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Cash Retention Strategies: Test of Free Cash Flow Theory

3.1 Introduction

This chapter examines financing decisions by firms listed on the Mumbai Stock Exchange. A study by Singh and Hamid of stock market data for the top 100 manufacturing firms in several industrialising countries showed how these firms use internal and external resources to finance investment (Singh and Hamid, 1992). They concluded that variations in corporate financing in developing countries have some common characteristics. They show that although firms in these countries maintain significant retention ratios, they quite often use external funds and shares to finance their investment. This differs from the more commonly accepted pecking order pattern of finance in most industrialised countries where profits and debt are more commonly used than equity as a source of capital. Singh and Hamid focus on large indigenous firms, but many collaborative ventures involving multinationals and smaller local firms also use similar financing measures as evident by their presence in emerging equity markets. Cherian (1996), Cobham and Subramaniam (1995), and Bhaduri (1999) are sceptical of the evidence regarding the level dependence on external finance as presented by Singh and Hamid. This chapter tries to extend this work by considering one of the basic determinants underlying the choice between internal and external finance: cash retention policy.

When firms disburse cash and use equity markets and external resources to finance their investment, there can be no single optimal solution for selecting appropriate financing options for all firms given firm heterogeneity. This chapter considers the benefits and disadvantages of earnings retention within the context of the imperfect capital market in which they operate. Furthermore, varying macroeconomic
conditions, i.e., recessions and booms, at their most extreme levels will be used to test the viability of this approach.

### 3.2 Purpose

A dynamic model explores the conditions for a dominant strategy of earnings retention using different views regarding excess cash flow. An optimal earnings strategy, balancing the benefits and costs of retained earnings, is one of the goals. Section 3.1 to 3.6 present the case for the Free Cash Flow Theory (FCFT) (Jensen, 1986), the consequences of imperfect capital markets (Fazzari, Hubbard and Petersen, 1988; Bernanke and Gertler 1990), and the financial accelerator (Bernanke, Gertler and Gilchrist, 1993). It will be emphasised that the appropriate use of excess cash should vary according to individual characteristics given firm heterogeneity. A further hypothesis that optimal earnings strategies are more important in firms with higher asymmetric information costs is analysed with the understanding that asymmetric information costs are greater for firms with private information. Small, high Tobin’s $q$ firms should retain earnings; moreover, the economic cycle, i.e., boom or recession, should influence the level of investment.

In sections 3.7 and 3.8 a model of earnings strategies which examines a sample of firms determines how cash flow influences their investment decisions. The model will attempt to capture the essential tradeoff between the two extreme cash strategies: earnings disbursement and earnings retention. Instances where a high external finance premium makes an earnings retention strategy superior to a earnings disbursement strategy will be demonstrated. Since the model is highly stylised, the chapter turns to an empirical investigation of investment and earnings retention, using a select sample of public firms listed on the Mumbai Stock Exchange. It finds that firms do not follow either extreme strategy as hypothesised, but rather they follow a mix of both strategies. To test for dynamic treatment of excess cash flow, tests will be conducted during times of monetary contraction to see how individual firms behaved and how their treatment of cash flow and dividend policies changed. A formula for calculating the optimal earnings retention level for firms will be devised.

When firms raise capital in the equity market, the object is greater future cash flow for shareholders. When this cash flow is not paid out as dividends, it is retained by firm managers for further investment. In a world without asymmetric information, shareholders would trust managers. With asymmetric information the abuse of earnings by firm