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Investor protection and cash holdings: Evidence from US cross-listing

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This paper examines (i) whether the level of firms' cash holdings differ depending on the strength of investor protection, (ii) whether excess cash holdings are valued more with better investor protection, and (iii) whether cross-listed firms that improve investor protection through "bonding" hold relatively more cash than non-cross-listed firms. We analyze 1405 ADR firms and their corresponding matched firms from 39 different countries and document that ADR firms have significantly higher cash holdings relative to their non-cross-listed peers, especially in recent years. The increase in cash holdings is much higher for emerging market firms because of their transition from particularly poor home country investor protection and accounting standards before cross-listing to much higher standards after cross-listing. In addition, firms with level III ADR listing, which represents the strongest investor protection, have higher cash holdings relative to other types of ADR firms.

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1. Introduction

The proverb "*Cash is King*" has attained renewed clout as corporate America's cash holdings have hit their highest level in half a century. Recent articles in the popular business press suggest that nonfinancial companies in the US increased their holdings of cash and other liquid assets in 2011 to a record $2 trillion, which represents 7.1% of the companies' total assets. Our analysis indicates that the proportionate cash ratio is even higher for international firms. According to Myers and Majluf (1984) pecking order theory, retained cash holdings provide a quick way to fund profitable expansion opportunities without resorting to costly external financing, thus reducing the marginal cost of liquid asset shortage. In this sense, cash is a desirable asset. On the negative side, Jensen (1986) posits that the deployment of cash is central to the agency conflict between managers and shareholders. Managers have strong incentives to build large piles of cash due to the relative ease with which cash can be expropriated or used for non-value-maximizing corporate activities for their own private benefit. Cash is also viewed as an idle and unproductive asset earning a minimal rate of return. This perspective implies that holding less cash is desirable due to its relatively high marginal cost compared to more productive assets. This trade-off between the positive and negative effects of cash has important implications for the optimal level of cash reserves that firms actually maintain.

In this study, we show that a reduction in agency costs obtained through strong investor protection plays a significant role in a firm's decision of how much cash to hold. Consistent with agency theory explanations of cash holdings, we show that better shareholder protection and better accounting standards are associated with higher levels of cash holdings. Moreover, we show that the positive association between investor protection and cash varies over and our results in the recent years depart significantly from our results in the prior years and from the prior literature (e.g., Dittmar et al., 2003). Specifically, after 1998 the relation between shareholder protection and cash holdings strengthens. We attribute this finding to changing investor perceptions on the efficiency of firms' use of cash. Investors value excess cash significantly more for firms with better investor protection after 1998. Because liquid assets are the most vulnerable to misappropriation, we conjecture that the period coinciding with the Asian, Russian, and Latin American financial crises of 1997–1998 caused investors to scrutinize more closely managerial behavior and infer productivity of cash based on observable country and firm-level attributes. Thus, investors assign higher valuations to firms that are less likely to misuse cash due to better shareholder protection.

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Since investors value cash more highly in strong investor protection environments, how can managers reliably commit to subject themselves to increase investor protection? A popular answer to the question is in the "bonding hypothesis" proposed by Coffee (2002) and Hope et al. (2007) which predicts that firms cross-listed on a US stock exchange provide better investor protection than their domestic peers in their respective home markets.[1] This hypothesis posits that heightened scrutiny by investors, analysts, traders, exchanges, the SEC, and government enforcement agencies effectively restrain managers of foreign firms cross-listed in the US markets from expropriating minority shareholders. Therefore, bonding leads to a significant reduction in agency costs. Recent empirical research (e.g., Frésard and Salva, 2010) shows that firms enjoy higher valuation of cash and other liquid assets by shareholders when they have better governance and lower agency costs. Given the prediction about the effects of bonding on mitigating agency conflicts, we hypothesize that the improved governance associated with cross-listing enables firms to retain a higher level of cash holdings for the purpose of increasing shareholders' wealth through easier exploitation of future business opportunities. With better investor protection in the US markets, managers are less inclined to misappropriate cash. Therefore, investors are less likely to discount the cash holdings of these firms. Thus, all else equal we expect that cross-listed firms will hold more cash than firms that do not cross-list in the US.[2]

We focus our analysis on the period from 1992 to 2009 during which 95% of the currently cross-listed firms entered the US exchanges. We test the hypothesis that investor protection is a significant determinant of corporate cash holdings by studying the level of cash holdings of 1405 ADR firms in our final merged sample from 39 countries with varying levels of shareholder protection and accounting standards. We also form a matched control sample of non-cross-listed domestic firms that have similar firm characteristics as the cross-listed firms. We find that the average cash holding, which is defined as cash plus equivalents divided by firm's net assets, is higher for cross-listed firms than for their matched counterparts listed only in the domestic markets. For cross-listed firms themselves, the ratio is higher after cross-listing than before. In our robustness tests, following Harford et al. (2008) we use the ratio of cash to sales as an alternative measure of liquidity and find that this ratio also increases with the degree of shareholder protection and cross-listing.

The bonding effect of cross-listing is more pronounced for firms from emerging markets which may previously suffer from inferior home country investor protection compared to that in developed markets. We observe a substantially higher increase in cash holdings of emerging market firms relative to cross-listed firms from the developed markets or matched samples of non-cross-listed home market firms. We also interact a home market investor protection variable with cross-listing in the US market to understand these differential impacts on cash holdings. Whereas firms from home markets with poor investor protection initially hold a lower level of cash than firms from home markets with better investor protection, firms in the former category also experience a much higher increase in the level of their cash holdings after cross-listing. Moreover, cross-listed level III ADR firms hold more cash than level I, level II or restricted ADR firms. Because level III ADRs require the strictest compliance with US laws and regulations and, therefore, represent the highest level of shareholder protection and information disclosure, shareholders discount the cash holdings of these firms less than the lower level ADR listings. The effect of level III ADR cross-listing is robust to the removal of sample firm-years that may have higher cash holdings due to the effects of new financing. In summary, the increase in the level of cash holdings depends on the degree of improvement in investor protection. To our knowledge, ours is the first study to show that an improvement in investor protection and reduction in agency costs resulting from cross-listing enables firms to hold more cash.

The remainder of the paper is organized as follows. Section 2 presents a brief literature review focusing on theories of excess cash valuation and other potential determinants of a firm's cash holdings. We then formulate testable hypotheses from this literature. We describe our data and the variables of our final sample in Section 3. We discuss our analyses and empirical results in Section 4, and Section 5 concludes the paper.

2. Literature

2.1. Agency theory

As agents of shareholders, corporate managers often have conflicts of interests dubbed as agency problems by Jensen and Meckling (1976). Corporate managers have a strong incentive to hoard cash, either to increase private benefits or to increase their power via greater control of resources. Large cash holdings enable managers to over-invest in projects, even if some of those projects have a negative NPV, because it is in the managers' best interests to let the firm grow into a corporate empire (Jung et al., 1996). On the other hand, shareholders who are concerned about managers' inclinations to extract excessive private benefits of control, aim at a lower level of cash holdings (Stulz, 1990). They prefer a payback of the return on their investment in the form of dividends or a stock repurchase instead of leaving the cash to the managers' discretion.

Thus, a testable implication of the agency cost model on the effect of information asymmetries between shareholders and managers, is that the level of cash holdings should optimally be kept low if the conflicts of interest between these two parties are high. With more severe conflicts, investors discount cash holdings more heavily. Dittmar and Mahrt-Smith (2007) document the relation between corporate governance and the relative valuation of a firm's cash holdings in the stock market, and provide empirical evidence that the value of cash is substantially less if corporate governance is poor. Pinkowitz et al. (2006) and Frésard and Salva (2010) show that the stock market discounts the value of cash held by poorly governed firms by 10–60% compared to well-governed matching firms in countries with better investor protection.

Strong investor protection makes it very costly for managers to pursue their conflicting personal interests over shareholders' interests, thus mitigating agency problems. For example, Lang et al. (2003), Hope et al. (2007), and Bailey et al. (2006) show that high quality accounting disclosures increase firm valuation by limiting the flexibility that the managers have for potentially abusing corporate assets. Drobetz et al. (2010) find that the value of corporate cash holdings is lower in states with a higher degree of information asymmetry, which is inversely related to the degree of investor protection. As a result, we posit that shareholder protection and accounting standards are significant predictive factors in determining the level of a firm's cash holdings. None of the papers cited above examine the effects of a valuation premium due to better investor protection on the actual level of cash holdings of the firm.

With growing investor sophistication, we expect time series variations in the importance of investor protection. For example,

[1] Coffee (2002) defines "bonding" as a term of art in modern institutional law and economics. It refers to the costs or liabilities that an agent or entrepreneur will incur to credibly signal and assure investors that it will perform as promised, thereby enabling it to market its securities at a higher price.

[2] While cross-listed firms have greater access to external finance and thus should have less need to hold cash, we assume the governance explanation dominates the effects of ease of access to external capital.

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