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Governance, product market competition and cash management in IPO firms

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ABSTRACT

This study evaluates the link between CEO governance heterogeneity, power structure of the firm, and product market competition on various facets of post-IPO cash policy. Our results suggest that post-IPO cash holdings as well as marginal value of cash reserves are higher under a founder CEO governance regime relative to non-founder CEOs. Concentrating board power in the hands of founder CEOs however, reduces their ability to maintain higher post-IPO cash reserves. Our results also suggest that product market competition influences both the level and marginal value of cash reserves in the hands of founder CEOs. Further, we find that stronger internal governance reduces the tendency of IPO firms to deploy excess cash reserves to fund internal investments in excess of industry rivals. Finally, our results suggest that excess cash reserves in competitive industry environments lead to superior post-IPO operating performance.

1. Introduction

Recently, several studies have indicated that U.S. firms tend to hold a significant amount of cash representing a dramatic shift from the cash holding policies of the past. For instance, Bates et al. (2009) document a dramatic secular increase in the cash holdings of U.S. firms during the period 1980–2006 with firms' average cash to assets ratio increasing from 10.5% in 1980 to 23.2% in 2006. Further, they find that the increase is concentrated among firms that do not pay dividends, belong to more recent IPO listing cohorts, and are from industries that experience the greatest increase in idiosyncratic risk. The growing propensity of corporations to maintain substantial cash reserves has been puzzling and has led researchers to study the determinants of corporate cash holdings as well as the value and uses of cash reserves in publicly traded firms (Opler et al., 1999; Harford, 1999; Dittmar and Mahrt-Smith, 2007; Harford et al., 2008; Bates et al., 2009).

The financial economics literature generally argues that corporate liquidity decisions involve striking a balance between the benefits of maintaining precautionary cash reserves versus the agency cost of managerial access to discretionary cash holdings. Under the financing friction argument, firms prefer to stockpile cash reserves in an effort to achieve transactional economies of scale and/or maintain sufficient precautionary cash balances to effectively withstand adverse shocks to external capital markets and reduce the potential for underinvestment (Mulligan, 1997; Opler et al., 1999; Almeida et al., 2004). Research however, suggests that agency conflicts tend to be particularly severe in the presence of large free cash flows due to the potential for inefficient investment or excessive perquisite consumption (Jensen, 1986; Harford, 1999; Opler et al., 1999; Harford et al., 2008). Consequently, shareholders are likely to limit managerial access to free cash flows in order to mitigate concerns over inefficient deployment (Jensen, 1986; Stulz, 1990). The downside of insufficient cash reserves however, is the increased exposure to predation risk as described by Bolton and Scharfstein (1990), whereby financially constrained firms are unable to capitalize on their growth prospects and consequently cede investment opportunities and market share to rivals.

Research however, indicates that good governance can reduce the cost of insufficient liquidity by mitigating shareholder concerns regarding managerial misallocation of cash reserves (Dittmar et al., 2003; Pinkowitz and Williamson, 2004; Dittmar and Mahrt-Smith, 2007; Harford et al., 2008). For instance, Dittmar and Mahrt-Smith (2007) find that good governance

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results in more efficient utilization of cash reserves and that the market value of excess cash for well governed firms is approximately twice that of poorly governed firms. Further, weak governance structures result in lower cash reserves, faster dissipation of cash, and lower profitability and valuations (Dittmar and Mahrt-Smith, 2007; Harford et al., 2008). Overall, the above studies indicate that good governance adds value by facilitating efficient cash management policies.

Although there is a burgeoning literature on governance and corporate liquidity decisions for established publicly traded firms, relatively little is known regarding cash management practices in newly public firms or the impact of alternative governance structures on various facets of post-IPO cash policy. Relative to established firms, we argue that the effect of governance structures on cash policy are likely to be even more consequential for IPO firms since their unique organizational context increases the strategic value of cash reserves as well as exacerbates agency conflicts over its deployment. Unlike established firms where cash tends to accumulate over time and managers face a relatively stable environment with respect to governance, investment opportunities, and financing choices, IPO firms receive an immediate infusion of cash while simultaneously transitioning to a fundamentally different organizational state in terms of ownership and governance structure, investment opportunities, and financing choices. As a result, managers of IPO firms enter unchartered territory as they attempt to determine how best to deploy their cash infusion to expand the boundaries of the firm in the face of enhanced scrutiny from capital market participants and rapidly evolving and uncertain conditions related to technology, product market competition, and financing options. The liability of newness, need to aggressively pursue growth options, and greater sensitivity to capital market conditions makes IPO firms particularly vulnerable to capital market shocks and predation risk which can undermine their ability to survive and grow (Jain and Kini, 2008). Research indicates that firms with characteristics that are typically associated with IPO issuers such as high growth opportunities, riskier cash flows, higher information asymmetry, higher R&D expenditures, and more limited access to capital markets, tend to need higher cash balances to reduce liquidity risk and the potential for underinvestment (Opler et al., 1999; Harford, 1999). Further, research suggests that cash holdings can be a valuable strategic resource for IPO firms since relaxation of financing constraints is an important factor in their gaining a competitive advantage over industry rivals (Hsu et al., 2010). In line with the notion that corporate liquidity is of considerable strategic importance to IPO firms, Kim and Weisbach (2008) report that firms tend to retain almost half of their IPO proceeds as cash. Additionally, Mikkelson and Partch (2003) find evidence to suggest that firms that find it optimal to maintain high cash reserves are able to deliver growth without sacrificing operating performance.

Although large cash reserves have the potential to provide vital strategic benefits to IPO firms, they also open up the possibility for managerial pursuit of empire building investments. Research indicates that the growth path pursued by IPO firms favors acquisitions over internal investments (Celikyurt et al., 2010). Acquisitions however, tend to exacerbate agency conflicts since they can increase CEO wealth even while destroying shareholder wealth (Harford and Li, 2007). Additionally, empirical evidence suggests that cash rich firms are more likely to pursue acquisitions and their acquisitions along with other forms of investments are more likely to be value decreasing (Dittmar and Mahrt-Smith, 2007; Harford et al., 2008). Further, research suggests that managers with weak incentives tend to destroy value when they spend large stockpiles of cash or cash windfalls (Blanchard et al., 1994; Harford, 1999). As such, the IPO market provides an attractive laboratory to study how alternative governance structures affect the optimality of cash policy decisions for firms that receive a cash infusion while simultaneously facing changes in their investment opportunity set and financing options.

Although a growing stream of literature suggests that CEO heterogeneity influences corporate decisions (Bertrand and Schoar, 2003; Malmendier and Tate, 2005; Graham et al., 2009), the economic impact of CEO heterogeneity on corporate liquidity decisions remains an unaddressed area of research. Since cash management models are largely agency driven, it is reasonable to infer that differences among CEOs on aspects such as incentives, motivation, power and influence, and risk taking behavior are likely to be reflected in the heterogeneity of their corporate liquidity decisions. Research on the governance of IPO firms suggests that founder CEO leadership represents a unique ownership and governance regime relative to non-founder CEO leadership whereby the potential for agency conflicts tends to be lower (Certo et al., 2001; He, 2008; Gao and Jain, 2011). As an alternative to purely self-serving behavior implied by agency theory, stewardship theory suggests that some types of managers pursue organizational goals and interests even when they conflict with self-interest (Donaldson and Davis, 1991; Davis et al., 1997). Research further indicates that as a result of differences on several psychological and situational factors, the actions of founder CEOs are more likely to be consistent with stewardship theory while non-founder CEOs are likely to be motivated by agency considerations (Wasserman, 2006; He, 2008). Since the extent of alignment of interests with shareholders is likely to be different in the case of founder CEOs relative to non-founder CEOs, we would expect the post-IPO cash policy to differ for these two types of CEO governance regimes.

In order to get a more complete picture of the impact of CEO governance heterogeneity on post-IPO cash policy, we also examine the extent the power structure of the firm and product market competition influence the link between CEO governance and post-IPO cash policy. The extent CEOs pursue self interest versus shareholder interest in corporate liquidity decisions is likely to be driven by the extent power is tilted in their favor relative to the board. While the agency theory perspective suggests designing the power structure of the board so as to constrain CEO power, stewardship theory advocates the opposite approach (Davis et al., 1997; He, 2008; Gao and Jain, 2012). In line with stewardship theory, research on IPO firms suggests that governance structures that determine the balance of power between the CEO and the board are designed to concentrate greater power in the hands of founder CEOs relative to non-founder CEOs (Certo et al., 2001; Nelson, 2003; Jain and Tabak, 2008). The economic consequences of concentrating power in the hands of CEOs relative to the board on post-IPO cash policy is however, an open question and therefore an important area of focus of this study.

Our evaluation of the effects of product market competition on the link between CEO governance heterogeneity and post-IPO cash policy is motivated by two unrelated streams of literature that point to the governance effects of product market competition and its ability to influence the competitive benefits of maintaining cash reserves. For instance, an emerging stream of literature suggests that competition increases the probability of liquidation and therefore has the potential to reduce managerial shirking and the potential for agency conflicts (Holmstrom, 1982; Nalebuff and Stiglitz, 1983; Hart, 1983; Giroud and Mueller, 2010, 2011; Guadalupe and Perez-Gonzalez, 2010). Another stream of research points to the strategic value of cash holdings since it allows firms to finance their growth opportunities while also serving as a deterrent for entry or aggressive investment behavior by rivals (Acharya et al., 2007; Haushalter et al., 2007; Denis and Sibilkov, 2009; Fresard, 2010). Further, research suggests that both the governance