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Ownership, capital structure and financing decision: Evidence from the UK

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This paper examines whether and to what degree agency conflicts in ownership structure affect firm leverage ratios and external financing decisions, using a universal sample of UK firms from 1998 to 2012. We use two distinctive measures to capture ownership structure, namely, managerial share ownership (MSO) and institutional ownership. Our empirical results show a non-monotonic relation between MSO and the debt ratio, supporting two competing theories: interest alignment theory and the management entrenchment hypothesis. Nevertheless, institutional ownership is found to be positively related to firm leverage levels. Our results further suggest that firms with concentrated MSO decrease their leverage by increasing the probability of issuing equity over bonds, an effect strengthened during hot market periods.

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1. Introduction

In corporate governance, ownership structure is a crucial instrument in alleviating agency problems. Previous research (e.g., Anderson, Mansi, & Reeb, 2003; Morck, Shleifer, & Vishny, 1988) provides evidence that agency conflicts in ownership structure have an impact on firm performance, but only a handful of studies look into how ownership structure affects firm capital structure by considering agency problems. This paper examines whether and to what degree agency conflicts in ownership structure affects firm leverage ratios and external financing decisions, using a universal sample of UK firms from 1998 to 2012.

A vibrant strand of capital structure research follows Jensen and Meckling (1976) in using owner–manager agency conflict to argue that managers make capital structure decisions to promote their own wealth, such that their behavior does not maximize firm value. Debt is a disciplining device that can be used to alleviate such agency problems by constraining management overinvestment behavior (Grossman & Hart, 1980; Jensen, 1986). In this case, entrenched managers who have discretion over capital structure choice pursue lower debt levels to avoid the disciplining role of debt. Further, they have an incentive to protect their under-diversified human capital from bankruptcy risk associated with debt (Friend & Lang, 1988;

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Jensen, 1986). Zwiebel (1996) further argues that entrenched managers only issue debt as a defensive device to commit sufficient value when their empire building is threatened by potential takeover and dismissal. Consistent with this argument, Berger, Ofek, and Yermack (1997) find that firm debt levels increase following entrenchment-reducing events, such as involuntary CEO turnover, unsuccessful tender offers, and the arrival of a new board of directors. However, Harris and Raviv (1990) and Stulz (1988) suggest that entrenched managers prefer more than the optimal amount of debt to inflate their equity voting power and avoid takeover threats. Given these inconsistent views of the influence of managerial incentive on firm debt levels, the first goal of this study is to explore how MSO influences the capital structure decisions of firms and provide further insight into the predictions above.

Moreover, Shleifer and Vishny (1986) point out that the presence of an external blockholder can help dampen the effect resulting from standard owner–manager conflicts of interest, since concentrated ownership leads to intense managerial monitoring. An active monitoring mechanism can limit the scale of managerial opportunism and resolve the issue of managers adjusting the capital structure of firms to serve their own interests. Institutional shareholders, by virtue of their large shareholdings, have stronger incentives and better skills to monitor management relative to minority shareholders (Grossman & Hart, 1980).[1] This is because they can enjoy greater benefits through monitoring and have greater voting power against financial policies that reduce shareholder wealth (e.g., Ashbaugh, Daniel, & Ryan, 2006; Bhojraj & Sengupta, 2003; Shleifer & Vishny, 1986). In this case, the cost of debt should be lower in firms with higher institutional ownership. Given this viewpoint, the second goal of this study is to examine whether the presence of institutional shareholders encourages firms to choose debt as a governance mechanism to constrain managerial entrenchment.

Proper management of firm ownership structure can have a significant effect on firm leverage levels, echoing the argument of Brailsford, Oliver, and Pua (2002), Florackis and Ozkan (2009), and Friend and Lang (1988). Such an effect is generally imposed via a firm's external financing activities, since, in practice, security issues and proceeds are used to directly affect capital structure. Therefore, this paper further examines the role of ownership structure on the external financing decisions of firms, using a dataset of UK bond and equity issues. Our study is in line with recent work by Lundstrum (2009), who investigates 111 financing offerings of US firms and finds a positive relation between MSO and a decline in leverage after issuance.

In addition, the literature suggests that market valuation interplays with ownership structure in determining leverage levels and external financing policies. Baker and Wurgler (2002) argue that firms raise external funds when their cost of equity is temporarily low and that previous equity issues have a long-lasting impact on leverage. Welch (2004) states that the fluctuation of a firm's own stock price is one of the primary determinants of capital structure changes. For example, a firm's stock price is likely to be overvalued because of rising demand from investors under hot market conditions. This naturally leads to MSO diffusion due to equity issues and share selling and thus lowers debt levels. In this line, Pedersen and Thomsen (2000) consider stock market valuation a probable determinant of firm ownership structure. However, the relation and, more specifically, the directions of the relation between market valuation, ownership structure, and external financing decisions are far from conclusive (e.g., Florackis & Ozkan, 2009; Pedersen & Thomsen, 2000). The third goal of this paper is to examine the moderating effect of market valuation on the relation between ownership structure and external financing channels.

Our study makes several contributions to the literature. First, this paper starts by recreating earlier findings of the relation between ownership and firm leverage (e.g., Florackis & Ozkan, 2009; Lundstrum, 2009). However, in addition to MSO, our analysis considers institutional ownership a key measure that leads to a more complete capture of ownership structure. In contrast to the work of Lundstrum (2009), our analysis focuses on UK listed firms. The UK market provides an interesting context for our study: UK firms are generally characterized as having widely dispersed ownership, with a growing concentration of institutional holdings. Short and Keasey (1999) suggest that, compared to the US market, UK managers become more entrenched at higher levels of ownership and institutional investors are better able to coordinate their monitoring activities. Additionally, UK bankruptcy law strictly enforces creditor rights against management and equity holders when a firm succumbs to financial distress (Rajan & Zingales, 1995). Therefore, managers in UK firms are more conservative in debt issuance, although strict enforcement reduces the cost of debt.

Second, we extend the study of Lundstrum (2009) by investigating whether and to what degree MSO, or institutional ownership, affects the external financing policies of firms, including the choice between bond and equity issues and the size of the issue. Moreover, unlike Lundstrum, we consider the relation between ownership and financing decisions under different market valuations. It is hypothesized that hot and cold market valuations limit managerial entrenchment and hence lower agency costs. We argue that both managers and institutional shareholders benefit (suffer) from equity issuance because of the lower (higher) costs of equity in hot (cold) markets. To address this issue, we explicitly take into account different (hot/cold) market valuations to interact with firm ownership proxies and assess their impact on external financing decisions.

Our study also addresses how the recent financial crisis has influenced the capital structure and financial decisions of firms, given that managerial and shareholder interests are naturally aligned and owner–manager conflicts over risk choice vanish with the threat of firm bankruptcy. In this setting, both managers and institutional investors are more concerned with firm survival; thereby, firms are more likely to lower their leverage levels by issuing equity over bonds. This study provides strong empirical evidence to support this argument.

[1] The literature recognizes that individual investors who own a small fraction of shares expect others to take responsibility for monitoring, because their cost of monitoring is generally much higher than their returns (Grossman & Hart, 1980).

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