OWNERSHIP STRUCTURE, DEBT MATURITY
AND INVESTMENT DECISIONS:
AN EMPIRICAL INVESTIGATION FOR UK FIRMS

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December 2005
ABSTRACT

The main purpose of this study is to provide more insight into our understanding of the impact of agency-related issues on corporate financial and investment decisions. Following the seminal work of Modigliani and Miller (1958) on the irrelevance of capital structure decisions on firm value, the corporate finance literature has emphasized that agency conflicts between the firm’s different claimholders are an important determinant of decisions inside the firm. Under the assumption of imperfect capital markets, agency problems may lead to suboptimal decisions that need to be kept under control. In this context, the ownership characteristics of firms are crucial, because they are a manifestation of the expected agency costs to which firms are subject. More specifically, they may be both a potential cause of agency frictions, and a potential solution to some costly agency problems. Most previous empirical work has either analyzed the impact of managerial ownership and other governance characteristics on firm performance, or has tried to measure agency costs more directly, and to investigate their empirical determinants. In contrast, our study attempts to provide more insight into how ownership characteristics affect and interact with the financial and investment decisions of firms, which, in turn, have significant implications for how well firms do. To accomplish this task, we divide our work into two parts. The first part provides a detailed account of the ownership and governance characteristics across firms and over time for a large sample of UK non-financial firms publicly traded between 1991 and 2001. From the ownership-related issues point of view, the UK market is particularly interesting, because it witnessed a rich debate in the quest for effective solutions to the agency problems stemming from the separation between ownership and control during the 1990s. In particular, Chapter 2 presents a comprehensive descriptive analysis of both the direct and ultimate ownership structure and the board composition of UK companies. On the one hand, it documents that substantial changes in ownership structures are not uncommon, and that the classic argument of ownership stability may not necessarily fully apply in the UK case. Managerial ownership shows a
sharp decreasing trend, mainly driven by executives’ shareholding. We provide evidence that this sharp trend is rather evenly spread across all board ownership quintiles distribution, computed in the first year that a firm enters our sample. In addition, ownership by outsiders increases when it is below 45% in the first year that firms enter the sample, while it decreases sharply above the cut-off level. Furthermore, average board size is relatively constant over time, and we show a mean reversion pattern around the average size of seven members. On the other hand, evidence on ultimate ownership structure reports that widely held firms are decreasing over time at each cut-off level. Additionally, the existence of complex ownership structures in the UK is far from negligible. More than 11% of firms in our sub-sample have an ultimate controller with complex structure, although this figure is decreasing over time at all cut-off levels.

In the second part of our work we investigate investment and debt maturity decisions. The examination of these decisions enables us to shed more light on the mechanisms through which the ownership and control characteristics of firms influence their decision taking processes. More specifically, investment choices are directly affected by agency costs. As with any other capital market imperfection, agency problems create a wedge between internal and external funds. In fact, expected conflicts between firms and outside investors prevent potential creditors from properly evaluating the real quality of companies. Consequently, a premium on external finance is required, and this, in turn, inefficiently increases the cost of capital. Therefore, firms needing more resources to invest than those available internally will be forced to pass up some projects with positive NPV (debt or equity rationing). In this context, ownership information is incorporated in the cash holding policy of firms, which, in our study, represents the firms’ ability to invest. The subsequent analysis of investment decisions enables us to assess the impact of agency costs on financial constraints. Our findings in Chapter 3 show that persistently low cash firms invest less in capital expenditures. In addition, these companies do not rely on liquid assets to finance their investments, and this is reflected in their decreasing investment cash flow sensitivity. Robustness checks tend to support the interpretation that PLC firms prefer to use cash flow to increase their cash holdings rather than to invest in capital expenditures, in an attempt to reach their target cash. They also show that these companies generally tend to
keep the hoarded cash and spend it, if at all, on intangible assets. On the other hand, being a cash-rich firm has no significant impact on capital expenditures. Nonetheless, a persistently high cash policy seems to reinforce the investment sensitivity to cash flow. Robustness checks seem to suggest that this is not caused by managerial discretion issues. Instead, the positive investment cash flow sensitivity of PHC firms seem to occur because positive excess of cash enables firms to invest in high growth projects, and may also help them to build a good reputation in the market through larger dividend payouts.

Chapter 4 presents our investigation on debt maturity policy. Debt maturity structure is related to agency problems, because, as discussed above, it is considered an effective alternative to ownership and corporate governance mechanisms, and it can be used to control either some of the problems arising from the ownership structure itself, or conflicts between bondholders and shareholders. In this setting, therefore, we include ownership characteristics, to investigate how they affect, and also interact with, corporate decisions on debt maturity. Significant results were found to support the view that short-term debt is an instrument for reducing managerial discretion, and can be used to signal alignment between the interests of managers and shareholders. At lower levels of insider shareholding, we detected a negative relation with short-term debt, which may suggest that the expected costs from liquidity risk implicit in short-term debt drive managers towards lengthening the maturity of debt. Conversely, at higher levels of managerial ownership, the increasing costs from expropriation seem to induce managers to raise the proportion of short-term debt, in an attempt to send the positive signal of self-imposed monitoring to the external investors. Furthermore, a significant negative relation between short-term debt and large external shareholders—in particular, non-financial owners—was detected. This corroborates the hypothesis of short-term debt and ownership characteristics as alternative control mechanisms to mitigate managerial discretion. Finally, our analysis reveals that banks as creditors use short-term debt to monitor managerial behaviour. Nonetheless, the signals they provide about the borrowing firms’ creditworthiness allow firms to have easier access to other capital markets and other types of funds, such as long-term finance.

Finally, Chapter 5 presents some overall conclusions of this work, and draws together the various aspects examined in this study. In particular, we emphasize how the
thesis enhances our understanding of the types and extent of agency conflicts inside the firm, and how they ultimately determine key corporate decisions, such as investment and debt maturity choices.