

Is cash negative debt? A hedging perspective on corporate financial policies

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Abstract

We show theoretically that while cash allows financially constrained firms to hedge future investment against income shortfalls, reducing current debt is a more effective way to boost investment in future high cash flow states. Thus, constrained firms prefer higher cash to lower debt if their hedging needs are high, but lower debt to higher cash if their hedging needs are low. We provide empirical evidence that supports our theory. Our analysis points to an important hedging motive behind cash and debt management policies. It suggests that cash should not be viewed as negative debt in the presence of financing frictions.

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1. Introduction

Standard valuation models subtract the amount of cash in the firm's balance sheet from the value of outstanding debt in order to determine the firm's leverage. This practice reflects the view of cash as the "negative" of debt: because cash balances can be readily used to redeem debt (a senior claim), only net leverage should matter in gauging shareholders' residual wealth. The

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traditional valuation approach assumes that financing is frictionless and does not assign much of a relevant, independent role for cash holdings in the presence of debt obligations.

In contrast to the traditional view, a number of recent studies show that corporate liquidity is empirically associated with variables ranging from firm value and business risk to the quality of laws protecting investors.¹ These studies imply that cash holdings are a relevant component of the firm's financial structure. However, as pointed out by Opler et al. (1999), most of the variables that are empirically associated with high cash levels are also known to be associated with low debt. The findings that corporate cash holdings are related to variables such as value and risk—although relevant in their own right—cannot differentiate firms' policies regarding cash and debt. In effect, those findings cannot rule out the argument that firms regard cash as negative debt.

This paper proposes a theory of cash–debt substitutability in the optimal financial policy of the firm. We start from the observation that while standard valuation models assume that financing is frictionless, there is ample evidence to suggest that raising funds in the capital markets can be rather costly. Information and contracting frictions often entail high deadweight costs to external financing. And exposure to those costs may affect the way firms conduct their financial and investment policies (e.g., Gomes and Phillips, 2005 and Rauh, 2006a), giving rise to a “hedging motive” (Froot et al., 1993). Building on this argument, we develop a theoretical framework in which cash and debt policies are jointly determined within the firm's intertemporal investment problem. Among the innovations of our theory, we explicitly identify when cash is *not* the same as negative debt. We also characterize circumstances under which cash and debt policies can be used as effective hedging tools. Our study presents novel empirical evidence on the interplay between corporate cash and debt policies, identifying a hedging motive behind financially constrained firms' cash and debt management

Our model considers the process governing a firm's investment demand and the firm's ability to fund investment. We study a firm that has profitable investment opportunities in the future, but that faces limited access to external capital when funding those opportunities. Anticipating these constraints, the firm chooses its current financial policy so as to match up available funds to investment opportunities over time. To achieve this, the firm may boost its cash balances. The firm can do so by saving currently available internal funds or by issuing additional debt. Alternatively, the firm may save debt capacity by using current cash flows to reduce outstanding debt or by avoiding new debt issues. Higher cash stocks and higher debt capacity both increase the constrained firm's future funding capacity, hence the firm's ability to undertake new investment opportunities. Cash and (negative) debt can both be used to transfer resources *across time*.

We show, however, that cash stocks and debt capacity are not equivalent when there is uncertainty about future cash flows. To understand the key intuition, consider a firm that issues risky debt against future cash flows. Because cash flows are risky, the current value of debt will be largely supported by future states of the world in which cash flows are high (the value of debt is higher in high cash flow states). By issuing risky debt today the firm transfers value from future states with high cash flows to the present. By subsequently saving the proceeds from the debt issuance (hoarding cash), the firm channels funds into all future states, including those in which cash flows and debt values are low. In other words, issuing risky debt and keeping the proceeds in the cash account is equivalent to transferring resources from future states with high cash flows into future states with low cash flows. On the flip side, saving/building debt capacity over time is

¹ An incomplete list of papers includes Kim et al. (1998), Harford (1999), Opler et al. (1999), Dittmar et al. (2003), Almeida et al. (2004), Pinkowitz et al. (2005), Hartzell et al. (2005), and Faulkender and Wang (2006).

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