Chapter 11
Zero-Leverage in European Firms:
The Role of Corporate Governance Mechanisms on the Phenomenon

Flávio Morais
Department of Management and Economics, CEFAGE, NECE Research Center in Business Sciences, University of Beira Interior, Portugal

Zélia Serrasqueiro
Department of Management and Economics, CEFAGE, University of Beira Interior, Portugal

Joaquim J. S. Ramalho
Department of Economics, Business Research Unit, Instituto Universitário de Lisboa, Portugal

ABSTRACT

This study analyzes the zero-leverage phenomenon in a sample of European listed firms for the period 2001-2016, with a focus on the role played by the corporate governance mechanisms on the explanation of the phenomenon. Considering a set of internal and external corporate governance variables, it is rejected that firms with poor internal mechanisms of corporate governance have a greater propensity to adopt zero-leverage policies. Nonetheless, a great ownership concentration—measure for external corporate governance mechanisms—decreases the firm's propensity to be debt-free, indicating that the presence of large shareholders reduces managers' opportunistic actions. Results that partially validate that zero-leverage policies are driven by entrenched managers avoiding the disciplinary power of debt, especially in the presence of small shareholders without incentives and power to control managers' actions. Additionally, zero-leverage firms seem to substitute debt by internal sources of liquidity. Results are robust to different zero-leverage classifications and econometric methods.

DOI: 10.4018/978-1-7998-2136-6.ch011

INTRODUCTION

The beginning of this century is marked by the recognition that a considerable number of firms have extremely conservative debt levels, reaching in some cases ratios close to zero (Graham, 2000). The "*zero-leverage puzzle*" or the "*zero-leverage phenomenon*" refers to the growing trend of firms that have a mysterious zero leverage in their capital structure, becoming known after the contemporary study of Strebulaev and Yang (2013). The existence of debt-free firms contradicts the arguments of the dominant capital structure theories that claim the benefits of debt (Frank & Goyal, 2008). According to Frank and Goyal (2008) firms should use debt to obtain debt-tax shields (Modigliani & Miller, 1963) as well as to reduce agency conflicts between shareholders and managers (Jensen & Meckling, 1976; Jensen, 1986). The zero-leverage phenomenon is even more enigmatic considering that the decision of debt-free to lever up would enable firms to increase substantially their market value (Korteweg, 2010; Strebulaev & Yang, 2013). The existence of firms without debt has aroused the interest of the scientific community, being a fertile area for new researches (Takami, 2016).

Empirical studies about zero leverage were developed mainly in samples of US firms (Byoun & Xu 2013; D'Mello & Gruskin, 2014; Ferrão et al., 2016), with Strebulaev and Yang (2013) showing that, on average, around 10% of large US listed firms do not have any kind of short- or long-term debt in their balance sheets. Beyond the considerable number of debt-free firms, Devos et al. (2012) found that this is a persistent capital structure policy. Bessler et al. (2013) add the international and growing nature of the phenomenon, being more usual in common law than in civil law systems, highlighting the determinant role of country on the phenomenon. Also Dang (2013) and Takami (2016) are examples of the country effect on the phenomenon, the former showing that approximately 12% of UK listed firms correspond to debt-free firms, while Takami (2016) found a proportion of zero-leverage observations that even not reach 6% on Japanese listed firms. More recently, studies have been developed on emerging economies, such India (Ghose & Kabra, 2016) and China (Huang et al., 2017). Despite recognizing that zero leverage is a global phenomenon, Ghoul et al. (2018) show that it is more pronounced in developed and high-income countries.

Previous studies resort to the following arguments to explain firms' motivation to present zero leverage: i) financial constraints or credit constraints (i.e., zero leverage results from market impositions that implies rejection of credit to the firm); ii) financial flexibility (i.e., zero leverage is a result of a financial decision taken by the firm that opts to remain without debt to preserve financial flexibility); iii) equity financing (i.e., firms resort to equity issuances in an attempt to take advantage of the overvaluation of the firm in capital markets and thereby reduce debt); iv) macroeconomic and specific-country effects and v) managerial entrenchment and corporate governance structures (i.e., poor corporate governance mechanisms gives more power and control to the manager, increasing their propensity to reduce firm's leverage to protect their own private benefits). However, there is little consensus on the literature about the motives that explain zero-leverage policies.

To the best of the authors' knowledge, the effect of managerial entrenchment and the structures of corporate governance on zero leverage were analysed only in US samples by Byoun and Xu (2013), Devos et al. (2012) and Strebulaev and Yang (2013) and despite using similar samples of firms the studies end up, in part, by providing conflicting results. In an attempt to fill the previous gap this study focuses on the following research questions: *Does the zero-leverage phenomenon in Europe result from the firm's internal/external mechanisms of corporate governance?* and *Which are the alternative sources of finance that substitute debt in debt-free firms?* To answer this questions and provide empirical evidence