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Do institutional investors monitor management? Evidence from the relationship between institutional ownership and capital structure

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ABSTRACT

We examine the dynamic relations between institutional ownership and a firm's capital structure. We find that a firm's leverage decreases when institutional ownership increases. This result implies that a firm reduces its debt level as institutional investors substitute for the monitoring role of debt. More importantly, we find that a firm's suboptimal leverage decreases when the institutional ownership increases, and institutional ownership decreases when a firm's suboptimal leverage increases. This finding shows that institutions not only effectively monitor a firm's capital structure but they also passively sell their shares when dissatisfied with it. In addition, we find that the monitoring evidence on a firm's leverage and suboptimal leverage are more pronounced when the institutional investors are less likely to have business relationships with a firm or the information asymmetry is high in the market.

1. Introduction

The role of institutional investors in influencing firm management has become increasingly important, as the aggregate institutional ownership has substantially grown over the past decades. The

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literature has documented several ways through which institutional investors may affect a firm's financial decisions, including mergers and acquisitions (Ferreira, Massa, & Matos, 2010), payout policy (Grinstein & Michaely, 2005), executive compensation (Hartzell & Starks, 2003), CEO turnover (Parrino, Sias, & Starks, 2003), earnings management (Chung, Firth, & Kim, 2002; Hsu & Koh, 2005; Wang, 2014), risk taking behavior (Chan, Lin, Chang, & Liao, 2013), and hedging policy (Tai, Lai, & Lin, 2014). In this paper, we examine the interrelationship between institutional ownership and a firm's capital structure choices. Specifically, we investigate whether institutional ownership and firm leverage influence each other.

In theory, institutional investors may actively influence a firm's capital structure. In studying agency costs and sources, Jensen and Meckling (1976) argue that although debt helps reduce the agency costs of free cash flow, it also incentivizes managers to make distorted investment decisions. In contrast, institutional investors as large shareholders have strong incentives to enhance firm value. So they may substitute for debt to mitigate agency costs. In this case, we should expect a negative relationship between institutional ownership and a firm's total leverage. Alternatively, institutional ownership and debt may complement each other to reduce agency costs. Institutional investors who have sufficient voting power to influence corporate decisions may pressure managers to make dividend payments, which likely leads to the need of future debt financing (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 2000). As a result, management discretion is limited and the agency costs of free cash flow are reduced. If this holds true, we should expect a positive relationship between institutional ownership and a firm's total leverage. In addition, the trade-off theory of capital structure suggests that firms have a target leverage at which firm value is maximized, and thus, any deviation from that target level will reduce firm value. If institutional investors can effectively monitor a firm's capital structure, we should expect a negative relationship between institutional ownership and a firm's deviant or suboptimal leverage.

Institutional investors may also passively influence firm management by liquidating their shares. The literature has shown that institutional investors "vote with their feet" when dissatisfied with management. Their selling creates downward pressure on the stock price, which may subsequently facilitate a change in management. Parrino et al. (2003) find greater reductions in institutional ownership in the year prior to forced CEO turnovers than in voluntary CEO turnovers. If institutional investors sell their shares when dissatisfied with a firm's capital structure, we should expect a negative relationship between institutional ownership and a firm's suboptimal leverage.

To capture the dynamic relations between institutional ownership and a firm's capital structure, we consider both contemporaneous and lagged relationships. The contemporaneous relationship assumes that both firm and institutional investors are well informed and can make rapid decisions, whereas the lagged relationship posits that a quick change in capital structure is difficult due to market imperfections and that it takes time for institutional investors to adjust their ownership stake due to liquidity shocks. Given the documented heterogeneity of institutional investors and firm management, both relationships are possible and therefore deserve careful examination[1]. Specifically, we study how concurrent firm characteristics, including leverage, are interrelated with concurrent institutional ownership in the contemporaneous relationship, and examine how lagged firm information, including lagged leverage and institutional ownership, affects concurrent institutional ownership and leverage in the lagged relationship.

We use the three-stage least squares model to examine the above interrelationships between institutional ownership and a firm's capital structure. We find that both contemporaneous and lagged model specifications produce quantitatively similar results. In particular, we find that institutional ownership is negatively related to total leverage. We also show that an increase in a firm's institutional ownership leads to a decrease in its suboptimal leverage, and that a decrease in a firm's suboptimal leverage leads to an increase in its institutional ownership. Although the results for total and suboptimal leverage are similar, the implications are different. The total leverage result implies that institutional investors can substitute for debt to exert monitoring efforts but does not indicate whether that monitoring is effective in changing the firm's management decision. The suboptimal

[1] Our empirical results show that the contemporaneous relationship explains the data better and thus suggests that firms and institutional investors may be well informed and little restricted by market imperfections.