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How institutional monitoring creates value: Evidence for the free cash flow hypothesis

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ABSTRACT

Institutional ownership of U.S. equities increased from 9.4% in 1980 to 42.9% in 2009. This paper analyzes the indirect role of institutional investors in monitoring firm managers and in the process of shareholder wealth maximization. Institutional monitoring reduces the agency problem of free cash flow. Controlling for reverse causality, we find that increased institutional ownership results in lower leverage and dividend payout that consequently lead to greater cash holdings and firm value. The results are consistent with the free cash flow hypothesis and provide an alternative explanation for why firms hold so much cash and why debt and dividends have decreased during the last thirty years.

1. Introduction

Classical agency theory predicts that corporate managers with substantial free cash flow are more likely to invest in negative net present value (NPV) projects, even if paying out cash would be better for shareholders (Jensen, 1986; Stulz, 1990). Jensen (1986) suggests using debt and cash dividends to control the agency problem associated with excess cash flow. The increased interest payments and dividend payouts reduce the cash flow accessible to managers. These two mechanisms help prevent such firms from overinvesting in low-return projects. Such passive monitoring has its costs: cash constraint, cost of raising external capital (Jensen & Meckling, 1976; Myers & Majluf, 1984), overleverage (Campello, 2006), agency costs associated with debt (Myers & Majluf, 1984), and underinvestment (Myers, 1977). However, the average cash-to-assets ratio for U.S. industrial firms doubled from 1980 to 2009, but the mechanisms that mitigate the agency costs – leverage and dividend payout – decreased. Assuming that debt and dividends are effective – but costly – mechanisms to control the agency problem associated with excess cash flow, the partial replacement of the two passive mechanisms – leverage and dividends – by an active monitoring could help explain the evolutions of firm fundamentals.

The active monitoring impacts cash holdings via two channels. First, the partial replacement of leverage and dividend payout with active monitoring reduces the interest and dividend payments that previously were used to reduce the cash flow accessible to managers and, thus, the agency problem associated with free cash flow. The decreased use of the passive mechanisms decreases leverage and dividend payout, and increases cash retained in the firm. Second, the value of an extra dollar of cash increases due to active monitoring,

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and therefore increases the optimal level of cash holdings. Both effects lead to the greater cash holdings. Firm value improves due to greater cash value and lower costs associated with passive monitoring. This explanation for significant changes in firm fundamentals is consistent with the free cash flow hypothesis.

The average institutional ownership of U.S. industrial firms has increased fourfold (from 9.4% in 1980 to 42.9% in 2009). A number of studies argue that institutional investors are active monitors.¹ Thus, the significant changes in ownership structure and external monitoring environment provide an excellent opportunity to analyze its impact on controlling the agency problem associated with excess cash flow and the channels of its impact on firm value. In this paper, we use institutional monitoring as the proxy for active monitoring. We examine the impact of increased institutional holdings in corporate equities on cash balances, the two passive mechanisms that reduce agency costs of excess cash flow (leverage and dividends), and firm value and test whether the recent empirical developments are consistent with the free cash flow hypothesis. Intensive research has been done on capital structure and payout policy. The increase in cash holdings has been also investigated recently. However, the goal of our paper is not to replicate or challenge the existing papers. This paper aims to test whether the recent empirical developments are consistent with the free cash flow hypothesis. This is possible by looking only at the synthesis of the impact of increased institutional holdings on leverage, dividends, cash holdings, and firm value. To our best knowledge, no studies have ever linked the three important topics of corporate finance in explaining the empirical trends in leverage, dividend payout, and cash holdings.

The empirical evidence for the free cash flow hypothesis is mixed. Richardson (2006) finds that over-investment is concentrated in firms with the highest levels of free cash flow, supporting the free cash flow hypothesis. One way to distribute excess cash is to pay out dividends to shareholders. Therefore, one strand of literature investigates the market reactions to dividend increases. An increase in dividend payout reduces the magnitude of overinvestment and thus leads to greater share price. Lang and Litzenger (1989) find that the overinvesting firms have significantly larger return associated with announcements of large dividend increases, supporting the free cash flow hypothesis. Howe, He, and Kao (1992) extend Lang and Litzenger's (1989) dividend results to a broader set of cash transactions. In contrast, they find that the market's reaction to share repurchases and specially designated dividend announcements is approximately the same for firms with high Tobin's q and low Tobin's q . Another approach to test the free cash flow hypothesis is to investigate the gains from corporate restructuring. Lehn and Poulsen (1989) find that the major source of the stockholder gains in going private transactions is the mitigation of agency problems associated with free cash flow. Griffin (1988) finds that the free cash flow hypothesis can partially explain the gains from the petroleum industry restructuring during the period 1979 to 1985. Similarly, Lang, Stulz, and Walkling (1991) analyze a sample of successful U.S. tender offers from 1980 to 1986. They find that bidder returns are negatively related to cash flows for bidders with low quality of corporate governance captured by Tobin's q , but not for bidders with high quality of corporate governance. However, Gregory (2005) uses U.K. takeovers of listed domestic companies during the period 1984 to 1992 and finds counter-evidence for the free cash flow hypothesis. They find that acquirers with high free cash flow perform better than acquirers with low free cash flow. Bathala, Moon, and Rao (1994), and Grier and Zychowicz (1994) find that leverage and managerial ownership decrease with institutional holdings.

A common drawback of most of those studies is the relatively small sample size, and therefore weaker power of the tests. For example, Lang et al. (1991) provide a total of 101 observations in their sample; Griffin (1988) uses the panel data set for 25 firms; the sample size of Lehn and Poulsen (1989) is 236 observations; the sample in Gregory (2005) consists of 217 observations. Bathala et al. (1994) and Grier and Zychowicz (1994) test their hypotheses using 295 and 516 observations, respectively. However, the sample used by Richardson (2006) covers 58,053 firm-year observations. Our paper uses a much larger sample that consists of more than 140,000 observations.² It spans three decades and covers most of Compustat firms.

Another stream of literature focuses on the increasing cash balances of industrial firms. Recent literature documents that the increased cash holdings are in line with the rational behavior of a firm. First, firms with riskier cash flow and better growth prospects tend to hold more cash (Opler, Pinkowitz, Stulz, & Williamson, 1999). Bates, Kahle, and Stulz (2009) find that the increasing risk in cash flow and the greater importance of research and development (R&D) expense relative to capital expenditure (CAPEX) requires firms to hold more cash. Haushalter, Klasa, and Maxwell (2007) report that firms hold more cash and use more derivatives if they share a larger proportion of their growth opportunities with rivals. If a firm cannot take full advantage of the growth opportunities, it risks being predated and losing its market share (Chevalier, 1995). Second, the tax costs associated with repatriations contribute to the magnitude of cash holdings (Foley, Hartzell, Titman, & Twite, 2007). Third, cash holdings increase with stronger corporate governance (Harford, Mansi, & Maxwell, 2008). In addition to the findings above, Faulkender and Wang (2006) find that additional cash is most highly valued by shareholders of firms with low levels of cash holdings; however, the value of additional cash diminishes in the level of cash holdings.

This paper is related to the third argument on the increasing holding of cash. We argue that concentrated institutional ownership, measured as the ownership controlled by the five largest institutional investors with long investment horizon, is an alternative monitoring mechanism for the agency problem of free cash flow. The results suggest that institutional monitoring has at least partially substituted debt and dividends for control agency costs associated with the free cash flows. The increase in institutional holdings leads to lower leverage and dividends. As institutions are good monitors, the decreased debt and dividends result in greater cash balances rather than investments in negative NPV projects. In the absence of effective monitoring, the managers are less constrained from investing in

¹ A large body of literature has documented the effectiveness of institutional monitoring and positive impacts on the firm (e.g., Ajinkya, Bhojraj, & Sengupta, 2005; Amihud & Lev, 1981; Bushee, 2001; Chen et al., 2007; Hartzell & Starks, 2003; Hill & Snell, 1989; Thomsen & Pedersen, 2000). The presence of large institutional investors is associated with lower information asymmetry (Brous & Kini, 1994; O'Neill & Swisher, 2003; Szcwyczyk, Tsetsekos, & Varma, 1992; Velury & Jenkins, 2006), better corporate governance (Carleton et al., 1998), and lower agency costs (Hartzell & Starks, 2003).

² In some tests, our sample size reduces to 83,524 observations as some firms are not covered by CRSP.

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