Effect of company-specific governance provisions and country-level governance quality on the level of cash holdings in Latin America

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Extended Abstract

There is ample evidence on the effect that corporate governance has on the level of corporate cash holdings in developed markets. Jensen (1986) supports the notion that excessive corporate cash reserves affects negatively the value of the firm in the context of the agency relationship that exists between managers and shareholders. In Latin America however, the main agency problem that exists is between minority shareholders and the main owners who in general are still managing and controlling the corporation. Pinkowitz et al. (2006) investigate how minority shareholders in countries with poorer investor protection value cash holdings. According to their result, the value of the firm's cash holdings is lower in countries with weaker investor rights, because controlling shareholders might use their position to extract private benefits from cash holdings, at the expense of minority investors. It is also important to recognize that cash reserves are subject to expropriation not only by entrenched managers but also by other external parties such as the government (Myers and Rajan, 1998). Therefore, in the Latin American context, it interesting to see how government quality and its interaction with the insider agency problem affect corporate cash holding decisions.

Opler et al. (1999) and Mikkelson and Partch (2003) recognize that keeping an excess cash reserve provides the corporations with the flexibility in making investment decisions in countries where raising money might be costly. Indeed, companies based in Latin America, which are subject to higher institutional and economic volatility might benefit of holding higher levels of cash reserves to avoid

raising capital in the capital markets where the cost of funding on average is higher than in developed financial markets. Hennessy and Whited (2005) provides evidence consistent with firms holding higher cash levels when the firm's ability to raise cash is lower. Chong and López-de-Silanes (2007) find that in Latin America, where countries offer less investor protection than the average protection found in French civil law countries, investors' expropriation risk and the cost of capital are higher, and the level of financial development is relatively low.

In Latin America, where in general the protection to investors' rights is very low, the potential agency problem between minority shareholders and the managers-owners clearly indicates that excess cash holdings are detrimental to the value of the corporation. In contrast to this however, the higher external cost of funding faced by corporations explained by low development of the financial markets and the low confidence in the institutional environment (i.e. low investor's protection) would indicate the need to hold higher levels of cash reserves to avoid losing good investment opportunities.

From the literature, country-specific governance variables such as protection of investors' rights, the level of corruption, regulatory compliance, and in general the rule of law, affect the level of cash holdings. Dittmar et al. (2003) analyzed cross-country differences in cash holdings. According to their analysis, the level of corruption, country risk, and the protection of shareholders' rights affect the average level of cash holdings. Francis et al. (2013), studying the relationship between corporate governance and investment-cash flow sensitivity, find that better corporate governance diminishes the dependence on internally generated cash flows, especially in countries with weaker country-level governance. Although, not directly associated to cash holdings, the investment-cash flow sensitivity has a positive relationship to the levels of cash flows: The more sensitive is the investment to the internally generated cash flow, the higher the levels of cash the company has to hold in order to avoid missing a good investment opportunity.

Recent articles study the effect of corporate governance on the levels of cash holdings in some emerging market economies. We previously mention the results of Francis et al. who study a sample of emerging market economies including Brazil and Chile with just few observations. Hall et al. (2014) study the determinants of cash holdings in private and public companies based in 20 emerging markets of Central and Eastern Europe. They find that private firms hold more cash than public firms do. They also find that firms based in market-oriented countries hold more cash reserves. Chen et al. (2014) study the effect of government quality on corporate cash holdings for a sample of Chinese public firms. They find that the level of cash is negatively related to the quality of government: Higher quality of government implies lower average level of cash reserves. How corporate governance interacts with country-governance variables is an open research question in Latin America, given that, to the best of our knowledge, there is no prior research that addresses this topic. Until recently, corporate governance data have not been included in most of the financial databases that cover Latin American public corporations. One reason is that corporations provide this information voluntarily in most of the countries.

Specifically, we are interested in knowing the effect that corporate governance plays in countries with not only low levels of investors' rights protection but also high volatility in their institutional environment, including high perception of political stability, corruption and low regulatory quality. One the one hand, corporate governance tools such as the number of independent board members or CEO duality are not completely enforceable in countries where investor's protection is weak. In this case, country governance and firm-specific corporate governance may complement each other. On the other hand, given the specific agency relationship between the manager / owner and minority investors that exists in Latin America, the manager / owner has incentives to expropriate minority investors, obtaining internal rents such as higher salaries or lower dividend payments. Firms with credible good governance mechanisms such as a higher proportion of institutional ownership should be more valuable in countries with weak country-governance because they can reduce more agency costs. In this case, company-specific governance works as a substitute for country-specific governance. An important contribution of our paper is to study the effect of corporate governance on cash holdings controlling for the quality of country-level governance in five Latin American countries.

Howard et al. (2013) show that higher levels of cash flows not necessarily are detrimental to firm value, if the cost associated to raising external capital is high. Firms in Latin America face higher cost of capital due to less developed capital markets and low investor's protection. In this environment, higher average levels of cash flows will be prevalent to avoid foregoing a +NPV project. In addition, when investor's protection is low and contracts are less subject to be enforced, minority investors cannot force the manager / owner to lower the free cash flow that might be subject to private rents enjoyed by managers / owners. We expect therefore a negative relationship between the quality of governance at the country level and the levels of cash holdings.

In countries with low quality of governance, where cash holdings might be subject to expropriation, a good corporate governance might work as a substitute for the deficient country-level governance environment. Strong corporate governance can signal to minority investors that managers / owners are under control. For example, a higher percentage of independent directors in the board of directors might signal effective monitoring activities. Institutional ownership can also bring additional external overseeing to the managerial decision making.

We identify two potential effects over the level of cash holdings. On the one hand, we posit that good corporate governance in countries with low governance quality can effectively signal effective monitoring, allowing companies to increase the optimal level of cash holdings when facing high cost of raising capital. On the other hand, good corporate governance in the presence of weak country governance may affect negatively the level of cash holdings decreasing the level of cash to avoid the potential expropriation of value by the manager / owner in detriment of minority shareholders. In this latter case, company-specific governance provisions are substituting the role that strong country-level governance characteristics should have played.

We study public firms based in five Latin American countries during the period 2010 - 2015: Brazil, Chile, Colombia, Mexico, and Peru. Our results show that in countries with lower regulatory quality, weaker rule of law, and higher political instability and more violence, the level of cash holdings are higher. The results are statistically significant at a 1 percent level and robust to different specifications. We also show that corporate governance plays a role in decreasing the cash holdings to avoid agency problems between the manager / owner and the minority investors.

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