

FINANCIAL FLEXIBILITY AND INVESTMENT DECISIONS: EVIDENCE FROM LOW-LEVERAGE FIRMS

Abstract

This paper analyzes the effects of financial flexibility on firm investment. Taking as a starting point the recent survey evidence on the determinants of capital structure, we investigate the hypothesis that a low-leverage policy directed at maintaining flexibility can affect company investment. We classify financially flexible firms as those that follow a low-leverage policy for at least two or three years. Low leverage is defined according to deviations from target that are, in turn, modelled through a partial adjustment model and estimated via GMM-SYS. Robustness checks are also performed using a classification of firms based on the distribution of leverage. Our analysis reveals that the low-leverage policy is a transitory one. Following a period of low leverage, financially flexible firms are able to make significantly more capital expenditures. In addition, we also detect a considerable increase in abnormal investment (spikes). Further evidence indicates that the new investments are financed through new issues of debt that take companies closer to their estimated target leverage. There is no evidence to indicate that these investments are financed through equity issues. Finally, this strategy appears value enhancing, as indicated by an increasing market to book ratio. Numerous robustness checks are performed in several directions and corroborate the results. When we analyse the data over a long time series, we are able to show that, in fact, the firms identified as financially flexible have a long-term financing pattern which is more consistent with the trade-off theory. In other words, it seems that their capital structures revert back, after an abnormal investment, to those levels of leverage that preceded the accumulation period of borrowing power. Furthermore, we show that firms classified as financially flexible appear to be less exposed to financial constraints, as indicated by the lower estimated coefficient of cash flow in the investment equation.

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Keywords: financial flexibility, investment, low-leverage, cash flow sensitivity, endogeneity