



Cash holdings and business group membership[☆]

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ABSTRACT

This study examines the cash policies of business group members (i.e., affiliates). Using a panel dataset of private Belgian affiliates and comparable non-affiliated firms, the empirical results show that business group affiliates hold significantly smaller amounts of cash as compared to non-affiliated firms. This finding is consistent with the notion that affiliates can afford to keep lower cash reserves because these firms can access the internal capital market of the group. The analysis also combines affiliate level and group level data to evaluate cash drivers and shows that groups in financial distress reduce cash holdings in affiliates. However, affiliates that are more important for the group's reputation and operations maintain cash levels comparable to affiliates belonging to financially healthy groups.

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1. Introduction

Both U.S. and European firms hold considerable amounts of cash on their balance sheets because of the presence of market imperfections such as information asymmetries, agency problems, transactions costs, and costs of financial distress (e.g., Chen & Chuang, 2009; Ferreira & Vilela, 2004; Iskandar-Datta & Yonghong, 2012).

The cash literature predominantly views the firm as a freestanding company. Yet, in non-Anglo-Saxon countries, many firms have corporate block holders (e.g., La Porta, Lopez de Silanes, Shleifer, & Vishny, 1999). For example, more than half of the largest European non-financial firms have a dominant corporate shareholder (Bureau van Dijk's Amadeus database, version 2009). This type of ownership

often results in the creation of a business group, where common stable and long-term equity ownership links legally independent firms together under the control of a corporate owner (i.e., the parent firm) that provides managerial coordination and/or administrative and financial control (Yiu, Lu, Bruton, & Hoskisson, 2007).

Group membership may have a significant impact on firms' cash policies. Business groups establish internal capital markets that lower information asymmetries and alleviate financial constraints (e.g., Schiantarelli & Sembenelli, 2000). Intra-group guarantees and group reputation can also improve the availability of external financing (Chang & Hong, 2000). By contrast, some studies also specify certain inefficiencies due to the possible presence of socialism (Scharfstein & Stein, 2000) and minority shareholder expropriation (Bertrand, Mehta, & Mullainathan, 2002). In addition, moral hazard problems can arise as affiliated firms are separate legal entities with their own limited liability. As a result, groups may extract resources from their affiliates and even let these firms go bankrupt without major consequences for the other group members (see e.g., Bianco & Nicodano, 2006).

This study contributes to the literature by examining the cash policies of business group affiliates. First, by comparing affiliates with a matched sample of non-affiliated firms, this study pinpoints the impact of group membership on cash policy. Second, this research extends the cash models of affiliates by systematically including both affiliate level and group level characteristics. In this way, the analyses show how group level variables complement individual affiliate characteristics in the design of affiliates' cash policy. Third, this paper evaluates the link between the firm's cash policy and the financial health of the group and provides empirical evidence on the manner in which groups differentiate between affiliates in case of group distress. Overall, this research provides additional insights into the functioning of internal capital

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markets and sheds more light on the use of financial resources within groups.

The existing empirical evidence concerning the cash policies of business group affiliates is extremely scarce. Without making a strict distinction between non-affiliated firms and affiliates, Deloof (2001) reports that intra-group claims negatively affect cash holdings. Pinkowitz and Williamson (2001) focus on the impact of bank power on cash holdings and find that keiretsu members hold less cash than non-member firms.

This study uses a panel of large non-financial affiliates of private Belgian domestic business groups and comparable private non-affiliated firms. This sample has several appealing properties. Firstly, as a typical Western European civil law country in a mature market economy, Belgium provides a particularly attractive setting for this study. This country has the highest presence of pyramidal structures and controlling shareholders compared to other industrialized countries (La Porta et al., 1999), and while many studies find evidence of the expropriation of minority shareholders in emerging markets (see e.g., Bertrand et al., 2002; George & Kabir, 2008), Buyschaert, Deloof, and Jegers (2004) show that, on average, equity sales within Belgian business groups create wealth for minority shareholders. In addition, Belgian accounting law obliges large companies to provide information on intra-group transactions in the notes to the financial statements, which is essential to be able to distinguish between affiliated and non-affiliated firms. Secondly, few studies focus on private business groups, though this type of organizations is a very important economic force. For instance, Dewaelheyns and Van Hulle (2010) report that up to one third of the largest non-financial firms in the Eurozone have ties to private business groups. In addition, comparing private non-affiliated firms to affiliates of private business groups allows for developing clean hypotheses by limiting the impact of external equity financing.

Previewing the main results, the analysis shows that the cash policy of affiliates and non-affiliated firms differs after controlling for firm-specific determinants of cash. Business group members hold smaller amounts of cash on their balance sheets than comparable non-affiliated firms. In addition, business group membership enhances or lessens the relationship between certain firm characteristics and cash, though not always as optimization arguments would predict. The data also show that group health affects affiliates' cash policy. More specifically, financial distress at group level negatively affects the cash holdings of business group affiliates, even after controlling for several group level and affiliate level characteristics.

Yet, affiliates that receive intra-group guarantees, generate a large part of the total group's sales, or are active in the core industry of the group hold cash reserves comparable to affiliates belonging to financially healthy groups. This result suggests that groups in distress focus on maintaining sufficiently high cash levels in affiliates that are important for group survival. Overall, the evidence supports the notion of optimization behavior within groups, even though some room for improvement remains.

The remainder of the paper proceeds as follows. Section 2 develops hypotheses concerning the cash holdings of affiliates and discusses the control variables used in the analysis. Section 3 describes the sample and provides univariate statistics and tests. Section 4 contains the results of the multivariate empirical analyses. Finally, Section 5 concludes.

2. Cash policy and business groups

2.1. Hypotheses

Business groups consist of a set of legally distinct entities under the control of a large corporate owner. The legal independence of business group affiliates preserves their limited liability in case of the failure of a fellow affiliate and enables them to obtain external financing, which contrasts with the theoretical conglomerate literature that often assumes that divisions only receive funds from headquarters (e.g., Gertner, Scharfstein, & Stein, 1994; Stein, 1997). Because of these characteristics business groups differ from other organizational forms such as multidivisional

firms or conglomerates wherein divisions or subsidiaries are legally consolidated (see e.g., Duchin, 2010). In addition to external financing, affiliates have access to the internal capital market of the group through which the group allocates financial resources. Bianco and Nicodano (2006), Dewaelheyns and Van Hulle (2010) and Schiantarelli and Sembenelli (2000) among others suggest that group-wide optimization is an important force in this process. This study uses optimization as a benchmark to develop testable hypotheses.

The literature on internal capital markets suggests several reasons why affiliates should hold less cash than non-affiliated firms. First of all, because of lower information asymmetries between group firms, internal capital markets allow for the mitigation of information and contract enforcement problems typical of external financing. More specifically, Gertner et al. (1994) show that the owner-provided nature of internal debt leads to higher monitoring incentives resulting in lower information asymmetries and enhanced allocation of resources. Hoshi, Kashyap, and Scharfstein (1990) posit that these smaller information asymmetries also cause a decrease in costs of financial distress because of more easy renegotiable debt contracts. In this respect, Deloof (2001) demonstrates that affiliates adjust intra-group trade credit terms to fit their liquidity needs. Second, affiliation can improve the affiliates' debt bearing capacity. Group reputation facilitates access to external credit (Chang & Hong, 2000; Manos, Murinde, & Green, 2007; Schiantarelli & Sembenelli, 2000). In addition, intra-group guarantees also enhance the availability of external financing as assets of one group member can serve as collateral for other affiliates, thereby averting credit rationing (Chang & Hong, 2000; Ghatak & Kali, 2001; Verschuere & Deloof, 2006).

These arguments lead to the first hypothesis.

H1. Business group affiliates hold less cash than non-affiliated firms.

Several group characteristics play an important role in the internal capital market's funding capacity (e.g., Dewaelheyns & Van Hulle, 2010; Manos et al., 2007). As measures of overall group financial health or distress encompass several of these variables – such as group leverage and group profitability – group financial distress likely has an important effect on affiliates' cash policy. However, the expected relationship between group financial distress and the cash holdings of affiliates is ambiguous.

On the one hand, companies should increase their cash levels in order to reduce costs of financial distress and overall default risk (Ferreira & Vilela, 2004; Garcia-Teruel & Martínez-Solano, 2008). This increase in cash in times of distress may more likely occur within affiliates than within non-affiliated firms, as groups have more opportunities to generate resources (e.g., by selling non-crucial assets and affiliates). On the other hand, groups in distress may not succeed in this objective and cash holdings of affiliates may even decline as group-wide financial distress puts the group under pressure to meet contractual obligations (García-Teruel & Martínez-Solano, 2008; Kim, Mauer, & Sherman, 1998).

The relationship between group financial distress and cash remains an empirical question and, therefore, results in the following second hypothesis.

H2. The cash holdings of affiliates depend on group financial distress.

Group level distress need not affect the cash levels of all affiliates in the same manner. Certain types of affiliates are more vital for the group's operations and/or reputation than others. The failure of such vital affiliates may have strong negative effects on the functioning and overall survival chances of a financially distressed group. Therefore, distressed groups may treat affiliates differently depending on the affiliates' importance for group survival.

Several factors could cause a difference in treatment. First, empirical findings suggest that affiliates active in the group's core industry are more important for the group's reputation and operations in case of distress. Lamont (1997) finds that an adverse shock in the group's

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