



The financial determinants of corporate cash holdings: Evidence from some emerging markets

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ABSTRACT

This paper investigates corporate cash holdings in developing countries. In particular, we look into the effect of capital structure and dividend policy on cash holdings in Brazil, Russia, India, and China and compare our results with a control sample from the US and the UK. Our sample contains 1992 firms across these countries for the period 2002–2008. We employ Instrumental Variables analysis to control for the endogeneity of the financial policies (cash holdings, capital structure, and dividend policy). Our results show some evidence that capital structure and dividend policy affect cash holdings. There are similarities between developed and developing countries on the factors determining corporate cash holdings. The results of our cross-country model provide evidence that capital structure, dividend policy, and firm size are important factors in determining cash holdings. Finally, we show that firms operating in countries with low shareholder protection hold more cash.

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1. Introduction

Ever since [Opler, Pinkowitz, Stulz, and Williamson \(1999\)](#) investigated the determinants of cash holdings, there has been growing interest in explaining why firms hold cash. In the UK context, [Al-Najjar and Belghitar \(2011\)](#) find that cash represents, on average, 9% of the total assets. [Dittmar and Mahrt-Smith \(2007\)](#), using US data, find that around 13% of total assets are cash and near-cash assets. Thus, cash represents a sizeable asset for firms.

The determinants of cash holding deserve investigation because cash holding has costs. Firms might hold cash to meet future contingencies but meanwhile, they may not invest in profitable projects, with positive NPV. High levels of cash may therefore indicate agency problems between firms' management and shareholders ([Jensen, 1986](#)). Another important cost of holding cash is the opportunity cost if firms are trading off their profitable projects to hold it.

According to [Scott \(1995\)](#), institutional factors are cognitive, normative and regulative structures that may affect firm's financial practices such as cash holdings. One of these factors is the socio-economic factor including laws, and actor's attitudes which is considered to be weak in many emerging markets relative to that in developed markets such as the US ([North, 1990, 2005](#)). This is likely to raise the level of uncertainty in transactions and consequently encourage a range of unproductive practices such as cash retention. Further, slow institutional development (i.e., stock market, bank, and other financial institutions) may motivate firms to adopt conservative financial practices ([North, 2005](#)). On the other hand, financial globalization driven by the International Financial Institutions has generated a consensus around the need to raise levels of confidence in transactions in the developing world and a tendency to adopt Anglo-Saxon conventions in this area

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(Kose et al., 2006). Thus, conflicting tendencies exist: national 'path dependency' and in international trend to institutional homogeneity. In this paper, we examine actual firm practice, which may reflect the influence of institutions in national settings but may equally be conditioned by global financialization and its institutional drivers.

We contribute to the literature by investigating the financial determinants of corporate cash holdings in developing countries, namely Brazil, Russia, India, and China, and compare the results with those based on developed markets: the UK and the US. This allows us to explore corporate cash holdings across countries with different institutional frameworks.

We employ both country specific analysis and static panel data estimations. We control for the endogeneity between capital structure, dividend policy and cash holdings. We use a different set of factors that can affect cash holdings for an updated period of time (2002–2008). Consequently, in this paper we shed more light on developing countries and then we develop a cross-country model to capture the financial determinants of cash holdings. To the best of our knowledge, this paper is among the first to concentrate on emerging markets (Brazil, Russia, India, and China). To do so, we use a large sample of 1212 non-financial firms listed in these countries.

The results of our analysis indicate that leverage, dividend payout, liquidity, profitability, and firm size impact cash holdings. We examine a cross sectional-time series model across the investigated countries and report that there are country effects on corporate cash holdings decision. The results of the cross-country model show that leverage, dividend payout ratios, and firm size affect cash holdings.

The remainder of this paper is organized as follows: Section 2 discusses the theoretical framework; Section 3 develops the hypotheses; Section 4 explains data and methodology; Section 5 highlights the results; Section 6 provides a common model for cash holdings, Section 7 demonstrates further analysis, and finally Section 8 concludes the study.

2. Corporate cash holdings: theory and empirical base

Here we provide the theoretical ground of cash holdings. In line with the previous literature we discuss the main theories of cash holdings (see, Opler et al., 1999; Ozkan & Ozkan, 2004). Then, we highlight the findings of the previous empirical studies.

2.1. Trade-off theory

Trade off theory argues that firms maximize their values by considering the marginal costs and marginal benefits of holding cash. Under the assumption that managers aim to maximize shareholder wealth, holding cash will bear the "cost-of-carry". This cost is related to the difference between the earnings from holding cash and the interest that firms will pay to fund additional cash (see, Dittmar, Mahrt-Smith, & Servaes, 2003). The benefits of holding cash are based on two motives: transaction minimization and precautionary motives. In relation to the former, it is suggested that firms stockpile cash when the rising-costs and the opportunity costs (related to cash deficits) are higher (Dittmar et al., 2003; Miller & Orr, 1966; Tobin, 1956). The precautionary motive, based on the effect of asymmetric information on raising funds, suggests that even if firms are able to raise funds from capital markets, they might be reluctant to do so because of market issues (for example if the market is under-pricing the planned securities to be issued). Ozkan and Ozkan (2004) further argue that firms raise cash levels to direct more financial resources into such investments when the costs of outside financing are explicitly high. Opler et al. (1999) ascertain the prevalence of an optimal level of cash where the marginal costs of cash shortage match the marginal costs of holding cash. Ferreira and Vilela (2004) argue that holding cash serves to reduce the probability of financial distress due to unexpected losses. Such firms stockpile cash levels as they are in a better position to direct these resources to investment plans, even if it is hard to obtain funds. Market imperfections are more severe in emerging markets compared to developed markets as well as bankruptcy related costs are significant in such markets, and hence trade-off theory can explain cash holding decisions in these markets. For example, the findings of Al-Najjar (2011) and Booth, Aivazian, Demirgüç-Kunt, and Maksimovic (2001) support this argument in emerging market context.

There are different proxies, as financial determinants of cash holdings, used by empirical studies to reflect this theory. For example, Al-Najjar and Belghitar (2011), following Ozkan and Ozkan (2004) and Opler et al. (1999) empirically investigate the trade-off theory from cash perspectives by employing leverage, dividend policy, firm size, risk, and asset liquidity. In the same vein, but using EMU data, Ferreira and Vilela (2004) also use liquidity, leverage, growth and size to empirically inspect this theory. We shed more light on the empirical evidence and our financial factors in Sections 2.3 and 3 below.

2.2. The pecking order theory

This theory suggests that there is no optimal level of cash holdings for a firm. Based on asymmetric information, Myers (1984) and Myers and Majluf (1984) suggest that firms follow a pecking order of financing to minimize costs related to information asymmetry. The order starts with internal sources and firms will use external sources, after the internal sources are exhausted. Myers (1984) proposes that firms favour external funding by debt compared to equity issuance, since debt has lower information costs than equity financing. Cash can be seen as an outcome of the different financing and investment decisions proposed by the hierarchal pattern of financing (Dittmar et al., 2003). Ferreira and Vilela (2004) claim that cash can be used for financing investments to pay firm's debt and in turn stockpile cash. Dittmar et al. (2003) also detect that firms with high level of cash flows are those to distribute dividends, apply for debt financing, and as a result hoard cash. Based on

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