Determinants of Corporate Cash Policy

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Sunday July 7, 2013 at 10:24 am

Editor’s Note: The following post comes to us from Huasheng Gao of the Division of Banking and Finance at Nanyang Business School; Jarrad Harford, Professor of Finance at the University of Washington; and Kai Li, Professor of Finance at the University of British Columbia.

In our paper, Determinants of Corporate Cash Policy: Insights from Private Firms, forthcoming in the Journal of Financial Economics, we exploit a database of private firms to help understand public firms’ cash policies. It is worth noting that the cash policy of private firms in itself is of great interest to financial economists due to a lack of data prior to our study. Further, the contrast between public and private firm behavior in cash management serves as cross-validation of prior research on cash policies using only public firms. We expect that the variation in agency conflicts across these two groups of firms is likely to be at least as substantial as the variation within public firms. Further, differences across these two groups of firms in financing frictions allow us to explore the relative importance of these two effects on cash levels, the speed of adjustment to target cash, and the dissipation of excess cash.

Using a sample of public and private U.S. firms over the period 1995–2011, we first show that, on average, private firms hold about half as much cash as public firms do. This is despite the fact that they arguably have less access to external financing and would be expected to have a stronger precautionary motive due to financing frictions. Even controlling for standard factors affecting cash reserves, we find that the effect of agency costs from being public, net of the reduced effect of financing frictions, still leads public firms to hold cash reserves that are approximately 4% of assets higher than are those of similar private firms.

Next, we examine how excess cash influences firm investment and performance across these two groups of firms. As compared to private firms, public firms tend to spend excess cash via investment in a myopic way and in ways that reduce firm operating performance. These results suggest that more severe agency problems make public firm managers spend excess cash in a less efficient way. We find consistent evidence for well- versus poorly governed public firms. By increasing investment, poorly governed public firms have a higher speed of adjustment away from excess cash than do well-governed public firms.

Taken together, our evidence allows us to reconcile mixed conclusions in the extant literature by viewing them in the context of a classic Miller and Orr (1966) inventory model allowing for agency conflicts. Agency problems affect both the target level of cash and the actions taken when a firm has excess cash (i.e., hits the upper bound of the inventory model). Between private and public firms there is a large increase in agency problems. The result is that managers, who prefer more freedom from external monitoring, hold more internal slack. The target cash level (from the manager’s perspective) increases. Thus, the average public firm holds more cash than the average private firm. However, governance quality still varies in public firms, and it affects what a firm does when it hits the upper boundary. Even well-governed firms will find themselves with excess cash. This is a natural consequence of being profitable, not overinvesting, and adjusting payout policy with a lag. Well-governed public firms will react to excess cash by paying out or reducing leverage. Poorly governed public firms will simply convert the cash into different assets (thus, not
shrinking the firm), by investing and acquiring. The difference is that poorly governed firms tend to make large investments with excess cash, while well-governed firms reduce leverage, but not in huge amounts. The net result is that poorly governed firms bounce down from the boundary much further than well-governed firms (resulting in the observation that within public firms, they have less cash on average), and also appear to adjust toward their cash target faster from excess cash. This is simply because they spend excess cash at a greater rate than well-governed firms distribute it. All of the extant results as well as our new results fit consistently within this framework.

Our inferences are vulnerable to selection concerns, so we take a multi-pronged approach to addressing them. First, we apply a treatment regression approach to addressing the selection issues that companies may choose to stay public or private. We find that the differences in the level of cash holdings are even greater between public and private firms after controlling for selection. Second, we implement propensity score-matching based on several sets of observable firm characteristics, and show that the level of private firms’ cash holdings is significantly lower than that of their propensity score-matched public peer firms, as observed in the full cross section. Finally, we employ a transitioning sample involving secondary initial public offerings (IPOs) where firms change their private status but do not receive proceeds from the offering. We find that the level of cash holdings increases significantly post-IPO for the transitioning firms relative to their matched public and private firm control samples.

Our study contributes to the literature by being one of the first to examine the cash policies of private U.S. firms and by using that sample to establish a conservative estimate of the effect of agency costs on cash holdings. Our ability to speak to big-picture questions of financing frictions and agency costs (with the somewhat surprising finding that private firms hold less cash) and to reconcile conflicting extant evidence is the real distinction of our paper from others. Previous investigations of the issue have been limited to using data on public firms only. For example, Dittmar, Mahrt-Smith, and Servaes (2003) show that one would expect U.S. firms to hold less cash than firms in countries with weaker investor protection, and we extend that by showing that even given better investor protection, U.S. firms still hold more cash than they would if their agency costs were mitigated by being private. We also show that despite the evidence that financing frictions such as the cost of external financing are greater for private firms, the effect of agency conflicts is strong enough to lead to much higher cash holdings in public firms. Finally, we provide an interpretation of the evidence that reconciles these and extant findings that within public firms, better-governed firms hold more cash on average.

The full paper is available for download here.

1 Comment

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