. Economic downturns induce managers to extract more private benefits and, thus, the conflict of interest between managers and shareholders escalate. This seems to worsen the already poor performance of firms during bad economic conditions. Accordingly, the self-centered actions of firms' managers may aggravate and even prolong the bad economic conditions. External and/or self-imposed regulations may be necessary to prevent managers from inflating their authority and perquisite consumption during macroeconomic downturns.

The remaining part of this paper is organized as follows. Section 2 develops the research hypotheses. Section 3 presents the data and descriptive statistics. Section 4 offers empirical evidence on the impact of the macroeconomic environment on industry turnover and managerial entrenchment. Section 5 investigates the effect of industry turnover and managerial entrenchment on firm value during different economic conditions. Section 6 checks the robustness of our results. Section 7 concludes our research.

2. Hypothesis development

During economic downturns, a firm is usually closer to financial distress and the manager is confronted with elevated job insecurity. Gilson (1989) suggests that financial distress leads to higher management turnover. The author shows that managerial turnover is higher for distressed firms than it is for non-distressed firms. Moreover, in a recession, poor decisions and behavior on the part of the CEO might worsen the already poor firm performance. In addition, the existing manager might lack the talent and skills required to face the challenges and obstacles presented by aggregate economic shocks. In this paper, we hypothesize that managerial turnover in a given industry amplifies during a recession. Thus, due to the increased risk of losing his/her job, the manager is subject to more pressure during economic downturns.

We also investigate the impact of business cycle changes on managerial entrenchment. As managers become more entrenched, they gain more authority and protection against monitoring and governance systems. Demsetz (1983) proposes that the CEO is more willing to take on self-centered negative net present value projects when he/she has more power over the board of directors. In general, an increase in managerial entrenchment is said to amplify agency problems and lead to higher agency costs. Gompers et al. (2003) suggest a positive relation between their G-index and agency costs. Managers generally tend to divert firm resources, operate less efficiently, and take on self-centered decisions when replacing them becomes harder and more costly. An extensive literature suggests that the manager is motivated to pursue projects that are value deteriorating for shareholders, as long as he/she can extract private benefits from such projects (e.g. Baumol (1959), Williamson (1964), and Jensen and Meckling (1976)). Jensen and Ruback (1983) and Shleifer and Vishny (1989) emphasize that the severity of this agency problem increases when managers are entrenched and have enough power to prevent takeover attempts. Moreover, several studies propose that the imposition of state takeover laws leads to higher agency costs (Borokhovich et al., 1997; Bertrand and Mullainathan, 1999a,b, 2000; Garvey and Hanka, 1999).

[1] Excess turnover for each firm in a given recession year is defined as total industry turnover less the median total industry turnover for that firm during nonrecession years.

[2] Excess entrenchment for each firm in a given recession year is defined as the E-index less the median E-index for that firm during nonrecession years.

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