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Product market competition and the value of corporate cash: Evidence from trade liberalization ☆

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ABSTRACT

This paper uses the 1989 Canada–U.S. Free Trade Agreement as a source of exogenous variation in product markets to establish the impact of increased competition on the market valuation of corporate cash reserves. I find that the trade liberalization leads to a significant increase in the value of cash for firms experiencing a larger shock to their competitive environment. The impact of the trade liberalization is stronger among firms that face greater risk of losing investment opportunities to rivals. I also show that these inferences about the valuation effect of competition apply more broadly to a large sample of firms.

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1. Introduction

It is widely recognized that important corporate decisions are fundamentally affected by competition in product markets. In particular, finance scholars have shown that the nature of product market competition influences firms' financing and investment choices and, therefore, their cash flows (e.g. Haushalter et al., 2007; Xu, 2012). Hou and Robinson (2006) and Hoberg and Phillips (2010) further document a significant effect of competition on the riskiness and market valuation of these cash flows. To date, however, relatively little is known how competition affects the market valuation of important corporate policies, such as cash management. This is a surprising gap in the literature given a tremendous increase in cash holdings of firms in the U.S. over the last three decades and the massive value gains or losses to investors that can result from firm cash management choices (e.g. Bates et al., 2009). Over that same period, firms have experienced a significant increase in the intensity of competition due to globalization of business activity, reductions in trade barriers, and technological progress. Therefore, it is important to understand the effect of increased competition on the contribution of cash holdings to firm value. The goal of this study is to examine whether and how *changes* in the intensity of competition faced by firms affects the value of their cash holdings.

To establish a convincing link between competition and the value of cash, however, a researcher needs to deal with the fact that many commonly used proxies for competition, such as industry-level concentration ratios or profit margins, are difficult to

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interpret due to the endogeneity of industry structure to firms' chosen financial and investment policies (Schmalensee, 1989). I attempt to deal with this endogeneity problem by using the Canada–United States Free Trade Agreement (FTA) as a source of an exogenous change in firms' competitive environment. The FTA came into effect in 1989 and involved substantial reductions in tariffs and other trade barriers between the two countries, and thus significantly reduced entry barriers into a large number of industries. As discussed by Trefler (2004), the FTA represents a clearly defined trade policy experiment which was exogenous to individual companies and was not driven by changes in economic climate or political climate. As a result, this trade agreement plausibly represents a substantial exogenous shock to firms' competitive environment and allows me to assess the *causal* impact of increased competition on the value of cash. I further exploit the cross-sectional differences in the impact of the competitive shock across firms based on their exposure to trade with Canada. Specifically, my empirical analysis isolates the effect of the trade agreement by studying its *differential* impact on the value of cash across firms, based on the degree to which firms were protected by tariffs on Canadian imports prior to the agreement. The identifying assumption of this empirical strategy is that firms that experience larger import tariff reductions as the result of the FTA (and thus greater decline in entry barriers into their industries) should be exposed to a greater increase in foreign competition.

Using a large panel data that spans the period from 1984 to 1995, I conduct difference-in-differences tests, in which I compare the market valuation of cash reserves before and after the trade liberalization (first difference) for firms experiencing relatively large versus small tariff cuts due to the FTA (second difference). I find a significant value impact of an increase in competition due to the decline in tariffs. Following the trade liberalization, the value of an additional $1 of cash increases, on average, by $0.59 more for firms that experience relatively large tariff cuts due to the FTA relative to the value of cash for firms that experience smaller tariff cuts. This effect is estimated controlling for all other factors that may affect the marginal value of cash as well as firm and year fixed effects that account for permanent unobserved firm heterogeneity and economy-wide factors. To reduce concerns about reverse causality, I trace out the timing of the effect of the trade liberalization and find that its effect manifests only two years after the passage of the agreement.

It is important to note that the FTA eliminated U.S. tariffs on Canadian imports as well as Canadian tariffs on U.S. exports and thus increased growth opportunities for U.S. firms. I examine the effects of increased market expansion opportunities and find that the reductions in Canadian tariffs on U.S. exports have no significant effects on the value of cash. Overall, the results point to the positive and *causal* effect of increased competition in firms' product markets due to the trade liberalization on the value of firms' cash reserves.

After establishing the average valuation effect of increased competition, I next attempt to understand the mechanism through which changes in competitive environment impact valuation. To do so, I turn to theories of predation or competitive threats and agency conflicts for the insight into the links between competition and the use of corporate cash (which ultimately determines its value to investors). Predation threat-based theories stress the strategic role that cash reserves play in ensuring a firm's ability to successfully compete in product markets. For instance, Bolton and Scharfstein (1990) and Froot et al. (1993) show that a firm's stockpile of cash provides an important source of flexibility in product markets because cash allows the firm to effectively counter possible predatory threats by their rivals or to even prevent entry of new competitors. The predation threat view thus implies that a rise in foreign competition will increase the value of corporate liquidity through an increase in the level of competitive threats faced by firms in their product markets.

In contrast, the agency-based theories suggest that stockpiles of cash can exacerbate agency conflicts at the firm by providing self-interested managers with discretionary funds to undertake suboptimal investment (e.g. Jensen, 1986). Dittmar and Mahrt-Smith (2007) show that investors indeed discount the value of cash reserves in firms run by potentially entrenched managers. Economists have long argued that the competitive pressure from product markets serves as a powerful tool to mitigate agency problems. Tougher competition enforces discipline on managers to reduce inefficiency, or else be driven out of business. The agency-based view thus implies that a rise in competition will increase the value of corporate cash by reducing the discount associated with the agency problem of cash holdings.

Although the two theories are observationally equivalent with respect to the impact of increased competition on the value of cash, their predictions on the specific mechanisms through which competition impacts valuation are different. Specifically, the predation risk view predicts that the impact of the trade reform on the value of cash will be stronger among firms that share a larger proportion of their growth opportunities with existing rivals and thus have more to gain by using their cash to combat new product market threats. In contrast, the agency view suggests that an increase in competition will have a stronger impact on the value of cash among firms that have weaker governance mechanisms in place and thus have more to gain from a disciplining effect of increased competition.

To determine the relative merits of these competing explanations, I conduct two sets of tests. I first test whether the effect of the FTA-mandated tariff reductions on the value of cash varies systematically with the firms' exposure to predation threats and the severity of agency problems before the event. The idea here is that one can study the heterogeneity of changes in the value of cash across firms to understand which mechanism, on average, is considered to be more important by the market. I find that the large FTA tariff reductions have a stronger impact on the value of cash for firms facing greater predation threats, as measured by proxies for the interdependence of their growth opportunities with rivals. In contrast, I do not find that the impact of the trade liberalization is stronger among firms with weaker governance, as measured by proxies for the presence of large institutional monitors.

In the second test, I look whether firms change the use of their cash reserves for investment purposes following the trade liberalization. The predation and agency views imply that an increase in competitive pressure will potentially have two opposing effects on the use of cash for investment. One possibility is that firms spend more of their cash reserves on investment in an attempt to counter increased competitive threats from foreign rivals or deter entry. Alternatively, if competition enforces discipline on opportunistic managers, firms may cut wasteful spending when faced with growing competitive pressure. I find that firms with a greater increase in competitive pressure (i.e. firms with larger FTA tariff reductions) spend more of their cash

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