

Accepted Manuscript

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PII: S0929-1199(15)00127-3
DOI: doi: [10.1016/j.jcorpfin.2015.10.006](https://doi.org/10.1016/j.jcorpfin.2015.10.006)
Reference: CORFIN 972

To appear in: *Journal of Corporate Finance*

Received date: 18 December 2014
Revised date: 23 September 2015
Accepted date: 13 October 2015



Please cite this article as: Guariglia, Alessandra, Yang, Junhong, A balancing act: Managing financial constraints and agency costs to minimize investment inefficiency in the Chinese market, *Journal of Corporate Finance* (2015), doi: [10.1016/j.jcorpfin.2015.10.006](https://doi.org/10.1016/j.jcorpfin.2015.10.006)

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A balancing act: managing financial constraints and agency costs to minimize investment inefficiency in the Chinese market

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Abstract

Using a large panel of Chinese listed firms over the period 1998-2014, we document strong evidence of investment inefficiency, which we explain through a combination of financing constraints and agency problems. Specifically, we argue that firms with cash flow below (above) their optimal level tend to under- (over-)invest as a consequence of financial constraints (agency costs). Furthermore, focusing on under-investing firms, we highlight that the sensitivities of abnormal investment to free cash flow rise with traditionally used measures of financing constraints, whilst for over-investing firms, the sensitivities increase with a wide range of firm-specific measures of agency costs.

Keywords: Under-investment; Over-investment, Free cash flow; Financial constraints; Agency costs; China

JEL classification: G31; G32; O16; O53

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