Exploitation of the internal capital market and the avoidance of outside monitoring

Brandon N. Cline \(^a\),1, Jacqueline L. Garner \(^a\),*, Adam S. Yore \(^b\),2

\(^a\) Mississippi State University, Department of Finance and Economics, P.O. Box 9580, Mississippi State, MS 39762, United States
\(^b\) Northern Illinois University, Department of Finance, DeKalb, IL 60115, United States

Abstract

Internal capital markets (ICMs) provide firms an alternative to costly external financing; however, they also provide an avenue to avoid the monitoring associated with issuing external capital. We argue that firms operating inefficient internal capital markets will avoid outside financing. Consistent with this view, conglomerates that cross-subsidize divisions or engage in value-destroying investment avoid external capital market oversight by refraining from issuing both debt and equity. We further show that firms issuing bonds while engaging in value-destroying investment experience yield spreads that are, on average, 46 basis points higher than those of other diversified firms. They similarly experience yield spreads that are 18 basis points higher when they issue syndicated loans. Value-destroying conglomerates also witness SEO announcement returns that are, on average, 1% more negative than firms operating more efficient internal capital markets.

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1. Introduction

Internal capital markets (ICMs) allow conglomerates to allocate resources to their most profitable divisions, thereby providing them a unique advantage relative to their focused counterparts. This is particularly valuable in the presence of high information asymmetries or when firms face financing constraints. In a world where not all projects are funded, informed managers engage in “winner-picking” by transferring scarce capital to the firm’s most promising divisions, thereby profiting from investment opportunities which likely would not have been financed at stand-alone firms (Stein, 1997, 2003). This resource allocation process provides an alternative to external financing when managers face meaningful floatation costs (Matsusaka and Nanda, 2002), substantial information asymmetry problems (Peyer, 2002), or when the costs of external financing are high (Hovakimian, 2011; Yan, 2006). Therefore, multidivisional firms should benefit from the decision to avoid expensive external capital as these firms have a valuable alternative to finance their investments internally.

It is puzzling, however, that numerous studies on conglomerates suggest that this internal capital allocation process often destroys value rather than enhances it (Berger and Ofek, 1995; Lang and Stulz, 1994; Rajan et al., 2000). This destruction of value...
is linked to agency problems associated with excess free cash flow and is often the direct result of insufficient monitoring (Jensen, 1986; Jensen and Meckling, 1976; Myers and Majluf, 1984). As Matsusaka and Nanda (2002) theorize, internal capital markets can be destructive since they allow for overinvestment despite the avoidance of external flotation costs. We note that this avoidance of the external capital markets is made at the discretion of managers and may not always be done in the best interest of shareholders. Hence, the very flexibility that allows conglomerates to avoid costly external financing also provides a mechanism to elude the external monitoring associated with it.

To better understand the motivations behind project financing at conglomerates, we study the determinants of the decision to issue capital at diversified firms. We also examine how diversified firms' financiers react to capital issuances when their managers are not allocating resources in a value-maximizing manner. The analysis indicates that conglomerates are significantly less likely to issue capital when they transfer resources to divisions with lower firm Tobin's Q values than firm average Tobin's Q when they engage in value-destroying capital investment (i.e., transfer resources to divisions that have Tobin's Q values less than one). Point estimates imply that value-destroying firms are 6.9% less likely to issue capital. Similarly, cross-subsidizing ICMs are 1.7% less likely to issue. The size of the effects is comparable to a one-standard deviation increase in the cost of outside financing (—5.84%). Collectively, our findings support the argument that managers engaging in empire building (Stulz, 1990) or other forms of inefficient investment allocation avoid capital market oversight, instead preferring to fund their projects internally.

While firms with inefficient internal capital markets generally avoid external financing, some of them actually issue capital. We show that when these firms access external markets, they prefer equity issuances to debt. If empire building managers fuel their firms' growth using excess cash, then our findings are consistent with prior arguments on the effectiveness of debt to curtail wasteful spending. Specifically, Jensen (1986) points out that the interest payments on debt will limit the amount of free cash flow available for wasteful spending. We also show that these firms prefer public to private capital issuances. Gomes and Phillips (2012) suggest that private markets have an information advantage over public markets since a limited number of investors acquire securities through direct negotiation with the firm. Therefore, it appears that these inefficient firms prefer public markets since their poor investment policies could be more easily detected through private issuance.

We then investigate whether investors price the issued securities differently for those firms operating inefficient internal capital markets. Specifically, we examine the market reaction to new offerings of debt and equity securities such as corporate bonds, syndicated loans, and common stock. Supporting our capital market avoidance results, we show that investors react negatively to those firms that choose to issue either bonds or loans while engaging in suboptimal investment. The yield spreads on corporate bond issuances are 46 basis points higher for value-destroying ICMs. Cross-subsidizing ICMs likewise pay an additional 21 basis points when issuing bonds. Value-destroying (cross-subsidizing) ICMs also, on average, pay yields on syndicated loans that are 18 (9) basis points higher than non-value-destroying (non-cross-subsidizing) ICMs. These results are confirmed in multivariate tests which control for known firm covariates and the self-selection bias resulting from capital market avoidance.

A similar pattern emerges when we examine seasoned equity offerings (SEOs). As is common in the literature, we find that the conglomerates in our sample experience negative announcement returns when they issue an SEO (Asquith and Mullins, 1986). However, value-destroying (cross-subsidizing) ICMs experience a market reaction that is on average 0.97% (1.43%) more negative than firms operating more efficient internal capital markets. After controlling for other covariates, the announcement return is 2.09% and 1.83% lower for those conglomerates with value-destroying and cross-subsidizing internal capital markets, respectively.

We contribute to the overall literature on diversification by documenting that empire-building managers utilize their internal capital markets to avoid external oversight. While Matsusaka and Nanda (2002) suggest that diversified firms may utilize their internal capital markets to avoid costly outside financing, we are the first to show empirically that they do so for more sinister motives. We also contribute to the literatures on debt and equity issuance. We show that when inefficient conglomerates access these capital markets in spite of their investment policies, their investors punish them with significantly negative market reactions. Collectively, our results suggest that the external capital market is able to distinguish firms operating inefficient internal capital markets and prices their securities accordingly.

The remainder of the paper is organized as follows. Section 2 develops our testable hypotheses for the capital market avoidance by conglomerates engaged in suboptimal resource allocation. Section 3 discusses the sample selection, methodology, and describes our data. In Section 4 we discuss the relation between inefficient internal capital markets and the avoidance of external capital markets, as well as the preferences for the type of security issued (i.e., debt versus equity and public versus private). We discuss the market reaction to capital issuances when firms operate inefficient internal capital markets in Section 5. Section 6 concludes.

2. Discussion and hypotheses

2.1. Avoidance of outside monitoring

The existence of an internal capital market provides a means by which the conglomerate manager can avoid external financing by utilizing excess internally generated equity from one division to finance the investment projects of another. While the avoidance of outside capital markets may be valuable (Matsusaka and Nanda, 2002; Stein, 1997), the recurrent need for outside funds presents a critical avenue for managerial oversight. When raising capital to finance a project, managers essentially offer investors a referendum on their investment policy (Myers and Majluf, 1984). Jung et al. (1996) argue that investors will refrain...
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