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Internal capital markets, empire building, and capital structure

Alexandros P. Prezas

Suffolk University, Sawyer Business School, Finance, 8 Ashburton Place, Boston, MA 02108-2770, United States

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ABSTRACT

Internal funds generated by assets in place are available to finance the bulk of new investment by nonfinancial firms. Self-interested management has incentives to misallocate these funds in order to increase their control rents. There are two ways to impact future discretionary investment. First, using debt diverts funds to creditors and away from management. Second, having in place more assets that do not provide internal financing reduces the funds subject to managerial discretion. Investment in such assets and debt financing are inversely related in controlling self-interested management. As a result, firms borrow more and own proportionally more assets that provide internal funds as the average profitability of these assets, or that of future investment, increases. Firms may borrow less while increasing investment in the less valuable assets that do not supply internal financing as the expected profitability of these assets increases.

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There is evidence that U.S. nonfinancial firms rely on internal funds for investment. Fama and French (1999) find that in 1951–1996 sample firms could exclusively finance their new investments using internal funds; it is because of their substantial dividend and interest payments that these firms financed internally only about 70% of such investment. Lamont (1997) finds that in 1981–1991 more than 75% of the investment by sample firms was financed internally. Further, he points to the liquidity spillovers associated with the 1986 oil price shock as evidence for the financial interdependencies the allocation of internally generated funds creates across corporate segments.¹

E-mail address: aprezas@suffolk.edu.

¹ Williamson (1975) suggests that the allocation of cash flows across competing investment projects is an important managerial choice. Stein (1997) provides a rationale for internal capital markets where credit-constrained headquarters creates value using winner-picking to reallocate scarce funds across projects it oversees.

As Jensen (1986) indicates, internal funds enable firms to avoid the monitoring of the capital markets. When there is separation of ownership and control, management may have incentives to engage in empire building, i.e., invest the funds in projects that maximize managerial control rents, even if these projects have negative net present value (NPV). Donaldson (1984) documents such behavior. Servaes (1994) provides evidence of overinvestment by oil and gas firms and large firms that were takeover targets or went private. Berger and Ofek (1995) find that, compared to undiversified firms, diversified firms tend to overinvest in and subsidize money-losing divisions. Shin and Stulz (1996) find that investment spending by small divisions of diversified firms strongly depends on the cash flows of other divisions.

Jensen (1986) argues that empire building can be reduced if the firm issues debt but does not retain the proceeds of the issue (e.g., uses them to buy back equity or pay dividends). The debt service obligation incurred forces management to disgorge future cash flows instead of investing them in new negative NPV projects. Jensen (1986) argument is formalized in Stulz (1990) for short-term debt which matures when the new investment decision is made, and in Hart and Moore (1995) for long-term debt maturing after the new investment decision is made.

This paper suggests a way of controlling empire building for firms that finance new investment internally that has not been considered in the literature. It proposes that investment in assets that do not provide internal funds for future investment may help mitigate this managerial agency problem.² Examples of such assets are new product or market development, investment in start up companies, mine development, etc. Empirical literature provides evidence of the existence of these assets. Poterba and Summers (1995) find in their survey of CEOs at 1000 of the largest American firms that, on average, 21.1% of the respondent firms' budget was devoted to projects with no expected payoffs in the first five years. Reinhardt (1973) calculates it took about \$1 billion and a gestation period of 42 months between the beginning of the development effort and the onset of production for Lockheed's L-1011 Tri Star Airbus aircraft.³ Essentially, such investment amounts to a managerial commitment to refrain from future empire building and is rational even if these assets have lower cash flows than competing ones that provide internal funds for new investment. Given debt's well established role in curbing empire building, it follows that investment in assets that do not provide internal financing for new investment could work along with debt in controlling overinvestment costs.

However, managers apply effort to manage the projects from which they derive control rents. When profitable new projects cannot prevent bankruptcy, control rents are impaired so that management has no incentive to exert the effort required to manage these projects. Therefore, underinvestment results if management (and shareholders) do not benefit from positive NPV investment. For firms financing future investment internally, increasing either debt or investment in assets that do not provide internal funds can mitigate overinvestment but exacerbate underinvestment. Nevertheless, the origin of this effect differs depending on the tool used. Debt diverts funds to creditors and thus away from self-interested management or shareholders. Assets that do not supply internal funds reduce the cash flow from assets in place thereby leaving less in the hands of self-interested management or shareholders. It then follows that different pairs of debt and investment can be used to control suboptimal (i.e., over- and under-) investment.⁴ In these pairs, employing more assets that preclude future investment is associated with lower debt levels and vice versa, leading to a link between the two corporate policies.

² This is consistent with Lamont (1997) who also suggests overinvestment declines when internal financing falls, although he does not provide a formal analysis.

³ Similarly, recent financial press reports it took Airbus almost \$20 billion of investment and seven years prior to delivering its first B380 airplane. At the same time, Boeing after years of investment has not yet delivered its first competing 787 Dreamliner aircraft. Finally, it took more than a decade and staggering costs for Pfizer Inc. to make and market Exubera, an inhaled insulin drug.

⁴ Other models that explore the role of debt in preventing self-interested management from undertaking unprofitable investments account for a trade-off between overinvestment and underinvestment. In Stulz (1990), short-term debt reduces the probability of overinvestment, increases the probability of underinvestment, and leads to the loss of investment opportunities in the event of bankruptcy. In Hart and Moore (1995), low levels of long-term debt allow management to subsequently borrow against cash flows from assets in place and overinvest, but high levels of debt overmortgage these cash flows leading to underinvestment.

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