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The Effect of Free Cash Flow on the Relationship Between Managerial Entrenchment and Debt: Evidence From French Firms

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Abstract
At first, this paper examines the association between managerial entrenchment and corporate leverage in French case. Then, the effect of free cash flow in this relationship is investigated. Using a sample of 98 listed French companies in Euronext Paris from 2000 to 2014, it was found that CEO entrenchment is related positively to debt before financial crisis and negatively after crisis. Also, free cash flow moderates the relationship between CEO entrenchment and corporate debt before crisis.
Keywords: CEO Entrenchment- Debt- Free Cash-Flow- moderator variable

1. Introduction

The manager's entrenchment is considered as an active behavior of the CEO who seeks to keep his position in the company. A manager pursues some entrenchment strategies; The CEO focuses to invest on specific assets which are related to his training even if the investments are not profitable for the company (Shleifer and Vishny, 1989). The CEO can also manipulate information by omitting some information and advance information which gives value to his human capital (Stiglitz et Eldin, 1992). On the other hand, Pigé (1998) considers that to be a member of a relational network can help the CEO to be more entrenched. To have a relationship with administrators (Pichard-Stamford, 1998) or with shareholders (Paquerot, 1997) allows CEOs to have more control and power of the board.

Through those strategies, the CEO seeks to overcome control mechanism. This article focuses specifically on debt which CEO entrenchment avoids his disciplining role.

Many studies were examined with the relationship between CEO entrenchment and debt in several contexts of the world, and specifically in countries where the corporate governance system is an outsider (notably Berger, Ofek and Yermack, 1997: USA; De Jong and Veld, 2001: Netherland; Bunkanwanicha, Gupta and Rokhim, 2008: Thailand and Indonisia; Pokharel, 2013: Nepal). It was noticed that such research is rare in countries where companies are characterized by concentrated ownership or control (insider systems). To our knowledge, there is one study that examines the relationship between CEO entrenchment and debt (Paquerot and Chapuis, 2006). In their study, authors consider CEO entrenched only when he belongs to network ex-student of National School of Administration (ENA)[1].

The current study tries to answer the question if CEO entrenchment and debt are related negatively in a French context and whether free cash flow affects this relationship.

Using a sample of 98 listed French companies from 2000 to 2014, the aims of this research are to develop a panel model to investigate the impact of managerial entrenchment on leverage ratio and the effect of free cash flow on this relationship.

By comparing the situation before and after financial crisis, the results show that managerial entrenchment is positively related by leverage before financial crisis. On the other side, the same relationship is negative and confirms the empirical evidence that firms with stronger managerial control power tend to use less debt (Berger, Ofek and Yermack, 1997) after crisis. Free cash flow moderates negatively the relationship between entrenched manager and leverage only before crisis.

Results show differences in regards to the relationship between CEO entrenchment and debt before and after crisis.

The empirical analysis of this study has two goals. First, four models will be tested. Every model represents the association between entrenchment's proxy and debt. Second, the effect of free cash flow as a moderator variable in the relationship between CEO entrenchment and debt will be explored.

The remainder of this paper is organized as follows: Section 2 the literature review. The third section presents sample and data. The fourth section provides the empirical model and variables measurement. The fifth section exhibits findings. The conclusions are given in section 6.

[1] ENA : Ecole Nationale d'Administration

2. Literature review

2.1 Managerial entrenchment and Leverage

According to agency theory, there exists conflict of interest between managers and shareholders over capital structure decision. Managers prefer less debt because they seek lower firm risk to protect their human capital (Fama, 1980).

Berger, Ofek and Yermack (1997) studied the effect of managerial entrenchment on leverage in an American context. It was found that the level of corporate debt depends on the degree of managerial entrenchment. The first results of this research indicate that the CEO seeks to avoid debt. The authors then went on to test the effect of tender offer on the studied relationship. They found that the level of debt changes. However, leverage increases significantly to push tender offers.

For Gamble (2000), a low debt on total assets ratio reduces the need to cover fixed costs and increase manager's opportunism (Weir and Jones, 1999). An entrenched manager tries to avoid debt to escape stakeholder's control and thus to blend his power in the firm.

De Jong and Veld (2001) show, in their study, those managers of Dutch companies are entrenched and have flexibility on financial decisions. The authors conclude that managers decrease the level of leverage to avoid the disciplining role of debt.

Lee and Yeo (2010) find that firms with higher CEO entrenchment have lower levels of leverage of Asian firms. They confirm that entrenched CEO of Asian firms prefer lower levels of debt to avoid monitoring allied by debt financing.

Pokhrel (2013) tests the effect of CEO entrenchment on the level of leverage on Nepalese firms. According to Gompers, Ishii and Metrick (2003), Pokharel (2013) establishes an index of governance that shows the level of entrenchment. Pokharel (2013) concludes that the relationship between CEO entrenchment and debt in Nepal is negative but not significant.

In this regard, the manager seeks to avoid debt financing and prefers equity financing. In this case, when CEO entrenchment increases, leverage decreases.

The first hypothesis is

H1: Managerial entrenchment is negatively related (or associated) to leverage

This first hypothesis is divided into four sub hypotheses according to four chosen items of entrenchment:

H1.1: Age of manager is negatively related to leverage
H1.2: When manager is CEO and director of the board, the level of leverage decreases.
H1.3: CEO's stock ownership is negatively related to leverage.
H1.4: Relationship network's manager is negatively related to leverage

2.2 The effect of Free Cash Flow

Free cash flow is defined as cash flow in excess of that required funding all projects that have positive net present values when discounted at the relevant cost of capital (Jensen, 1986). When the firm generates free cash flow, conflicts of interest between shareholders and managers increase. The problem is how to affect this resource to motivate managers not to make over-investment that causes a destruction of shareholder value (Shleifer and Vishny, 1997).

To reduce agency costs, Jensen (1986) suggests debt as an important mechanism to control opportunistic behavior of leaders. In fact, debt limits the managerial discretion by reducing the amount of free cash flow. The discipline of the debt means that managers invest on efficient projects to refund borrowing and therefore, create value for shareholders.

Poincelot (1999) examined the role of debt to control manager's behavior when companies generate a free cash flow in French case. Empirical results provide that debt is not an efficient mechanism of control (contrary to free cash flow theory) but rather a variable manipulated by managers.

Lee and Yeo (2010) tested the relationship between managerial entrenchment and capital structure of Asian firms. They found that manager entrenchment and corporate leverage are negatively related. This association appears when firms have a higher agency cost of free cash flow.

In this respect, the hypothesis to be tested is:

H2: Free cash flow moderates negatively the relationship between CEO entrenchment and leverage.

3. Sample and data

The population for this study is 98 listed companies on Euronext Paris from 2000 to 2014. Financial variables are collected from Datstream data base. Governance data are obtained from Dasfsaliens database and "Guide des Etats Majors" and company websites. Financial firms (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) are excluded from the sample, because there are differences in leverage and corporate governance between those industries and other sectors.

4. Model

To test the hypotheses, multivariate linear regression model was used. Statistical methods used are panel data approach. Data analysis software utilized in this study is STATA 13.
Five models are defined in the following table:

Table 1. Regression models

Hypothesis	Regression	Model
H.1.1	$RATEND_{it}= \beta_0+\beta_1 AGEDIR_{it}+ \beta_2 SIZE_{it}+ \beta_3 ROE_{it}+ \beta_4 ROA_{it}+ \beta_5 SEC_{it}+ \varepsilon_{it}$.	M_1
H.1.2	$RATEND_{it}= \beta_0 +\beta_1 CUMUL_{it}+ \beta_2 SIZE_{it}+ \beta_3 ROE_{it} + \beta_4 ROA_{it} + \beta_5 SEC_{it} + \varepsilon_{it}$.	M_2
H.1.3	$RATEND_{it}= \beta_0 +\beta_1 ACTID_{it}+ \beta_2 SIZE_{it} + \beta_3 ROE_{it} + \beta_4 ROA_{it} + \beta_5 SEC_{it} + \varepsilon_{it}$.	M_3
H.1.4	$RATEND_{it}= \beta_0 +\beta_1 RESDIR_{it}+ \beta_2 SIZE_{it} + \beta_3 ROE_{it} + \beta_4 ROA_{it} + \beta_5 SEC_{it} + \varepsilon_{it}$.	M_4
H.2	$RATEND_{it}= \beta_0 + a\ ACTID_{it}+ b\ FCF_{it}+ c\ ACTID*FCF_{it}+ \beta_1 SIZE_{it}+ \beta_2 ROE_{it}+ \beta_3 ROA_{it}+ \beta_4 SEC_{it}+ \varepsilon_{it}$.	M_5

Where:
RATEND Leverage is measured by total debt on total assets ratio (Berger and al.1997, Gamble, 2000).
AGEDIR is dummy variable that takes the value '0' when the CEO's age < 60 years and '1' otherwise.
CUMUL is dummy variable that takes the value '0' when the CEO and the director of the board are the same person and '1' otherwise.
ACTID CEO's stock ownership= Shares owned directly.
RESDIR is dummy variable that takes the value '0' when the CEO is an ex-student of National School of Administration or Polytechnic School 'X' and '1' otherwise.
ROA Return on assets: (Earnings before interest, taxes and depreciation)/total assets.
ROE Return on equity: Net income/Shareholder's equity.
SIZE Company size Log (total assets).
SEC Type of industries
FCF operating income before depreciation after deducting payments for taxes, interest expense and dividends paid to shareholders (Lehn and Poulsen, 1989).

5. Results

5.1. Descriptive statistics

Table 2 exhibits descriptive statistics of different variables used in the analysis. Results reveal that level of debt, before crisis, on average is higher than after crisis one. CEO's stock ownership (ACTID) does not change before and after crisis. Average rate of firm's size is 11.803 before crisis and 12.161 after crisis. Average rate of return on assets does not change before and after crisis. Average rate of return on equity is 0.049 before crisis and 0.019 after crisis. FCF before crisis is higher than FCF after crisis.

Table 2. Descriptive statistics

	Before crisis				After crisis			
	Mean	Sd	Min	Max	Mean	Sd	Min	Max
RATEND	0.208	0.272	0	3.218	0.194	0.216	0	2.713
ACTID	0.124	0.202	0	0.941	0.126	0.203	0	0.94
SIZE	11.803	2.59	6.448	18.58	12.161	2.634	6.448	19.044
ROA	0.274	0.122	-0.788	0.55	0.201	0.866	-0.557	0.376
ROE	0.049	0.221	-0.981	0.836	0.019	0.188	-0.944	0.566
FCF	0.024	0.924	-0.586	1.383	-0.09	0.416	-3.073	1.594

Table 3. Cross table AGEDIR/CUMUL (Before crisis)

	CUMUL		Total
AGEDIR	0	1	
0	608	109	717
	68.93	12.35	
1	148	17	165
	16.78	1.927	
	756	126	882
	85.714	14.285	

Table 4. Cross table AGEDIR/CUMUL (after crisis)

	CUMUL		Total
AGEDIR	0	1	
0	310	60	370
	52.72	10.2	
1	196	22	218
	33.333	3.741	
	506	82	588
	86.054	13.945	

Tables 3and 4 show that 85.714% (86.054%) of managers have accumulation of responsibilities and 16.78% (33.33%) are above retirement age. So CEO's entrenchment accumulates responsibilities, before or after crisis, can justify his presence in company above retirement age (Paquerot, 1997).

Table 5. Cross table AGEDIR/RESDIR (Before crisis)

	RESDIR		Total
AGEDIR	0	1	
0	145	572	717
	16.439	64.852	
1	42	123	165
	4.761	13.945	
	187	695	882
	21.201	78.798	

Table 6. Cross table AGEDIR/RESDIR (after crisis)

	RESDIR		Total
AGEDIR	0	1	
0	73	297	370
	12.414	50.51	
1	47	171	218
	7.993	29.081	
	120	468	588
	20.408	79.591	

Tables 5 and 6 demonstrate that 21.201% (20.408%) of French managers studied in ENA or X-Mines of which 4.761% (7.993%) are above retirement age.

Table 7. Cross table CUMUL/RESDIR (Before crisis)

	RESDIR		Total
CUMUL	0	1	
0	145	611	756
	16.439	69.274	
1	42	84	126
	4.761	9.523	
	187	695	882
	21.201	78.798	

Table 8. Cross table CUMUL/RESDIR (after crisis)

	RESDIR		Total
CUMUL	0	1	
0	104	402	506
	17.687	68.367	
1	16	66	82
	7.993	29.081	
	120	468	588
	20.408	79.591	

Tables 7 and 8 provide that 21.201% (20.408%) of French managers studied in ENA or X-Mines of which 16.439% (17.687%) accumulate responsibilities.

Table9. Non-parametric test for relationship between ACTID, AGEDIR, CUMUL and RESDIR.

	Before crisis				After crisis			
	G1 (0)	G2 (0)	Z	sig	G1 (0)	G2 (0)	Z	sig
AGEDIR	321623	67780	1.785	0.0742	107671.5	65494.5	-0.684	0.494
CUMUL	344269.5	45133.5	4.121	0.000	153043.5	20122.5	2.967	0.0003
RESDIR	71675	317728	-3.659	0.0003	33100.5	140065.5	-1.419	0.156

It was identified that ACTID is not normal, therefore a Mann Whitney test was used to present the relationship between ACTID, AGEDIR, CUMUL and RESDIR.

Table 9 shows, before crisis, that CEO's stock ownership depends on manager's age. In fact, the manager who is under retirement age has more stocks than the manager who is below retirement age. CEO's stock ownership depends on manager's education. When manager has studied in National School of Administration or Polytechnic School, he has a lot of stocks. CEO's stock ownership depends, also, on responsibilities accumulated by manager. When manager is director of the board and CEO, he possesses a lot of stocks.

On the other hand, after crisis, the table shows that CEO's stock ownership depends only on responsibilities accumulated by manager.

5.2. Multivariate analysis

Table 10. Correlation matrix

	Before crisis					After crisis				
	ACTID	FCF	SIZE	ROA	ROE	ACTID	FCF	SIZE	ROA	ROE
ACTID	1					1				
FCF	0.066	1				0.043	1			
SIZE	-0.303	-0.06	1			-0.302	-0.085	1		
ROA	0.025	0.243	0.138	1		0.089	-0.166	0.238	1	
ROE	-0.006	0.189	0.233	0.728***	1	0.106	-0.165	0.271	0.782***	1

Note: ***signification 1%

Table 10 presents a correlation matrix between independent and control variables. It shows that for all relations, the coefficients are significant. Managerial entrenchment is positively and significantly related to free cash flow and return on assets, before and after crisis. However, managerial entrenchment is negatively and significantly associated with the size of the firm, in the two cases. On the other hand, CEO entrenchment is negatively and significantly related to return on equity after crisis. But, after crisis, CEO entrenchment is positive and significant related to return on equity.

Table 11. Results multivariate regression: Model 1

	Before crisis		After crisis	
	Coeff	p-value	Coeff	p-value
AGEDIR	-0.010	0.334	0.002	0.556
SIZE	0.019	0.000	0.010	0.000
ROA	-0.122	0.001	-0.216	0.002
ROE	-0.039	0.012	-0.007	-0.073
SEC	0.075	0.000	0.074	0.000
Constant	-0.078	0.005	0.038	0.074

It can be seen, in Table 11, that age of manager has no significant effect on level of debt, before and after crisis. The first hypothesis is thus rejected. It can be concluded that corporate leverage does not depend on age of manager (under or over retirement age).

Table12. Results multivariate regression: Model 2

	Before crisis		After crisis	
	Coeff	p-value	Coeff	p-value
CUMUL	-0.001	0.947	-0.038	0.005
SIZE	0.019	0.000	0.011	0.000
ROA	-0.118	0.001	-0.261	0.003
ROE	-0.038	0.014	-0.009	0.781
SEC	0.075	0.000	0.073	0.000
Constant	-0.081	0.004	0.023	0.286

From this table, it can be seen that CUMUL has a negative but not significant effect on the level of debt, before crisis. But CUMUL has a significant and negative effect on the level of debt, after crisis. From this, H1.2 can be confirmed only after crisis. When manager is CEO and director of board, he has power and can choose decisions concerning capital structure, so he tends to avoid debt to increase stockholder's control (Gul

and Wah, 2002).

Table13.Results multivariate regression: Model 3

	Before crisis		After crisis	
	Coeff	p-value	Coeff	p-value
ACTID	0.077	0.036	-0.092	0.000
SIZE	0.019	0.000	0.008	0.000
ROA	-0.110	0.002	-0.258	0.003
ROE	-0.040	0.009	-0.008	0.801
SEC	0.082	0.000	0.067	0.000
Constant	-0.094	0.001	0.076	0.002

Table 13 illustrates that the coefficient is positive and significant, before crisis. This positive relationship may be explained by the fact that the highly CEO ownership gives CEO more powerful incentives to make value-maximizing decisions about capital structure (Berger and al, 1997). In this case, debt is not an efficient control mechanism.

After crisis, it can be seen that CEO ownership is negatively and significant associated to leverage. These results corroborate those of Kammoun and Boujelbène (2012), who demonstrated that there is a negative relationship between CEO ownership and debt for American firms.

Table14.Results multivariate regression: Model 4

	Before crisis		After crisis	
	Coeff	p-value	Coeff	p-value
RESDIR	0.043	0.003	0.008	0.435
SIZE	0.019	0.000	0.010	0.000
ROA	-0.106	0.004	-0.272	0.002
ROE	-0.040	0.010	-0.001	0.972
SEC	0.073	0.000	0.072	0.000
Constant	-0.115	0.000	0.025	0.270

Table 14 does not confirm that managerial entrenchment is related negatively to debt. Indeed, a positive and significant coefficient was found between RESDIR and RATEND. These results corroborate those of Chapuis and Paquerot (2006). French CEO's who belong to relational network of older students of National School of Administration or Polytechnic School opt for debt. In fact, they have advantages when they borrow from big business bank because those banks are colonized by members of the same relational network.

It can be concluded that CEO entrenchment is positively related to debt before crisis. This result can be explained by the higher level of debt according to bank. In this case, debt is not an efficient control mechanism, but a way for CEO's to entrench and increase their power.

After crisis, it was found that CEO entrenchment is associated negatively with debt. It appears logical, because after subprime crisis CEO avoid financing debt. Moreover, banks are in bankruptcy and cannot lend as usual firms.

As for the control variables, and for all tables above, it was found that the coefficient of firm size is positive and significant before and after crisis. This reflects that larger firms have a higher level of debt. Concerning return on assets, tables show that the coefficient is negative and significant; but, return on equity is not all the time negative and significant.

Table15.Results multivariate regression: Model 5

	Before crisis		After crisis	
	Coeff	p-value	Coeff	p-value
ACTID	0.089	0.023	-0.091	0.000
FCF	-0.099	0.008	0.014	0.001
ACTID*FCF	-0.417	0.021	-0.002	0.923
SIZE	0.020	0.000	0.008	0.000
ROA	-0.904	0.016	-0.293	0.001
ROE	-0.033	0.034	0.010	0.762
SEC	0.061	0.001	0.065	0.000
Constant	-0.103	0.001	0.072	0.002

ACTID*FCF has a negative and significant effect on the relationship between CEO entrenchment and leverage, before crisis. After crisis, FCF has a negative but not significant effect on the relationship between CEO entrenchment and leverage. Hence, free cash flow moderates negatively the relationship between CEO entrenchment and leverage, only before crisis.

6. Conclusion

Using a sample of 98 French listed firms that belong to the Euronext Paris, over the period 2000 to 2014, it was found that CEO entrenchment positively affects debt before crisis. In other word, debt is not an efficient control mechanism; it is the CEO's choice (Zweibel, 1996; John and Litov, 2010). After crisis, the relationship is different and becomes negative. Indeed, banks have problems of liquidity so they decrease the level of debt according to firms.

The current finding also confirms that free cash flow can moderate negatively the relationship between CEO entrenchment and debt, before crisis. In fact, French managers choose to use firm's resources to invest in profitable projects.

This paper contributes to existing literature by studying the moderator effect of free cash flow on the relationship between CEO entrenchment and debt.

The results and implications of this research are subject to several limitations that suggest future research. Firstly, due to difficulties in collecting data, the sample size of the research is relatively small compared to their studies examining CEO entrenchment. Future research could be benefit from using a larger sample when data becomes more readily available. Secondly, the research did not include all factors that may influence the relationship between CEO entrenchment and debt. Thus, future research may include governance variable such as audit committee.

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