

Majority Ownership and Enterprise Value: Free Cash Flow Hypothesis Testing

Victor Soeindra[1*] Eduardus Tandelilin[2] Hermeindito[3]

1. Department of Business, Widya Mandala Catholic University, Surabaya – Indonesia
2. Department of Economics and Business, Gadjah Mada University, Yogyakarta – Indonesia
3. Department of Business, Ciputra University, Surabaya – Indonesia

Abstract

This study examined the free cash flow hypothesis. The manager, with the authority which is granted by the enterprise owners, can make use of the internal funds in the enterprise to make investment less profitable for the shareholders so that the enterprise owners need some oversight on policies made by the managers in this regard. This study then examined and analyzed the influence of operating cash flow on enterprise investments and debt which had impact on the increase or decrease of enterprise value. The study employed majority ownership as the moderating variable for the correlation between (1) operating cash flow and investments as well as (2) the correlation between operating cash flow with debt. The sample of this study comprised 94 manufacturing enterprises which were selected based on certain research criteria during the period of 2000 to 2013. This study also used three simultaneous equations. Also, the regression analysis technique used was the three-stage least squared (3-SLS). These results indicated that the presence of majority ownership in the enterprise could act as a control mechanism to evaluate the decisions made by the enterprise management that would enhance enterprise value.

Keywords: free cash flow hypothesis, operating cash flow, investment, debt, enterprise value, majority ownership.

1. Introduction

At the beginning, an enterprise is traditionally initiated and managed by a family. Family enterprise which is originally small may further develop into a large and complex enterprise with respect to its management. Management of large companies requires certain abilities/competencies that help employers develop the enterprise. The owners of an enterprise which has become large and complex need to recruit people and delegate authority in order that the person can manage the enterprise well. Jensen (1986) states that an agency correlation occurs when the owners begin to hire a manager (agent) and delegate authority to run the enterprise, and the owners (principal) of the enterprise act as the shareholders.

The managers appointed by the enterprise owners must be able to maximize the welfare of the enterprise owners through an enhancement in the value of the enterprise. Managers must be able to take strategic decisions to enhance the enterprise value. Managers should also be able to look for profitable investments and be careful in taking into account the sources of fund. Remuneration received by the managers involves salary, bonus, allowance and other facilities. However, the fact is that this agency correlation does not always run well as the managers may conduct moral hazard in meeting his favorable needs. Managers who get direct authority from the owners to manage the enterprise would have better information about the enterprise than the enterprise owner. Asymmetric information that occurs between the enterprise owners and the managers can be used by the managers to prioritize his personally preferred interests and ignore the enterprise owner's interests. Making strategic enterprise decisions can be detrimental to the owners by taking decisions that are not in the optimum point. In this respect, the conflict between the managers and the owners is known as agency conflict.

Jensen and Meckling (1976) state that the conflict between managers and enterprise owners lies in the use of internal capital of the enterprise (free cash flow hypothesis). Jesen & Meckling (1976) state that internal funding in the enterprise should be used to invest in the projects that are profitable for the enterprise owners and the rest must be returned to the enterprise owners in the form of dividends or to creditors. However, managers may deviate by investing in projects that are not optimal which then reduce the value of enterprise. The free cash flow hypothesis put forward by Jensen (1986), Vogt (1994) and Cleary (1999) states that free cash flow hypothesis is something unobserved not the kind of free cash flow in the practical form or value. The definition of free cash flow in this study is the consideration of using internal funds to be better spent on investment options or not, so that the free cash flow hypothesis is an overall testing mechanism that includes investment and financing decisions that will impact on the increase/decrease of enterprise value.

Conflicts between managers and owners of companies may occur when the decision of allocating funds to finance the enterprise's investments is taken. Managers can use internal funds to finance an optimal investment in order to increase the enterprise value (alignment). In contrast, an unoptimal investment will reduce the enterprise value (entrenchment). Information about the condition of the enterprise owned by the managers is