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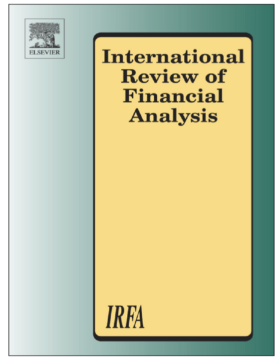

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Does derivatives use reduce the cost of equity?

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Abstract

This paper examines the impact of hedging on the cost of equity capital. Using hand-collected data on derivatives use for a sample of German non-financial firms, we find that user firms have a 109 basis point lower industry-adjusted cost of equity than non-users. This reduction in the cost of equity of users is attributable to their lower market, size, and value risk factor exposures. The observed negative relation between derivatives use and the cost of equity remains robust to specifications that account for potential endogeneity arising from a firm's derivatives hedging and capital structure decisions. We find that the reduction in the cost of equity is largest for smaller firms and for firms making use of foreign currency and interest rate derivatives. Moreover, new derivatives users experience a significant reduction in the cost of equity in the first year of adoption. Finally, using expected default frequency data, we show direct evidence that firms' derivatives use reduces financial distress risk.

JEL Classification: G12, G13, and G32

Keywords: Derivatives, Risk management, Asset pricing, Financial distress risk.

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