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Financial flexibility of public companies from
the shareholders' perspective

Summary of the doctoral thesis

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1. Justification of the choice of the subject

Over the last several years, the problem of financial flexibility and its relation to managers' financial decisions has become the subject of many articles published in renowned scientific journals. Uncertainty about changes taking place in the environment forces managers to make appropriate financial decisions ensuring the ability of the company to finance its future adaptation activities in response to these changes. Theoretical studies deal with the subject of defining financial flexibility, the role it can play in managers' financial decisions, ways of securing it and methods of its measurement. Empirical research focuses mostly on the managers' decisions on financial flexibility and the impact of these decisions on the enterprise value.

In public companies, financial decisions made by managers are assessed by the capital market participants who assign value to financial flexibility. The assessment of the managers and that of the capital market participants as to the company's basic level of needs for financial flexibility may differ. The perception of financial flexibility by market participants, as well as its significance for financial decisions made by managers - so far - has not been often raised in foreign literature. According to the author's knowledge, this thesis is one of the few in Poland that takes up the issue of financial flexibility taking into account its assessment from the perspective of capital market participants (investors).

Despite the publication of numerous articles on financial flexibility, the aspect of the ownership structure is often overlooked, including the role played by blockholders, in particular institutional investors. The literature shows that institutional blockholders have

motivation and, at the same time, ability to effectively monitor the companies' managers. In particular, the scale of their capital commitment enables them to use their voting rights, as well as their exit rights, and the benefits of monitoring activities outweigh their costs. The significant increase in the share of institutional investors in the ownership structure of public companies observed in recent years is an argument in favour to define the role of these shareholders in managing firms' financial flexibility.

It should be emphasized that research about financial flexibility has been mostly conducted on companies from US, Asia and selected European countries. Recently, pioneering research on public companies listed on the Warsaw Stock Exchange has also appeared. However, it should be mentioned that these studies did not sufficiently emphasize the role of institutional blockholders in the company's ownership structure and the assessment of market participants as to the company's need for financial flexibility. The empirical research conducted in this dissertation aims to fill this research gap.

2. Primary object of the dissertation and research hypotheses

This dissertation combines issues from two research areas e.g., corporate finance and corporate governance. The primary object of the research is to answer the question of **whether or not institutional investors have influence on the management of financial flexibility in public companies.**

For the purposes of the primary object of the research, the main research hypothesis was formulated, stating that the role of institutional investors in managing financial flexibility is related to the number of shares they hold and the nature of non-investment relations between investors and their portfolio companies.

The main hypothesis was verified based on empirical verification of the following four partial research hypotheses relating to capital structure and cash management.

Hypothesis 1: The presence of an institutional blockholder in the ownership structure increases - along with the rise in the value of financial flexibility - the propensity of managers to maintain unused debt capacity.

Hypothesis 1a: The presence of an independent institutional blockholder in the ownership structure increases - along with the rise in the value of financial flexibility - the propensity of managers to maintain unused debt capacity.

Hypothesis 2: The presence of an institutional blockholder in the ownership structure increases - along with the rise in the value of financial flexibility - the propensity of managers to maintain cash reserves.

Hypothesis 2a: The presence of an independent institutional blockholder in the ownership structure increases - along with the rise in the value of financial flexibility - the propensity of managers to maintain cash reserves.

The first of the hypotheses relates to financial flexibility in respect to capital structure decisions (debt flexibility), which manifests itself with managers maintaining unused debt capacity, i.e. leverage below levels available to a firm with specific characteristics. Based on the current research it could be expected that as the value of financial flexibility increases, the propensity of managers to maintain unused debt capacity increases. However, keeping low leverage can lead to higher agency costs of equity. According to agency theory, debt is indicated as one of the mechanisms that discipline managers and its appropriate use can increase the efficiency of their decisions. The results of the latest research indicate an active role of institutional investors in capital structure decisions. A higher level of debt allows institutional investors to limit the scale of direct monitoring. On the other hand, monitoring by institutional investors could substitute the disciplinary role of debt. Because of this specific "substitution effect" it can be expected that the presence of an institutional blockholder increases, as the value of financial flexibility increases, the propensity of company managers to maintain unused debt capacity. In order to support the tested dependence, a partial hypothesis was additionally formulated, which highlights the role of independent institutional blockholders. It is widely accepted that this group of investors is characterized by a relatively high level of effectiveness of monitoring activities.

The third partial hypothesis relates to financial flexibility secured through cash reserves (cash flexibility). Cash flexibility manifests itself by maintaining cash reserves above the level

necessary to finance transactions related to the company's day-to-day operations. Agency theory suggests that maintaining excess cash reserves in the firm may tempt managers to using them inefficiently (free cash flow agency problem). The latest studies provide evidence that active monitoring by institutional investors over managers allows the efficiency of cash management to increase. Thus, it can be expected that the presence of an institutional blockholder in the ownership structure is conducive to maintaining cash reserves by companies where the value of financial flexibility increases. Apart from identifying the presence of institutional blockholders, other characteristics of this group may also be important for maintaining a reserve of liquid assets. Therefore, as in the case of the hypothesis related to the unused debt capacity, an additional partial hypothesis was formulated, in which the role of independent institutional blockholders was emphasized.

3. Data sources and research methods

Empirical research in the dissertation has been conducted among non-financial Polish public companies whose shares were listed on the Warsaw Stock Exchange in the years 2004–2017. Due to limited availability of the data necessary for the analysis and the adopted method of measuring some of the variables, the final size of the research sample has declined. The basic source of empirical data in terms of financial reports, ownership structure and share prices were two databases: Capital IQ by Standard&Poors and Notoria Serwis.

The data used in the study is panel data and the research methods used in this dissertation to verify research hypotheses are classified as microeconometrics. In the first part of the research, classical linear regression (OLS) was used when estimating the value of financial flexibility. In the second part of the research, hypotheses relating to financial decisions were verified using a logit model.

4. Structure of the dissertation

The main objective of the doctoral thesis and presented hypotheses determine the structure of the dissertation. The dissertation consists of an introduction, three chapters and a conclusion. The two first chapters are the theoretical part of the dissertation and the third chapter is its empirical part.

The first chapter is devoted to the discussion in the literature on the importance of financial flexibility in manager's financial decisions. The concept of enterprise flexibility, including financial flexibility, is discussed in detail. The methods of measuring financial flexibility applied in the existing empirical research are presented. The last part of this chapter presents the concept of financial flexibility in corporate finance and describes the impact of financial flexibility on decisions related to capital structure, cash management strategy and payout policy.

In the second chapter, the importance of financial flexibility in building shareholder value is addressed. Then, the corporate governance systems are discussed and the importance of the ownership structure for the functioning of a company is characterized. The last part of the chapter focuses on the role of blockholders, including institutional investors, present in the ownership structure, in monitoring managers' decisions regarding capital structure and cash management strategy.

The third chapter presents the concept of the conducted empirical research. The first part of the chapter presents the procedure and the obtained results of measuring the value of financial flexibility from the perspective of capital market participants for the companies under examination. The next part of the chapter presents the results of the performed research related to the impact of institutional blockholders, present in the ownership structure, and firm's financial flexibility on managers' decisions regarding unused debt capacity and cash reserves were presented. The chapter ends with the presentation of the results of robustness tests.

The dissertation ends with conclusions and with the indication of directions for future research.

5. Research results

The empirical research was divided into two main stages, the result of which allowed for verification of the research hypotheses. The first stage included the presentation of the applied method and the obtained results of the measurement of the financial flexibility of public companies in Poland.

Taking into account the indications of the theory regarding what factors could potentially affect the value of financial flexibility, only two parameters of interactive variables used to estimate the value of financial flexibility had the direction as expected. The lack of statistical significance and the different signs of other parameters may suggest limited usefulness of the measure applied to value financial flexibility in markets other than the US. However, some of the parameters used in another studies for valuing financial flexibility, estimated based on a group of US companies, were also statistically insignificant and inconsistent with the theory in terms of their direction.

The analysis of the value of financial flexibility of the companies covered in the research, despite potential limitations mentioned before, seems to provide arguments for the usefulness of the model in markets other than the US. Admittedly only the fourth-largest, but still relatively high, average value of financial flexibility of the analysed companies in 2008 coincides with the outbreak of the financial crisis on world markets. The negative effects of this crisis were also felt by companies operating in Poland. During this period, banks limited the availability of external financing by introducing higher margins, bank commissions and stricter criteria for assessing creditworthiness. The limitation of the possibility of obtaining external capital was reflected in a decrease in the value of investment expenditure and a decrease in the accumulation of internal capital. The high, compared to the period around the crisis, average value of financial flexibility in 2008 indicates that in response to the financial crisis the value of financial flexibility of companies listed on the Warsaw Stock Exchange increased.

The differences in the level of market information efficiency and the role of banks in the financial supply system for enterprises, at least to some extent, may explain why the factors influencing the company's needs for financial flexibility, as indicated by the theory, do not play such an important role on the Polish capital market.

The main part of the empirical research was carried out in the second part of this dissertation, in which the importance of the presence of an institutional blockholder in the ownership structure on the relationship between the value of financial flexibility and the company's financial decisions was investigated. This part of the research was additionally divided into two areas referring to the different fields of corporate financial strategy: capital structure decisions and cash management strategy.

Based on the conducted research, it was found that the presence of an institutional blockholder in the ownership structure significantly magnifies the impact of the value of financial flexibility on the management's propensity to maintain unused debt capacity. The obtained dependence is consistent with the indications of the theory and the results of the work of other researchers on the role of institutional blockholders in reducing agency costs. In companies where, in the opinion of investors on the capital market, it is justified to maintain financial flexibility, institutional blockholders, through their presence, in some way authorize managers to maintain unused debt capacity. Monitoring by institutional blockholders replaces the supervisory mechanism related to the disciplining role of debt. This is also confirmed by the research conducted when dividing the companies into subgroups with low and high value of financial flexibility. Only in companies with a high value of financial flexibility a positive relation was noted between the presence of an institutional blockholder in the ownership structure and the propensity of managers to maintain unused debt capacity. Additional research to verify the second partial hypothesis showed that the presence of the an independent institutional blockholder increases, along with the rise in the value of the company's financial flexibility, the propensity of managers to maintain unused debt capacity. The results of the research are essentially consistent with the theory and with the results of research conducted for other markets.

However, based on the conducted research, it is not possible to find arguments in favour of the third and the fourth partial hypothesis. There were no statistically significant relationships indicating any role of institutional blockholders in moderating the impact of the value of financial flexibility on the propensity of managers to maintain cash reserves.

Robustness tests of the conducted research showed that the obtained results were insensitive to a change in the method of estimating the financial flexibility measure, a change in the period covered by the study, and the inclusion in the models of additional control variables representing the effects of managers' decisions regarding the level of debt and cash resources taken in previous periods.

It should be stressed that the presented conclusions are drawn with caution and full awareness of many limitations. Firstly, the results of the conducted research were influenced by the choice of the measure of firm's financial flexibility. The adopted measure reflects the theoretical value that capital market investors assign to the incremental monetary unit left in

a company, taking into account its possible use to secure financial flexibility. Secondly, when comparing the results of the research conducted on companies from other countries with the results of the empirical research presented in this dissertation one should consider that countries differ in terms of the models of their financial systems and the stage of their development. Thirdly, it should be noted that the endogeneity problem could exist. On the one hand, institutional investors can influence managers' decisions on capital structure and cash management strategy. On the other hand, institutional investors may prefer and choose companies that are characterized by low leverage and high cash reserves. However, presented consideration hopefully will contribute to the discussion on the impact of institutional blockholders on managers' financial decisions, especially concerning financial flexibility. The conducted analyses may constitute a starting point for further research, e.g., analysis of other measures allowing to reflect the degree of the company's need for financial flexibility, research of the role of other groups of shareholders in financial flexibility decisions, analysis of the role of banking and insurance conglomerates operating in Poland, analysis covering the role of potential conflicts of interest between particular groups of shareholders. Understanding the rationale behind managers' financial decisions, taking into account a company's need for financial flexibility, can be particularly valuable for current owners, potential investors in the capital market or financial institutions providing capital to the company.