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The impact of recent financial shocks on the financing and investment policies of UK private firms

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ABSTRACT

This study examines how shocks to the supply of credit during the financial crisis of 2007–2009 affect the financing and investment policies of private companies in the United Kingdom. To investigate this issue we adopt a fixed effects model as our research methodology. Our final sample includes a total of 4973 firms. Our results highlight that the recent credit crisis has adversely affected the leverage ratio of private firms. This effect is most significant on short term financing channels such as short term debt and trade credit. As a consequence, private firms hold cash and issued equity for hedging the negative effect of credit contractions. However, no evidence was found on the issue of net debt issue or obtaining longer trade credit as substitutes for preserving their financial slack by the private firms. The results also revealed, that private firms did not scale back shareholder distribution in response to their financial difficulties. The results further highlight that credit contraction has negatively affected the performance and investment of private firms. Moreover, the increase in cash reserve and decrease in investment would suggest that firms may have raised funds through equity for managing their cash balances. Overall, the results highlight that financial and investment policies of private firms are susceptible to variations in the supply of credit and firms which are unable to find alternative sources of finance may bear a much larger cost compared to those who manage their financing more appropriately. Our findings have implications for the ongoing financial crisis as well as future policy designs by monetary and banking authorities.

1. Introduction

The recent financial crisis, which sparked as a result of problems in the subprime market in the United States, is regarded by many researchers as the most severe financial crisis since the Great Depression (see for example, Kahle & Stulz, 2010; Melvin & Taylor, 2009; Mian & Sufi, 2009). This crisis has affected not only financial markets and institutions, but also goods markets and consumers all over the world and has thus generated a global effect. It is thus well documented in some of the latest research papers that the 2007 US financial crisis has affected not only the stock market performance of the United Kingdom and Japan but also the stock market of emerging economies such as Malaysia and Indonesia (Majid & Kassim, 2009).

In the UK, the effect of the financial crisis can be seen from the increased number of defaults in the financial sector. The early victims of the crisis were Northern Rock, Bradford and Bingley, Alliance and Leicester, HBOS and Cheshire and Derbyshire, building societies. Northern Rock, for example, after receiving an emergency loan from the Bank of England in September 2007 eventually went into state ownership in February 2008. Alliance and Leicester was taken over by the Spanish bank Santander in July 2008. In the same way, HBOS was taken over by Lloyds TSB in September 2008. This was followed by the nationalization of Bradford and Bingley in September 2008. In the same year Cheshire and Derbyshire building society was also taken over by Nationwide in September 2008 (Hall, 2008, 2009).

The defaults and disruptions in the financial markets increased awareness of the significance of risk management on the part of financial institutions. As a result the willingness and ability of financial institutions to take risks in lending were reduced. There is also evidence that financial institutions' terms and conditions for the issue of credit became tighter (Campello et al., 2011; De Haas & Van Horen, 2009). These disruptions to the financial markets raised an important issue of the spill-over effect of the financial crisis into other sectors and the real economy.

In response to the crisis, a significant amount of research was undertaken by exploring the underlying causes of the crisis (Carmassi, Gros, & Micossi, 2009; Crotty, 2009; Murphy, 2008). In addition, other studies have focused on the impact and consequences of the financial crisis (Greenlaw et al., 2008; Mian & Sufi, 2009). However, evidence of the effects on firms' behaviour with respect to financing and investment decisions of firms is limited and the existing research literature has mainly concentrated on publicly listed large firms (see for example, Allen & Carletti, 2008; Duchin, Ozbas, & Sensoy, 2010; Tong & Wei, 2008, amongst others).

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Similarly, little attention has been paid to the effects of credit supply shocks on the financial and investment decisions of private firms,[1] for which the number of external sources of finance are limited. It is, however, well documented that small and medium size firms[2] are very important for economic growth, innovation, employment, revenue generation and technological advancement (Acs & Audretsch, 1990; Kotey & Meredith, 1997; Neck & Dockner, 1987). It is also important to note that SMEs represent more than 90% of enterprise and account for more than half of the labour force in the OECD countries (Lukacs, 2005).[3] Also, Brav (2009) highlights that private companies represent 98% of incorporated companies in the United Kingdom.

However, despite their significant role in the economic development of the global economy, research on private firms is limited. In this regard, Zingales (2000) argues that '*the emphasis on large companies has led us to ignore (or study less than necessary) the rest of the universe: the young and small firms, who do not have access to public markets*'. In line with this Daskalakis and Psillaki (2008) argue that non-listed firms represent a huge majority of the population of firms in developed and developing countries and need more emphasis from researchers. Similarly, Hall et al. (2000) report a lack of research on SMEs and highlight the role of such research in the economy. Bartholdy and Mateus (2011) argue that the degree of information opacity and funding sources between private and public firms is different due to which further research about understanding the behaviour of private firms is needed to add new insights.

Also, an in-depth review of the existing literature has revealed that few studies have examined the effect of credit supply shocks on firms' financing mix, performance and investment decisions. Most importantly, in the context of the recent financial crisis, few studies have focused on private firms (see for example, Allen & Carletti, 2008; Duchin et al., 2010; Tong & Wei, 2008) which may also signify the need for further research in this area. In addition, an in-depth examination of the findings of the existing literature, would reveal that the majority of these studies provide mixed and inconclusive evidence (Allen & Carletti, 2008; Bakke, 2009; Duchin et al., 2010; Leary, 2009; Lemmon & Roberts, 2010; Lin & Paravisini, 2010). This further highlights the need for more research in this area. In light of all the above-mentioned discussion we argue that the impact of the current financial crisis on the financing and investment decisions of private firms appears to have scope for a thorough investigation.

In addition to the above, we consider the United Kingdom for this investigation. This is because the majority of published studies have considered the United States (see for example, Chava & Purnanandam, 2011; Duchin et al., 2010; Lemmon & Roberts, 2010; Lin & Paravisini, 2010). This may be due to the size of the US economy and the existence of a large body of researchers based in US academic institutions. However, it is also evident to argue that the United Kingdom being the sixth largest economy in the world with unique institutional features and financial reporting requirements for private firms also needs investigation. In addition, institutional differences such as the insolvency code, tax system and ownership structures (see for example, Beattie et al., 2006; Dahya & Travlos, 2000; Franks et al., 1996; Kaiser, 1996; Rajan & Zingales, 1995) between the US and the UK, further justify the need for this research as an alternative source of evidence.

This study therefore, investigates the financial and investment behaviour of private firms during the recent financial crisis of 2007–2009 in response to shocks to the supply of credit in the UK. To pursue such an investigation this study is making an in-depth analysis of the shock to the supply of credit and its effect on the leverage of private firms and tries to determine those components of capital structure which are affected most by credit supply contractions. The purpose of examining the components of capital structure individually is to comprehend the exact channel(s) through which credit supply shocks travel. It will also help to understand better the extent of substitution across credit sources. We also investigate how private firms managed their finances during the crisis period. In other words, we investigate how private firms minimize the effect of credit contractions by resorting to alternative sources of finance such as internal funds, net debt issue, net trade credit and net equity issue. Finally, we investigate the effect of credit contractions on the performance and investment behaviour of private firms in the UK.

Investigating the effect of credit contractions on firm behaviour is important for two reasons. First, variations in the supply of credit may affect the financial and investment behaviour of firms, which is independent of any monetary policy shift (Duchin et al., 2010; Leary, 2009; Lemmon & Roberts, 2010; Voutsinas & Werner, 2011). This has clear policy implications. It will also help to better understand how firms managed their financing and investment decisions during the crisis period. From another perspective, it may be helpful in diminishing the controversies in the existing literature on the above issues and would aid future researchers in this area. Second, there are differences in views about whether the firm's financing decisions tend to be governed by users' demand for capital or preferences of the supply of capital (Graham & Harvey, 2001; Titman, 2002). However, the main challenge in estimating the effect of credit supply shocks on firms' financial and investment behaviour arises from clearly disentangling the credit supply effect from the endogenous demand effect (Chava & Purnanandam, 2011; Gan, 2007). The simultaneity of corporate financing and investment decisions makes it a difficult task to identify clearly the supply shocks. To respond to this challenge, our identification strategy has three elements that helped to address this problem.

The three elements are: identification of exogenous variations in the supply of credit; the use of the firm fixed effects model; and the use of firm level control variables. In addition, we also conduct a number of robustness checks to validate our results. The results show that the financial crisis has adversely affected the financial and investment decisions of private firms. It is also found that firms increase their cash balances and issue private equity in response to exogenous credit contractions. In addition, the crisis has negatively affected the investment strategies and operating performance of the sample companies. The rest of the paper is organized as follows. Section 2 presents a review of previous literature. Section 3 explains the research methodology and data, followed by a discussion of the results in Section 4. Section 5 concludes the paper by presenting a summary of the main findings of the study.

2. Previous literature

2.1. Financial crisis and firm's leverage

It is generally argued that private firms are characterized by high information asymmetry and control considerations (Brav, 2009; Michaelas et al., 1999a). Therefore, moral hazard and adverse selection problems may be high in these firms (Michaelas et al., 1999a). Also, the theory of credit rationing suggests that adverse selection and moral hazard problems result in credit rationing in the loan market (see for example, Stiglitz & Weiss, 1981). Similarly, because of information asymmetry the cost of external finance is also high for such firms (Berger & Udell, 2002). These problems may further worsen during an economic downturn (Michaelas et al., 1999a) which suggests that the financing mix and investment in private firms may be vulnerable to credit supply shocks.

[1] In the context of this study, private firms are defined as those firms whose shares are not traded on a stock exchange.

[2] The majority of SMEs are non-listed firms (Hall, Hutchinson, & Michaelas, 2000). They are normally unquoted/unlisted firms classified as private firms.

[3] According to the OECD's (2009) report SMEs account for over 99% of all enterprises in the European Union.