

Is the free cash flow hypothesis valid in Turkey?

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Abstract

This study tests the validity of the free cash flow hypothesis in the context of firms traded on Borsa İstanbul. The study applies a panel regression to a data set composed of 1267 observations from 227 companies during the period 2008–2014. The results reveal a significant, negative correlation between dividends per share and free cash flow. Likewise, a significant, inverse relationship is found between leverage and free cash flow. Thus, the results support the free cash flow hypothesis.

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1. Introduction

Instances of corruption and bankruptcies have brought agency theory to the forefront in recent years. Agency theory contends that conflict often exists between the interests of shareholders and those of managers. Free cash flow is one of the tools managers use to promote their personal interests, and the problem of reigning it in is of equal interest to academics, regulatory bodies and companies.

Agency theory (Jensen & Meckling, 1976) serves as a theoretical basis for the free cash flow hypothesis (Jensen, 1986, 1989, 1993), which argues that managers use free cash flow to invest in projects with negative net present value (NPV) even when these investments are not in the interests of shareholders. According to the free cash flow hypothesis, managers may be reluctant to debt financing or pay out dividends, as these moves reduce free cash flow in their hands. However, that is precisely the reason these moves can stem the

agency problem caused by excessive free cash flow in the hands of managers.

While definitive results have yet to be obtained, the studies of Rozeff (1982) and Easterbrook (1984), DeAngelo and DeAngelo (2000), and La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) have reached conclusions supporting the free cash flow hypothesis. Denis, Denis, and Sarin (1994) have also reached similar findings. Titman, Wei, and Xie (2004) and Fairfield, Whisenant, and Yohn (2003) uncovered poor share performance among firms making extreme amounts of investment. Similarly, Dechow, Richardson, and Sloan (2008) proposed that firms with excessive amounts of free cash flow have low future performance. Lang, Ofek, and Stulz (1996) suggested that indebtedness reduced free cash flow at firms with low Tobin's Q ratios. Li and Cui (2003), Byrd (2010), Khan, Kaleem, and Nazir (2012), and Zhang (2009) also reached similar conclusions.

In Turkey, as in many developed financial markets, principals of corporate governance are being put into practice in order to reduce agency cost stemming from the agency problem. In 2003 corporate governance principals made their debut in Turkey with the “comply or explain” approach. In 2012 they became compliance rules and achieved the status of law with

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the introduction of the Capital Markets Law at the beginning 2013. Similarly, corporate governance principals are partly seen in the Turkish Commercial Code of 2012. Given the importance of corporate governance in Turkey, it should be investigated as to whether the regulations fit a theoretical framework as well as whether they achieve their goals. This study aims to shed light on the relationship between dividend distribution and free cash flow, in particular. Similarly, the effect of external financing upon free cash flow should be investigated. The results may guide to corporate governance regulations and practices in Turkey.

Even though there are many studies in Turkey related to corporate governance and firm performance or dividend policy and corporate governance or capital structure and firm performance, we couldn't find a study directly testing free cash flow hypothesis or testing relationship between free cash flow and dividend or leverage in the context of agency cost or corporate governance.

This study investigates whether the free cash flow hypothesis is valid for firms traded on Borsa İstanbul using the IFRS yearly nonconsolidated balance sheets and income statements of 227 firms for the period 2008–2014. A panel regression is used to test for a relation between free cash flow and the variables dividends per share, debt ratio and total assets.

According to the results of the panel regression, a statistically significant, negative relation exists between dividends per share and free cash flow as well as debt ratio and free cash flow. In addition, total assets and free cash flow have a significant, positive correlation. These relations are still valid, when the crisis year 2008 and 2009 excluded from the analysis. Thus, the results support the free cash flow hypothesis. As the hypothesis suggests, dividend distribution and debt financing reduce free cash flow. In other words, firms with high dividend distribution or high debt ratios have a lower amount of free cash flow in the hands of managers.

Section 2 of the study provides an overview of the relevant literature. Section 3 outlines the data and methodology while Section 4 presents the results and their implications. Finally, Section 5 summarizes the conclusions of the study.

2. Literature review

At the heart of the free cash flow hypothesis proposed by Jensen (1986, 1989, 1993) lies the agency problem (Jensen & Meckling, 1976), defined as the divergence of the interests of managers from those of shareholders. Richardson (2006) defined free cash flow as possession of cash outside that used for asset maintenance and the finance of new investments. Chen, Hope, Li, and Wang (2011) found free cash flow to be an indicator of overinvestment.

According to the free cash flow hypothesis, managers are able to manipulate free cash flow under their control. As these managers do not want to go under threat of bankrupt, they are reluctant to pay out dividends or debt financing. Similarly, they do not look favorably on using external capital, being unwilling to bear the scrutiny of lenders or shareholders.

Excessive free cash flow in the hands of managers leads to overinvestment due to investment in projects with negative net present value (Jensen, 1986; Jensen & Meckling, 1976). While this reduces profitability and company worth, it helps managers to control a greater amount of wealth or assets. According to this hypothesis, managers of firms with a high amount of free cash flow avoid market checks. These managers do not feel the need for external funds for investments or expenditures; therefore, they are not subjected to the investigation or regulation of lenders or shareholders. In the event that funds are provided by capital markets; ample, detailed information needs to be shared with market participants and more these bring more questions that have to be answered by the managers. Rubin (1990) and Lang, Stulz, and Walkling (1991) argued that managers prefer to use any free cash flow remaining after investment negative-NPV projects to continue to invest in such projects rather than pay out dividends.

Apart from using free cash flow to invest in projects with negative NPV, managers tend to make unnecessary expenditures aligned with their personal interests. Tangible or intangible assets unrelated to company operations may be purchased in the firm's name, but function purely for a manager's personal use. According to La Porta et al. (2000), overinvestment and personal expenditures are seen even in environments with stricter investor protections. Acquiring firms that are not feasible investments is also seen more frequently at firms with greater free cash flow (Opler, Pinkowitz, Stulz, & Williamson, 1999).

According to Christie and Zimmerman (1991), paying out dividends is helpful for reducing free cash flow in the hands of company managers as well as reducing agency cost. They found that, as a result, dividends help check managers and create a discipline mechanism without the direct intervention of shareholders. The reduction of free cash flow in managers' control was found to reduce agency cost and raise company worth (Park & Jang, 2013). Similarly, securing outside capital was found to bring overinvestment problems under control. The payment of interest upon debts reduces the amount of free cash flow in the hands of managers.

While studies have yet to offer definitive results, the findings of Rozeff (1982) and Easterbrook (1984) support the free cash flow hypothesis. According to these researchers, paying greater dividends can reduce firms' agency costs. As firms paying high dividends are financed more often by the market, they are subject to closer scrutiny. DeAngelo and DeAngelo (2000) and La Porta et al. (2000) also reached similar conclusions. However, Denis et al. (1994) did not obtain results supporting this hypothesis.

Brush, Bromiley, and Hendrickx (2000) found that free cash flow negatively impacted growth while Titman et al. (2004) and Fairfield et al. (2003) found a much lower stock performance among firms with overinvestment problems. Similarly, Dechow et al. (2008) proposed that firms with excessive free cash flow had a lower future performance.

Lang et al. (1996) suggested that higher debt ratios reduced free cash flow at firms with low Tobin's Q ratios. Similar findings were obtained by Li and Cui (2003), Byrd (2010), Khan et al. (2012), Fatma (2011) and Zhang (2009).

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