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Customers and cash: How relationships affect suppliers' cash holdings

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ABSTRACT

If one customer accounts for a large portion of a supplier's sales, then the loss of that one customer can cripple the supplier's financial health. As a precaution against the additional operating risk induced by being in an important relationship with a customer, I find that suppliers in such relationships hold more cash on average than suppliers that are not in important relationships. Additionally, supplier's cash holdings increase proportionately with the importance of their customer relationships. Being in an important relationship affects cash holdings and leverage differently, indicating that firms manage cash and debt for different purposes. I find that suppliers in relationships primarily accrue cash through issuance of stock as opposed to debt or retained earnings. The results highlight the importance of understanding buyer–supplier relationships when evaluating a firm's financing policy.

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1. Introduction

Two recent trends in corporate business practices have contributed to an increase in both the prevalence and importance of buyer–supplier relationships. First, we have witnessed a decline in the vertical integration and industrial diversification of firms which has given rise to a host of new buyer–supplier relationships.[1] Simultaneously, instead of choosing a trading partner based solely on price, many American companies have shifted their overall business-to-business strategy to focus on a few key partners to create enduring trading relationships which encourage teamwork, foster innovation, and enhance product quality (Emshwiller, 1991). These long lasting relationships, based largely on implicit contracts, create both costs and benefits for the supplier. Despite the dramatic increase in both the prevalence and importance of relationships, there is little empirical evidence of how the costs and benefits of buyer–supplier relationships affect firm financial policy.

This paper investigates when and how buyer–supplier relationships affect one aspect of a supplier's financial policy, namely cash holdings. I hypothesize that suppliers in relationships should hold additional cash as a precautionary measure. If one customer comprises a large portion of the supplier's sales, then the loss of that one customer will result in a large adverse cash flow shock resulting in financial distress. Firms recognize and acknowledge the additional risk partnerships pose. For example, in their June 28, 2003 annual 10-K statement, Salton Inc. reported, “If we were to lose one or more of our major customers, our financial results would suffer.”[2] As a result, suppliers in relationships might hold additional cash as a precaution.

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[1] For papers which document the decline of vertical integration see Comment and Jarrell (1995), Denis et al. (2002), and Dimitrov and Tice (2006). In general, there has been a trend for manufacturers to relinquish direct control of their suppliers and establish looser forms of collaboration (Zingales, 2000).

[2] The statement continues, “We do not have long-term agreements with our major customers, and purchases are generally made through the use of individual purchase orders. A significant reduction in purchases by any of these major customers could have a material adverse effect on our business, financial condition and results of operations.”

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As predicted, I show that firms in important relationships do indeed hold more cash. Further, I find that as the importance of the relationship increases, measured by the percent of sales and sales concentration to important customers, so does a supplier's cash holdings. Quantitatively, the estimates imply that a one standard deviation increase in customer concentration is associated with an 8% increase in the cash ratio. To put this in perspective, a one standard deviation change in the R&D ratio used as a proxy for the relative cost of financial distress (Opler et al., 1999) is associated with a 7.5% increase in the cash ratio.

I find that the proportion of firms which reports having a major customer increases over time and that suppliers in relationships hold more cash on average than firms not in relationships. Therefore, the puzzle of the increase in overall cash holdings over time reported by Bates et al. (2009) may be partially explained by firm relationships.

My results are robust to proxies for the degree of relationship dependence such as supplier's industry, R&D spending, and industry Herfindahl–Hirschman Index. I find that regardless of the manufacturer's type the relation between customer importance and cash holdings is positive and statistically significant.

Further, the effect of a buyer–supplier relationship on cash holdings is distinct from the effect on (negative) debt. While only some suppliers in relationships maintain lower leverage (as shown by Banerjee et al. (2008), Kale and Shahrur (2007), and confirmed here), all suppliers in relationships hold additional cash. This is a unique and important finding given the traditional view of cash as negative debt.

This paper makes important contributions in several areas of corporate finance. First, the results contribute to understanding the determinants of corporate cash holdings. Bates et al. (2009), Haushalter et al. (2007), Opler et al. (1999), and Subramaniam et al. (2011) find that firms hold cash for precautionary reasons. My results compliment and extend this research by showing that even after controlling for the sources of risk previously documented firms hold additional cash specifically as a precaution against buyer-induced risk.

Additionally, I contribute to the ongoing discussion of when cash is distinct from negative debt (Acharya et al., 2007). Banerjee et al. (2008), Kale and Shahrur (2007), and Titman and Wessels (1988) all conclude that firms maintain lower leverage as a commitment to their buyers. The analysis reveals that the strategic motive of maintaining lower leverage as a commitment to buyers is markedly distinct from the precautionary motive for holding cash due to the risk posed by being in a significant relationship with a buyer.

Finally, this study contributes to the growing body of literature which investigates how corporate financial decisions are affected by strategic interactions between buyers and suppliers. To date researchers have examined the effect of inter-firm relationships the following factors, including sales, profit margin, transaction costs (Kalwani and Narayandas, 1995), distress costs (Hertzel et al., 2008), information transmission costs (Gomes-Casseres et al., 2006; Johnson et al., 2010a,b), bargaining power (Brown et al., 2009; Fee and Thomas, 2004), investment-cash flow sensitivity (Itzkowitz, 2012), and leverage (Banerjee et al., 2008; Kale and Shahrur, 2007; Titman and Wessels, 1988). Most recently, a working paper by Bae and Wang (2010) examined the effect on cash holdings. While I echo their general finding, this paper significantly furthers their work by showing why this is the case. By comparing the effects of a relationship on cash holding with the effects on leverage, this paper provides strong support for the precautionary motivation. Finally this paper bolsters Banerjee et al. (2008) and Kale and Shahrur (2007) findings that firms in major buyer–supplier relationships have a more conservative financing policy in two distinct ways. First, whereas the previous work focuses on debt management, I show effects on cash holdings. Second, for firms in relationships, I find that the motivation for additional cash holdings (precaution) is distinct from that of debt management (commitment).

2. Literature review and hypothesis development

2.1. Cash holding literature

There are a variety of theories which describe why a firm might hold cash. Recent empirical work indicates that corporate cash holdings may serve as a risk management tool (Bates et al., 2009). Cash used as a risk management tool can be especially valuable to firms with high external financing costs and large growth opportunities by reducing underinvestment problems (Brown and Peterson, 2011; Mikkelson and Partch, 2003; Opler et al., 1999). Used in this way, cash holdings provide benefits similar to the use of derivatives (Froot et al., 1993). Further, Haushalter et al. (2007) find that holding cash enables firms to successfully compete in product markets by allowing firms to fully invest in growth opportunities.

Recent literature also establishes that cash and negative debt are distinct specifically when a firm's hedging needs are high. Specifically, Acharya et al. (2007) and Gamba and Triantis (2008) provide evidence that cash holdings are distinct from maintaining low leverage and benefit companies by serving as a risk management tool. Confirming this theory in the case of lines of credit, Sufi (2009) documents that the 'material adverse clause' is invoked more often than assumed by the previous literature, thereby, denying liquidity to firms precisely when their need for liquidity is high.

2.2. Motivations for firms in relationships to hold cash

A firm has a major buyer then it depends on that one customer for a large percentage of its sales.[3] In most cases, major buyers buy goods based on very short-term purchase orders. And, while most relationships last for several years, they are based solely on implicit contracts. As a result, for the supplier, entering into a relationship with a major customer can be a double-edged sword. Benefits

[3] In line with regulation SFAS No. 131 a major (or principal) buyer is defined as a buyer representing more than 10% of a supplier's total sales.

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