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# Investment policy, internal financing and ownership concentration in the UK

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## Abstract

This paper investigates whether investment spending of firms is sensitive to the availability of internal funds. Imperfect capital markets create a hierarchy for the different sources of funds such that investment and financial decisions are not independent. The relation between corporate investment and free cash flow is investigated using the Bond and Meghir [Review of Economic Studies, 61 (1994a) 197] Euler-equation model for a panel of 240 companies listed on the London Stock Exchange over a 6-year period. This method allows for a direct test of the first-order condition of an intertemporal maximisation problem. It does not require the use of Tobin's  $q$ , which is subject to mismeasurement problems. Apart from past investment levels and generated cash flow, the model also includes a leverage factor which captures potential bankruptcy costs and the tax advantages of debt. More importantly, we investigate whether ownership concentration by class of shareholder creates or mitigates liquidity constraints. When industrial companies control large shareholdings, there is evidence of increased overinvestment. This relation is strong when the relative voting power (measured by the Shapley values) of the combined equity stakes of families and industrial companies and the Herfindahl index of industrial ownership are high. This suggests that a small coalition of industrial companies is able to influence investment spending. In contrast, large institutional holdings reduce the positive link between investment spending and cash flow relation and, hence, suboptimal investing.

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Whereas there is no evidence of over- or underinvesting at low levels of insider shareholding, a high concentration of control in the hands of executive directors reduces the underinvestment problem. © 2001 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

In perfect capital markets, investment decisions are independent of financing decisions and, hence, investment policy only depends upon the availability of investment opportunities with a positive net present value (NPV) (Modigliani and Miller, 1958). In the standard neo-classical model of investment, firms have unlimited access to sources of finance and invest as long as the marginal dollar of the capital expenditure generates at least one dollar of a present value of cash flows (Tobin, 1969). Consequently, firms with profitable investment opportunities exceeding available cash flow are not expected to invest any less than firms with similar opportunities but larger internal cash flows.

However, the empirical literature supports the model about the hierarchy of financing which predicts that the investment expenditure of some firms may be constrained by a lack of internally generated funds. For many firms, the cost of external capital does indeed seem to exceed the cost of internal funds. As profits are highly cyclical, the existence of liquidity constraints makes investment spending more sensitive to fluctuations in economic activity. Differing views on the riskiness of investment projects between shareholders and management and, hence, on the relevant discount rate may result in good investment projects being rejected.

Underinvestment due to asymmetric information (Greenwald et al., 1984) results from the fact that the market requires—even for high quality firms/projects—a premium equal to the one required for investing in the average firm. Consequently, due to adverse selection, it may be the (relatively) lower quality projects which may seek external financing and some positive NPV projects are not undertaken at all.<sup>2</sup> Myers and Majluf (1984) have labelled the hierarchy of financing—driven by asymmetric information and/or the real direct and indirect costs of different sources of financing—the pecking order theory. Firms finance positive NPV projects in the first instance with internal financing, subsequently with debt (as the least risky form of external financing) followed by all kinds of hybrid debt with equity components and finally with external equity as a last resort.

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<sup>2</sup> This adverse selection process is similar to Akerlof's 'lemons market'.

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