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How creditor rights affect the value of cash: A cross-country study

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ABSTRACT

We examine how legal protection of creditors affects the value of cash across countries. We find that the marginal value of cash is considerably higher in countries with weak creditor rights. Creditor rights are at least as relevant as shareholder rights, which other studies have found to be an important factor affecting various corporate policies. In addition, we find that marginal investment is more valuable for firms in countries with weak creditor rights. This combines the findings of previous studies that weak creditor protection makes firms financially constrained and that cash is more valuable for financially constrained firms. Subsample analysis suggests that financial constraints generated by weak creditor rights create underinvestment among cash starved firms but alleviate agency conflicts among cash rich firms. Further analysis reveals that good country governance complements laws protecting creditors in cash valuation.

1. Introduction

The international cash valuation literature has focused mainly on investor protection from the perspective of shareholders and has found support for principal–agent theories of cash valuation (e.g., Frésard and Salva, 2010; Pinkowitz et al., 2006). In addition, previous research has shown that debt is an important form of external funding used by publicly listed companies to fund investments. For example, Leary and Roberts (2005) document that United States firms issue debt twice as often as equity, and that the average debt issue is more than twice the size of equity issues. The contribution of this paper is to investigate how investor protection from the creditors' point of view affects the value of cash.

In this study, creditor rights refer to the laws of a country that provide protection for creditors in the event of default. With strong rights, creditors can more easily seize collateral, force repayment, or even gain control of the firm. Creditor rights is a measure of creditor power and, according to economic theory, is one determinant of how much private credit a financial system will extend to firms (Djankov et al., 2007). These power theories of credit, based on the transfer of control rights upon default (Aghion and Bolton, 1992; Hart and Moore, 1998), also imply that when creditors have stronger rights, they will extend debt on more favorable terms. Moreover, a recent theoretical model by Almeida et al. (2011) can also accommodate debt financing that is constrained by the protection of outside creditors, and that the cost of external financing declines as the level of creditor protection increases. Consistent with these models, Qian and Strahan (2007) provide cross-country empirical evidence that bank

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loans tend to be cheaper and have longer maturities in countries with stronger creditor rights. Therefore, financial constraints are likely to be higher in countries in which legal rules designed to protect creditors are weak.

The role of corporate liquidity in providing financial flexibility has received increasing attention in the corporate finance literature (e.g., Denis, 2011). The major advantage of a liquid balance sheet is that it allows firms to fund value-increasing investment projects when external sources of funds are not available or are excessively costly, i.e. when firms are financially constrained. This perspective emphasizes the hazardous nature of financial constraints as a source of underinvestment and the positive role of cash in resolving this underinvestment problem. The positive relation between financial constraints and the value of cash is established theoretically and empirically by Faulkender and Wang (2006), and is explained in more detail by Denis and Sibilkov (2010). However, both of these studies only use data from the United States which means that the legal and institutional framework of the country is constant.

On the other hand, the downside of liquidity is that self-interested managers could waste cash on value-decreasing projects when minority shareholders are not adequately protected (Jensen, 1986; Myers and Rajan, 1998). This theoretical premise has been emphasized in previous studies of international cash valuation that focus on investor protection from the perspective of shareholders. However, it is not only shareholder protection but also financial constraints that can potentially reduce the empire-building tendencies of corporate insiders (Luo, 2011). According to this bright side view, financial constraints may have a positive role because they provide incentives for corporate insiders to use cash holdings less opportunistically.

Both the dark side and bright side views of financial constraints lead to our main hypothesis: the value of cash is greater when legal protection of creditors is weaker. We empirically test this hypothesis by using Worldscope data from 48 countries that span from 1990 to 2008. The final sample consists of 131,592 firm-year observations. Using the creditor rights index of Djankov et al. (2007), we find that the marginal value of cash is substantially higher for firms in countries with weak creditor rights than in countries with strong creditor rights. The most influential components of creditor rights appear to be the rights of replacing management in the process of bankruptcy and repossessing collateral. The results also indicate that marginal investment is more valuable for firms in countries with weak creditor rights. In addition, the results indicate that weak creditor rights increase the value of cash both among cash poor and cash rich firms, which is consistent with both the dark side and bright side views on financial constraints. We also find that good country governance is needed for laws protecting creditors to be effective.

Our study contributes to the literature on the determinants of the valuation of corporate cash holdings by showing that the marginal value of cash declines with stronger creditor rights. In particular, we extend studies examining cross-country differences in the marginal value of cash by demonstrating that country-level creditor protection generates differences in the marginal value of cash across firms through what we contend to be its effect on financial constraints. Our findings are also related to the emerging view in the literature that cross-country differences in creditor rights influence a host of firm policies, ranging from cash holdings (Ferreira and Vilela, 2004; Seifert et al., 2012), and corporate payout (Brockman and Unlu, 2009) to corporate risk-taking (Acharya et al., 2011).

In the broader context, this paper is related to studies that examine the effect of firm-level credit-related supply side factors in determining corporate finance decisions such as investments and their financing. For example, earlier studies find that debt covenants are related to firms' investment policies (Nini et al., 2009) and capital structure (Roberts and Sufi, 2009). Moreover, Faulkender and Petersen (2006) report that firms that have access to bond markets have significantly more leverage.

Finally, Almeida et al. (2004) show that firms should respond to financial constraints by saving more out of cash flow. Kusnadi and Wei (2011) find support for this prediction by documenting that those firms in countries with strong legal protection for investors (less financially constrained firms) display a smaller cash flow sensitivity of cash than firms in countries with weak legal protection of investors. We note that although theory predicts that financially constrained firms should hold more cash, Denis and Sibilkov (2010) show that some financially constrained firms appear to hold relatively low levels of cash due to low and declining cash flows. Our results suggest that some financially constrained firms are unable to hold enough cash due to weak creditor protection while others are made more efficient by the threat of more expensive credit.

The rest of the paper proceeds as follows. Section 2 develops our hypotheses. Section 3 describes the data and methodology. Section 4 presents and discusses our results. Finally, Section 5 concludes.

2. Hypotheses development

In perfect capital markets of Miller and Modigliani (1961) firms can always borrow to finance their profitable investment opportunities. However, with financing frictions, there can be some states of the world in which firms are constrained from undertaking valuable projects (e.g., Almeida et al., 2011; Denis, 2011; Kaplan and Zingales, 1997). A financially constrained firm is one whose investments are distorted from its first-best level due to costly external financing (Almeida et al., 2011). In a survey, Campello et al. (2010) asked chief financial officers whether their firms are financially constrained, by inquiring whether their companies have been affected by the cost (price constraint) or availability (quantity constraint) of credit. They document that financial constraints impact corporate behavior by affecting firms' spending plans in areas such as technology spending, employment and capital spending. They also report that the inability to borrow externally caused firms to bypass positive net present value (NPV) projects.

Our hypotheses are based on earlier theoretical and empirical findings that weak creditor rights aggravate financial constraints. Creditor rights are determined by the bankruptcy and reorganization laws of a country in which debt has been granted. These rights confer creditors power, for example, to gain control of a firm or seize collateral when a firm fails to make promised interest and principal payments. Theories of debt based on incomplete contracts and the transfer of control rights upon