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Jensen, Michael C., 1986, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review*, vol. 76, no. 2, pp. 323–329

Payout to shareholders ↑
⇒ Resources under manager's control ↓
⇒ Manager's power ↓
⇒ The capital market's monitoring ↑ (if the firm requires new money)

Internal financing: avoid monitoring ⇒ new fund will be impossible (or possible only at high cost)

Managers: incentive to grow (beyond optimal) ⇒ to increase resources under their control, to increase their compensation (∵ sales ↑ ⇒ compensation ↑)

The tendency of firms 'promotion≳bonus': bias toward growth (∵ growth ⇒ supply of new position ↑)

Competition in the markets
⇒ manager increase efficiency to survive
The markets with high economic rents or quasi-rents
⇒ competition ↓ and free cash flow (FCF) ↑
⇒ internal control system and market for corporate control is important

Free cash flow: remained money after all profitable investment ($\rho^* > \rho_k$ in MM)
Substantial FCF ⇒ severe conflicts of interest between shareholders and managers over payout policy
Problem: motivate managers to disgorge FCF (rather than investing badly or wasting it inefficiently)
Theory developed here:
1) Debt ⇒ agency cost of FCF ↓
2) How debt substitutes dividend
3) Why diversification loss>takeover or same line expansion or liquidation-motivated takeover
4) Why factors generating takeovers in many industries are similar to those in oil
5) Why bidders and some targets tend to perform abnormally well prior to takeover

I. The Role of Debt in Motivating Organizational Efficiency

Control hypothesis

FCF ↑

⇒ leaves managers with control over the use of future FCF

⇒ Managers can promise to pay by announcing a permanent dividend increase

⇒ The promise is weak ∵ can be reduced in the future

⇒ 'Market punishes dividend cuts with large stock price reductions'

∴ Consistent with agency cost story

Debt creation

⇒ Bond managers' promise to payout future FCF

⇒ Can be an effective substitute for dividends

⇒ Give shareholder recipients of the debt the right to take the firm into bankruptcy court if they do not maintain their promise to make the interest and principle payment

∴ Reduces the agency costs of FCF

∴ Control effects=a potential determinant of capital structure

Debt ↑ ⇒ agency cost of debt ↑, bankruptcy cost ↑

Debt issues: not always positive control effect

For growing rapidly, high profitable projects

⇒ No FCF, control effect ↓, go to financial market instead

⇒ Markets have an opportunity to evaluate

∴ Important monitoring role by investment bankers and analysts

∴ The Market's assessment is made evident by the price investors

High FCF, low growth prospect (or shrink)

⇒ Wasting FCF serious, control hypothesis is most serious.

II. Evidence from Financial Restructuring

Leverage ↑ ⇒ price ↑: stock repurchase, common→preferred or debt

Leverage ↓ ⇒ price ↓: sale of common, debt or preferred→common

i.e. FCF theory,

Unexpected payouts to shareholder ↑ ⇒ price ↑

Reductions in payments, new requests for fund ⇒ price ↓

Exception:

1) Targeted repurchase: though leverage ↑, price ↓ ∵ probability of takeover ↓

2) Sale of debt and preferred stock: though leverage ↑, new cash under manager ↑ ⇒ price ↓

Commitment tightness ↑ ⇒ value change magnitude ↑

Effect of common→debt>effect of preferred→debt

Is this tax effect? Not exactly ∵ no tax effect in common→preferred (FCF problem ↓ ⇒ price ↑)

III. Evidence from Leveraged Buyout and Going Private Transactions

Competes successfully with the open corporate form ∵ advantages in controlling FCF agency costs

Desirable LBO candidate:

Firms or divisions of larger firms

1) Stable business history 2) substantial FCF 3) low growth prospects (cash cow)

∵ High FCF agency costs

Strip financing: package finance, "stapled", following current leverage ratio

Conflict of interest ↓, limits bankruptcy costs

Ex. Non-leveraged firm A, leveraged firm B, identical claims on CF distribution

Only firm B strip holders: have remedial powers (if managers withhold dividends to invest badly)

If default ⇒ the right to take the firm into bankruptcy, to have board representation, to intercede in the organization ⇒ (only firm B) replace managers easily and quickly

Strictly, not desirable

∵ IRS restriction (deny tax deductibility of debt interest), limits on bank holdings of equity

Mezzanine: riskless debt need not be in the strip, priority: common<mezzanine<debt

Top-level managers & venture capitalist who promote this:

Hold a larger share of the equity

Control board of directors & managers

Managers and these capitalists: interest in making the venture successfully

∵ Their equity interest are subordinate to other claims

IV. Evidence from the Oil Industry

Changes in the energy market since 1973

⇒ FCF ↑, required a shrinking of the industry, FCF agency costs ↑

⇒ Takeover market has played a critical role in reducing them

Environment: average productivity ↑, marginal productivity ↓

Firstly, FCF ↑ ⇒ price ↑

Management retained FCF (consistent with agency cost story)

Spend heavily on E&D activity ($\rho^* < \rho_k$)

Oil industry managers: diversified, invested outside the industry

⇒ Unsuccessful (bad luck+lack of expertise)

McConnell and Muscarella (1985, JFE): announcement of E&D expenditure ↑ ⇒ price ↓ (oil industry)

V. Takeovers in the Oil Industry

Retrenchment ⇒ cancellation or delay of projects ⇒ threatens the careers of involved people

∴ Resulting resistance: retrenchment will bring crisis ⇒ takeover attempts can generate crisis

Oil industry firms were led to merge ⇒ large gains in efficiency & in value

Actual takeover is not needed to induce the required retrenchment and return of resources to shareholders.

- Phillips and Unocal's restructure ⇒ resulted in stockholder gains
  - Repurchase ↑, dividends ↑, sales of assets, capital spending ↓
- Diamond Shamrock's reorganization ⇒ market value ↓ on announcement day
  - Dividends ↓, small repurchasing, sell a new limited partnership, E&D expenditure ↑

VI. Free Cash Flow Theory of Takeovers

Positive market response to debt creation in oil industry takeovers: consistent with,

- Debt ↑ ⇒ forcing organizations to disgorge FCF to investors ⇒ efficiency ↑

FCF theory: predicts which mergers and takeovers are more likely to destroy

- Managers with unused borrowing power and large FCF ⇒ likely to invest on bad items (diversification)
- Diversification ⇒ less waste than internal investment in unprofitable projects
- Acquisition: involve payout to shareholders, create benefits even merger generates inefficiencies
- Such low-return mergers: in industries with large FCF, exodus is expected
- In declining industry,
  - Mergers within industry ⇒ create value
  - Mergers outside industry ⇒ low- or even negative-return projects
- This theory prediction:
  - Breakdowns of internal control processes, big FCF, wasteful firm policy ⇒ value adding takeover
- Debt created in a hostile takeover:
  - Not permanent, motivates firm to refresh (cuts in expansion plans, sales of unnecessary divisions)
  - ⇒ Generates benefits
- The theory also predicts:
  - Many acquires≈exceptional good performance right before that acquisition (large FCF occurs!)
  - Two possible targets:
    1) Firms with poor management
    2) Firms that have done good enough, large FCF, but refuse to pay out to shareholders

Cash & debt takeovers ⇒ large benefits

- Takeovers done by exchange of stock: different, related to growth opportunities or shortage of FCF