

# **A STUDY OF THE RELATIONSHIP BETWEEN PROXY CONTEST AND CORPORATE EXCESS CASH – TAIWAN EXPERIENCE**

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## **ABSTRACT**

U.S. study indicates that pure proxy fight mechanism is able to resolve the agency problem caused by excess cash. Our results are different in many ways from U.S. experience. Our analysis considers the high value of land variable and distinguishes positive and negative excess cash firms. The potential land gain variable has a mixed result. Only positive excess cash firm has significantly positive relationship with proxy contest. The target firm has less cash than the comparable firms. There is no significant cumulated abnormal return (CAR) during the announcement period and no significant relationship between the excess cash and CAR. The reduction in cash after the contest is only because of pure waste in fighting the contest.

## **INTRODUCTION**

There are various studies about internal mechanism to solve the agency problem caused by excess cash. The other way for the dissident shareholder to force the management to solve the agency problem is through external merger mechanism. Harford [2] indicated that there is a negative relationship between merger target and excess cash because of takeover deterrence effect of corporate liquidity. Faleye [1] proposed proxy fight as a means to solve the excess cash agency problem since the contest is part of corporate control market mechanism and argued that proxy contest is cheaper than hostile merger in solving agency problem. Company's performance and the ownership structure are other factors might affect proxy fight. Our goal is to study the relationship between the proxy contest and excess cash for Taiwanese firms. Since land is quite precious in Taiwan, this variable is also included in our analysis to test its impact on proxy fight. We are also interested in what would be the impact from different type of excess cash flow on the proxy contest, which has not been addressed in previous research such as Faleye [1]. The rest of the study is followed by methodology, empirical analysis.

## **METHODOLOGY**

The data are from major newspapers, Wealth Magazine, Securities and Futures Institute (SFI) On Line, the Monthly Securities Summaries by Taiwan Stock Exchange, Knowledge Winner, United Knowledge Database, and Taiwan Economic Journal (TEJ). Our sample covers 272 firms from 1997 to 2002 and the number of company actually had proxy fight is 74 firms. We follow Faleye [1] approach by adopting different definitions of excess cash to examine if the different definitions of excess cash will affect the proxy fight result. First cash model is from Opler et al. [3] (OPSW). This model is a base cash holding model to predict excess cash flow. The cash is the dependent variable and the independent variables are M/B ratio, company size, earnings plus depreciation, net working capital ratio, capital expenditure ratio,

leverage, variability of cash flow relative to its industry, R&D expenditure, dividend, and managerial ownership. The excess cash is defined as the difference between the actual cash flow and the cash holding predicted by the OPSW [3] model. Because excess cash holding position will cause agency problem which may be solved by proxy fight, we expect there is a positive relationship between corporate excess cash flow and proxy fight. To make a comparison, the second cash model, Harford [2] cash holding model, is introduced. The dependent variable is the cash/sales ratio and the independent variables are net operational cash flow/sales ratio, risk premium, recession, M/B ratio, coefficient of variation of cash flow and company size. For the third model, we utilize Faleye [1] cash ratio model. The cash ratio is defined as the natural log of the ratio of cash and marketable securities to total assets. Other factors may affect the proxy fight are ownership of management, firm's pre-contest performance, potential land gain, net of market return, leverage and M/B ratio. Logistic regression is utilized in our analysis because the dependent variable is either zero or one. One is for the proxy fight target and zero is for non-target. To investigate the wealth effect for shareholder from the announcement of the proxy fight, we utilize the cumulative abnormal return (CAR) method in our analysis.

### ANALYTICAL RESULTS

Our results indicate that, on average, the contest firm significantly has more excess cash than comparable firm. The contest firm has higher potential land gain than the comparable firm at 10 percent of significant level. This indicates that normally the contest firm has more land assets than comparable non-contest firm. The difference for performance measurement, such as net return adjust for market, EPS, and ROE between the contest firm and the comparable non-contest firm is not significant. This means that performance is not the factor to determine engaging in proxy fight and this is contrary to the conclusion from research using U.S. data. Taiwan data also shows that, for all the sample firms, the possibility of proxy fight is decreasing in excess cash flow. This means the excess cash is not a factor for investor to engage in a proxy fight. This is also contrary to the result from Faleye [1]. But when we further divide the excess cash into two groups, i.e., positive excess cash group and negative excess cash group, the result is surprisingly divided. The possibility of proxy fight is significantly increasing with positive excess cash. This result conformed to the result from U.S. data. For the negative excess cash group, the possibility of proxy fight is also significantly decreasing in negative excess cash. This implies that for cash-poor firm, the proxy fight is not intended to solve the agency problem but with other purpose.

The potential land gain has a marginally significantly positive influence in determining proxy fight. In Taiwan, the land-rich firm is always the target for proxy fight. This is especially obvious in the negative excess cash firm case. The CAR over the contest announcement date is insignificantly higher than the market average return and the CAR is not significantly related to excess cash either. So, the investor maybe only look for the abnormal return due to the incitement of proxy fight issue or insider information, which is still quite prevailing in Taiwan, not because of intention to solve the agency problem.

After proxy fight, corporate liquidity decreased, but the reduction in cash was not used to disburse cash dividend, repurchase stock or increase capital expenditure. The money was simply wasted in fighting proxy contest. We further analyze the cash position for different excess cash firms. For the negative excess cash group, we find the cash ratio and excess cash are significantly increased but for the positive excess cash group, both cash ratio and excess cash are significantly decreased. This means the proxy fight target firm with positive cash flow wastes its cash in fighting the contest. On the other hand, for the

negative excess cash firm, it does not have to waste cash to fight the contest. After contest, some lands are sold and capital expenditure is reduced; therefore, both cash ratio and excess cash increase.

Our findings indicate some evidence contrary to U.S. study. We think the possible explanation is the culture and institution difference. In Taiwan, individual investors are still the major stock market participants. Most of these investors only focus on very short term capital gain. They do not care too much about long term agency problem. In the meantime, the separation of ownership and management in Taiwan is not clear. This complicates the traditional agency problem.

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