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Control–ownership wedge, board of directors, and the value of excess cash[☆]

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ABSTRACT

This study investigates the effects of the separation of control and ownership on the value of cash holdings in publicly listed French firms. It also sheds light on the role of board independence in such a relation. Theory suggests that investors are more likely to discount the value of excess cash held by firms with low corporate governance. Using the valuation regression of Fama and French (1998), empirical results show that the value of excess cash holdings decreases dramatically with the separation of control and cash-flow rights of the controlling shareholder. This value discount is, however, less pronounced in firms with more independent boards (i.e., boards with more independent directors and separate chief executive officer and chair positions). Our empirical findings support the argument that excess cash contributes less to firm value when minority shareholders are more likely to be expropriated by controlling shareholders. Independent boards seem to be effective in mitigating investors' concerns about the use of excess cash. Overall, the results provide compelling evidence that cash valuation is largely influenced by corporate governance quality in a concentrated ownership setting.

1. Introduction

In recent literature, the agency view of the firm has been dominated by the finding of La Porta et al. (1999) that throughout the world, firm control is typically concentrated in the hands of a few shareholders. Such shareholders tend to maintain control with a relatively small fraction of cash-flow rights. In such a controlling minority structure (CMS)[1], controlling shareholders are able to extract private benefits to the detriment of minority shareholders, who incur most of the implied agency costs. Hence, the relevant agency problem in CMS firms is between controlling shareholders and minority investors (type II agency problem), rather than the one between managers and all shareholders (type I agency problem) as suggested by Berle and Means (1932). The corporate governance literature documents that the likelihood of expropriation by controlling shareholders often increases with the control–ownership wedge. However, little is known about the expropriation activities in these firms. The present research explores this area by focusing on corporate cash holdings, a typical channel for extracting private rents in CMS firms.

Prior research on capital structure indicates that firms prefer using internally generated funds at the first-best level to undertake valuable investment opportunities since external financing usually entails additional costs due to asymmetric information as well as transaction costs (Myers and Majluf, 1984). Opler et al. (1999) argue that the level of cash holdings a firm maintains arises as a trade-off between the costs and benefits of keeping liquid assets within the firm. Hoarding cash provides a buffer against unexpected liquidity shocks and avoids the transaction costs of raising external funds (Kim et al., 1998). The availability of huge amounts of cash can, however, provide insiders with strong incentives to siphon off these resources to restock themselves, especially in the context of weak investor protection. Dittmar et al. (2003) point out that important cash holdings are ubiquitous in countries with poor investor protection, irrespective of ease of access to their capital markets. Harford et al. (2008) consistently show that cash exceeding optimal levels leads to inefficient capital investment and less valuable firms when internal governance mechanisms are not sufficiently effective to preserve shareholders' interests. In the same vein, Yun (2009)

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[1] The term *controlling minority structure* was initially coined by Bebchuk et al. (2000).

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finds that cash holdings tend to increase relative to lines of credit when the market for corporate control does not effectively carry out its disciplinary role.

To the extent that agency problems affect corporate cash holding decisions, the value that investors assign to cash may depend on the firm's quality of corporate governance. Building on this reasoning, Pinkowitz et al. (2006) and Kalcheva and Lins (2007) acknowledge that minority shareholders respond to high expropriation risk by discounting the value of cash holdings in countries with poor investor protection. Similarly, Dittmar and Mahrt-Smith (2007) show that well-governed firms exhibit a higher value of cash holdings than poorly governed ones. Analyzing diversification strategies, Tong (2011) shows that, compared to stand-alone firms, investors assign a lower value to cash holdings in diversified firms due to substantial agency problems in conglomerates. Studying payout methods, Haw et al. (2011) show that, in countries with weak investor protection, resorting to stock repurchases contributes less to cash value than paying out dividends. They conclude that payouts via repurchases are less effective than payouts via dividends in alleviating the agency costs of free cash flow.

The present research extends the literature on the effects of corporate governance on cash holdings by examining how investors value excess cash held by CMS firms. We particularly address the following questions: Does the separation of control and cash-flow rights reduce the contribution of excess cash to firm value (i.e., the value of excess cash)? Do independent boards constrain the use of cash in CMS firms? We suggest that cash that exceeds a firm's needs facilitates self-serving activities, especially when large shareholders enjoy more control rights relative to their cash-flow rights. We hence posit that investors' concerns about the use of such abnormally large cash stockpiles should be reflected in a lower value of the generated excess cash in CMS firms.

Severe agency problems arising from the control–ownership wedge make the role of internal corporate governance mechanisms, notably boards of directors, more important in curbing the opportunistic use of excess cash by controlling shareholders. Board independence is, in particular, considered to be essential to ensure high-quality governance. Researchers and practitioners consider that effective boards are those including independent members, who are deemed to act in the best interests of the shareholders by providing active monitoring of managerial actions (e.g., Jensen and Meckling, 1976; Rosenstein and Wyatt, 1990). Moreover, there is strong evidence that separating the chief executive officer (CEO) and chair positions indicates more effective board monitoring, since boards are deemed to exert more independent oversight over management when they are chaired by a person who is not involved in these managerial tasks (e.g., Bliss, 2011; Daily and Dalton, 1997).[2]

Moreover, the various laws and corporate governance guidelines—including the Cadbury report (1992) in the United Kingdom, the Vienot reports (1995, 1999) and the Bouton Committee (2002) in France—are being constantly reviewed to promote greater board independence. The Vienot report (1995), for instance, recommends the appointment of at least two independent board members whereas the 1998 revised version of this report requires a minimum of one-third of independent directors on boards. The Bouton report (2002) calls for raising this proportion to a half of board members. Nonetheless, board effectiveness in firms with concentrated control remains questionable, given that large entrenched shareholders often tighten their control over firm resources by holding top executive positions or serving on boards (Anderson and Reeb, 2004; Faccio and Lang, 2002).

In this paper, we address the question of whether boards of directors effectively carry out their governance role in CMS firms. More specifically, we investigate whether boards of directors affect the value of excess cash held by CMS firms by analyzing the effect of board independence and the separation of CEO and chair positions on the relation between control–ownership wedge and the value of excess cash.

We tackle these issues within the French context, where laws are less protective of outside investors and not well enforced as documented by La Porta et al. (1998) and control is typically concentrated through the use of a variety of control-enhancing mechanisms (Boubaker, 2007; Faccio and Lang, 2002). In such an environment, agency problems between controlling and minority shareholders (type II agency problem) can be important, which is potentially reflected in the valuation of excess cash holdings.

Our research extends existing studies in several ways. First, several studies including Harford (1999), Dittmar et al. (2003), and Dittmar and Mahrt-Smith (2007) examine the effects of agency relations on corporate cash policies. Our work provides new insights into the agency costs of cash by examining agency problems associated with the separation of control and cash-flow rights and the governance role of board independence. This study is among the first to focus on the management of cash policy in a context characterized by a large presence of dominant shareholders having control in excess of ownership. The role of the boards of directors in shaping firms' cash policies in such a setting is also not yet explored in the prior literature.

Second, unlike existing relevant research linking ownership structure to the value of cash holdings, this study examines the issue in light of type II agency problems induced by the control–ownership wedge. For example, using a broad cross-country sample, Kalcheva and Lins (2007) conclude that the concentration of control rights in managers' hands negatively affects the value of firms with important levels of cash holdings. The authors do not, however, explore the effect of the deviation of control rights from cash-flow rights for managers because of data limitations.[3] Kusnadi (2011) examines the effects of corporate governance on the market value of cash held by Singaporean and Malaysian firms without considering the implications of separating of control and cash-flow rights. Our work takes the control–ownership wedge of the controlling shareholders into account in gauging the severity of agency problems in CMS firms. We conduct a within-country analysis that overcomes the limitations of cross-country studies by taking advantage of a homogeneous cultural, legal, judicial, and economic environment, as argued by Bushman and Smith (2001). This study also adds to Masulis et al.'s (2009) work, which finds that insiders (i.e., officers and directors) holding more votes than equity rights significantly influences investment strategy, CEO compensation, and cash policy of U.S. dual-class firms. In a marked contrast to their study, we focus on type II agency problems, whereas they examine type I agency problems.

Third, despite the importance of corporate governance in a concentrated control setting, the role of boards of directors in CMS firms remains underexplored. Effective monitoring by independent boards can, in particular, be jeopardized by the power of controlling shareholders to appoint and replace board directors. To the best of our knowledge, our study is the first to investigate board effectiveness regarding the value of cash holdings in firms featuring an important separation of control and cash-flow rights and evolving in a weak legal investor protection environment.

Fourth, we extend the corporate finance literature by examining the implications of agency problems on cash holdings as a key financial policy. Hoarding cash is, indeed, predominantly ascribed to the transaction cost motive and/or the precautionary motive (Keynes, 1936; Myers and Majluf, 1984). Our research provides original evidence on the prevalence of the agency motive behind excessive amounts of corporate cash holdings in the specific case of CMS firms. French firms are interesting objects of study in this regard, given that they have relatively high cash-to-net assets ratios, as documented by Dittmar et al. (2003). Controlling shareholders are hence provided with more opportunities to consume private benefits, notably through cash diversion.

[2] We refer to the combined role of CEO and chair as a dual leadership structure or CEO duality.

[3] The authors use samples of Western European firms, emerging market firms, and East Asian firms from the datasets of Faccio and Lang (2002), Lins (2003), and Claessens et al. (2000), respectively, where cash-flow rights are computed differently for each dataset.