Financial Flexibility and Corporate Cash Policy

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Summary

As the amount of cash US firms hold on their balance sheets has grown, so has interest in how they manage liquidity and access to capital. Debt capacity creates financial flexibility and collateral-based debt capacity is the least sensitive to cash flow shocks. Using variation in real estate prices as exogenous shocks to corporate financing capacity, we investigate the causal effects of financial flexibility on firms' cash policies.

We find strong evidence that increases in debt capacity lead to smaller corporate cash reserves. The representative US public firm holds 14 cents less of cash for each additional $1 of collateral over the 1993-2007 period. We further find that the decrease in cash holdings is more pronounced in firms with higher hedging needs, greater investment opportunities, financial constraints, better corporate governance and lower local real estate price volatility. We also find that, following exogenous shocks to collateral value, the marginal value of cash decreases. Quantitatively, a high real estate-holding firm's value of a marginal dollar of cash is approximately 22% lower than that of an otherwise similar firm.