

Agency problems in young firms

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 - ▶ No: managers have an incentive to grow beyond the optimal size (Jensen 1986)

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 - ▶ Yes: cash can alleviate liquidity constraints (Manne 1965) or can be used as a deterrent (Benoit 1994, Bolton and Scharfstein 1990)
 - ▶ No: managers have an incentive to grow beyond the optimal size (Jensen 1986)
- ▶ Empirical evidence is inconclusive
 - ▶ Yes: Blouin *et al* 2018, Fresard 2010 *etc*
 - ▶ No: von Beschwitz 2017, Harford 1999, Blanchard *et al* 1994

An important question: should the cash beyond what is needed for operations be kept in the firm?

- ▶ Mixed results can partially be explained by potentially spurious correlations between cash and corporate policies. For example, firms may have high cash during economic booms, during which assets may in general be overvalued. In this case cash *per se* does not cause over investment
 - ▶ Omitted variables may correlate with acquisition activity and quality
- ▶ Ideally we need an environment where firms (without having cash constraints) receive random cash inflows

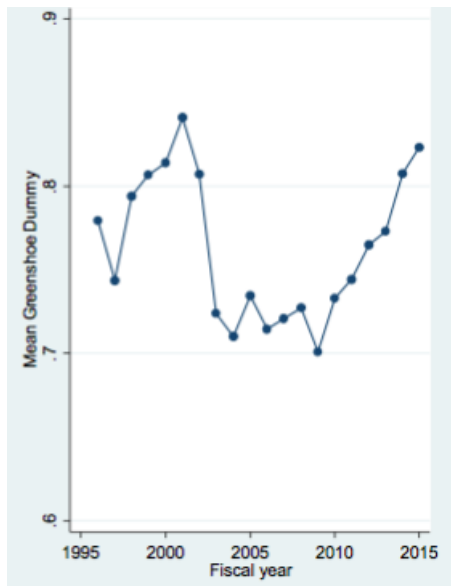
Our paper

- ▶ We look at behavior of firms after their IPOs
- ▶ Some firms receive quasi random (not fully anticipated) cash inflows during their IPOs thru the exercise of greenshoe options
- ▶ We find that “greenshoe firms” are more likely to engage in value destroying M&A
- ▶ We also have a weak evidence that these firms offer higher managerial compensation

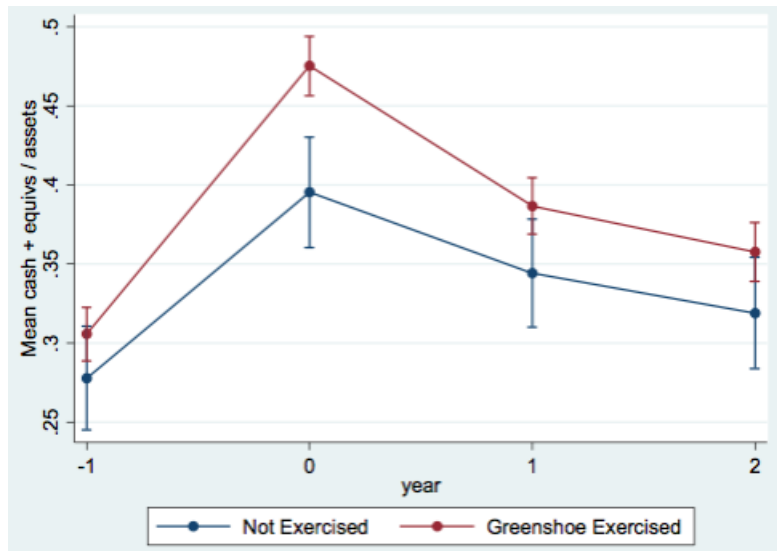
What is greenshoe?

- ▶ An underwriter is always given a call option in an IPO, issued either by the firm (primary) or by the selling shareholders (secondary)
- ▶ Underwriters sell 15% more shares than the official IPO size
 - ▶ Underwriter is short 15% of the shares
- ▶ They later close their position either by buying this extra shares from the market or by exercising the greenshoe option
- ▶ In sum, when the greenshoe is exercised, the firm sells more shares than indicated in the prospectus and receives extra cash

The greenshoe is exercised about 75% of the time



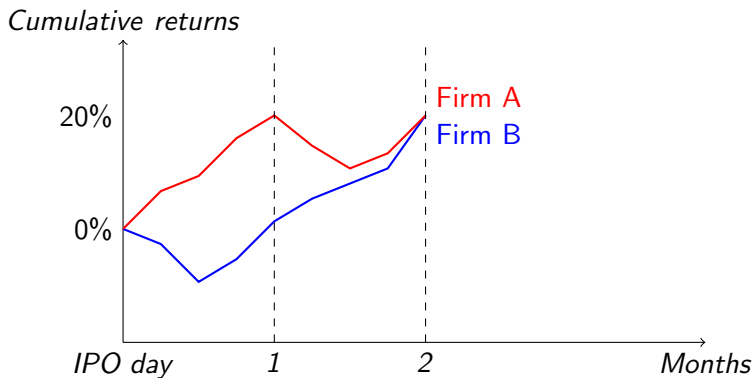
Greenshoe firms have more cash



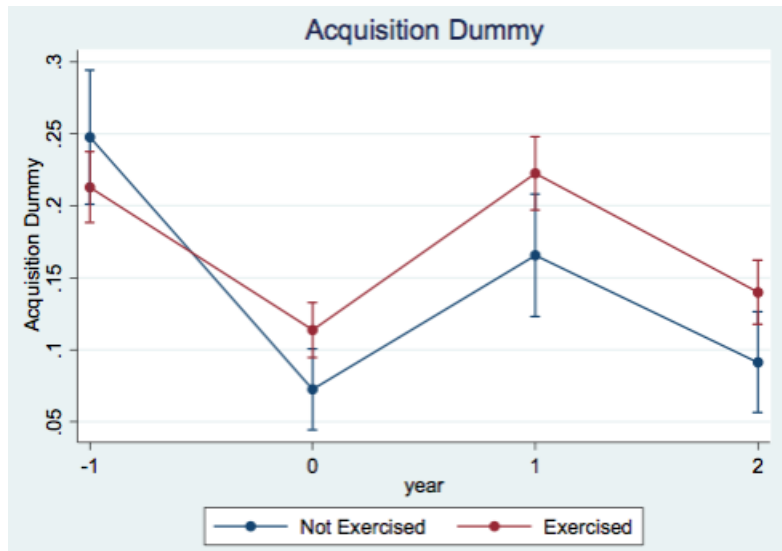
But, the greenshoe exercise is not random

- ▶ Comparing greenshoe firms directly with others would suffer from endogeneity: firms with better prospects are more likely to experience cash inflow due to greenshoe because their price after the IPO is likely to go up
- ▶ To address endogeneity of greenshoe with respect to investment, we account for the future prospects of the firm by controlling for 2-month and 1-year returns
- ▶ Moreover, we do not find any difference between secondary greenshoe firms and others

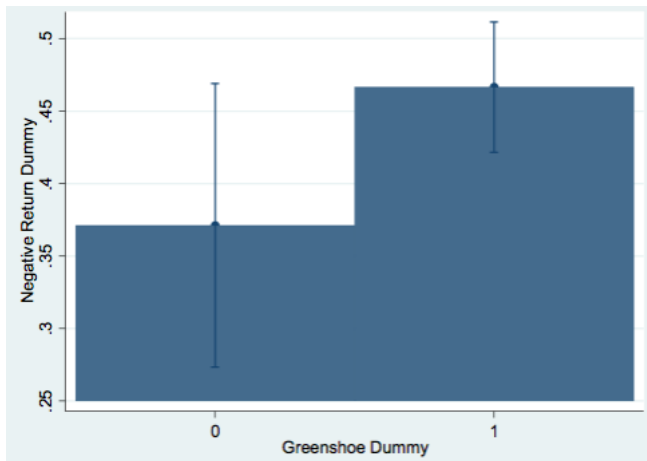
Addressing endogeneity



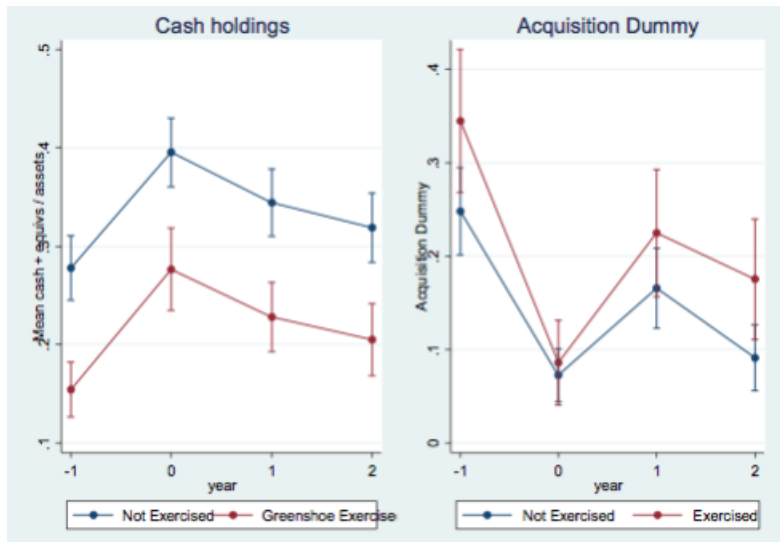
Greenshoe firms are more likely to make an acquisition



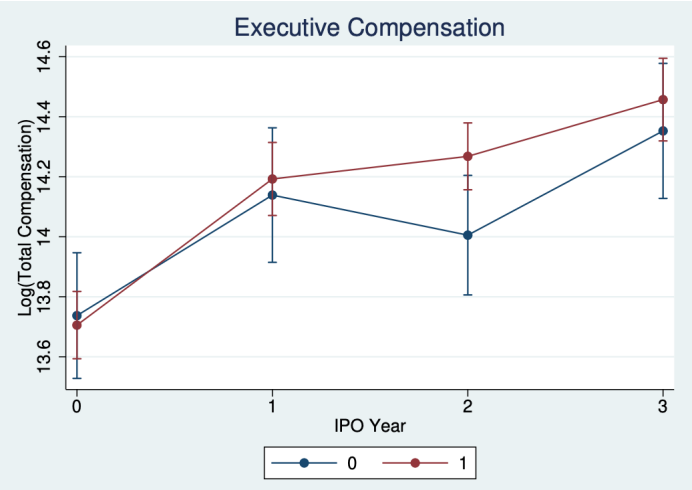
Acquisitions by greenshoe firms are more likely to be value destroying



A comforting placebo: secondary greenshoe does not predict acquisition



Greenshoe firms increase executive compensation



Summary

- ▶ We provide a casual evidence for Jensen's free cash flow hypothesis
- ▶ Our result is conservative. “Empire building” motive is believed to be more pronounced in mature firms. Yet, we observe it in our relatively young sample of firms