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The value of corporate financial flexibility in emerging countries

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ABSTRACT

Using a sample of firms from 33 emerging countries, we find evidence that corporate financial flexibility enhances investment ability and reduces the sensitivity of investment to cash flow. In addition, financial flexibility reduces equity payout and increases cash holdings. The effects of financial flexibility on investment ability and financial policies are elevated during the global financial crisis of 2007–2009. Our results also show that financial flexibility adds to firm value, particularly during the financial crisis. Financially flexible firms suffer less from negative shocks. We find that financially flexible firms had smaller cutbacks in investment expenditures and equity payouts and suffered less in operating performance than never financially flexible firms during the global financial crisis.

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1. Introduction

External financing decisions are major challenges for firms in emerging countries. One important reason is that capital markets are relatively underdeveloped in emerging economies. An issue that particularly affects firms seeking external financing in emerging countries is the high volatility of

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capital flows in these countries (Bekaert and Harvey, 2003; Demir, 2009; Guo and Stepanyan, 2011; Agosin and Huaita, 2012). There is evidence that volatile capital flows restrain the supply of capital and bank credit in emerging economies (Guo and Stepanyan, 2011). A large literature also stresses the disastrous effects of freewheeling capital has had through severe financial crises in Mexico in 1995, Asia in 1997 and Russia in 1998 (Claessens et al., 2001). As a consequence, it is likely that the quest for financial flexibility is exceptionally important in corporate financing decisions in developing countries. Financial flexibility is desirable because financial economists suggest that financially flexible firms are more capable of overcoming the adverse effects of negative exogenous shocks than non-flexible firms (Gamba and Triantis, 2008). Researchers have long considered financial flexibility a missing link in capital structure research as firms on average have less leverage than the dominant theories predict (DeAngelo and DeAngelo, 2007). Surveys of corporate CFOs also suggest that attaining financial flexibility is one of the most important goals in corporate financing decisions (Graham and Harvey, 2001; Bancel and Mittoo, 2004).

Empirical research on corporate financial flexibility in developed economies is scant (Marchica and Mura, 2010; de Jong et al., 2012; Rapp et al., 2014). Similar research on firms in emerging countries is even less. Arslan-Ayaydin et al. (2014) examine 1068 firms from five East Asian countries. They measure financial flexibility by a firm's total leverage and/or cash holding and find that financially flexible firms are more capable in terms of investment ability and perform better than less flexible firms during the Asian financial crisis of 1997–1998. Ferrando et al. (2014) measure financial flexibility by a firm's unused debt capacity; they find that financial flexibility enhances corporate investment ability in nine European countries which include two developing economies, Spain and Portugal. Arslan-Ayaydin et al. (2014) and Ferrando et al. (2014) have included only a handful of emerging countries in their investigations. Thus, our first objective in this study is to add to the scant research on corporate financial flexibility by providing a comprehensive investigation of firms in 33 emerging countries. Our second objective is to determine if financial flexibility is valuable to firms in emerging economies. The effect of financial flexibility on firm value in emerging countries has not been examined in prior studies. Our investigation focuses on emerging firms because emerging countries provide an interesting environment for understanding the benefits of financial flexibility. For example, high volatility of capital flows is not a common phenomenon in developed economies. Researchers have found evidence that volatile capital flows have adverse impacts on the investment expenditures of private firms in emerging countries (Joyce and Nabar, 2009; Demir, 2009). To the extent that financially flexible firms are more capable of handling the adverse effects of negative exogenous shocks, it is expected that financial flexibility has a positive effect on firm value in emerging countries. Our third objective in this study is to examine the effect of financial flexibility on firm behavior in emerging countries. Most of the existing empirical studies on financial flexibility are conducted on firms in developed economies such as the US and UK and their results may not be applicable to firms in emerging countries as there are disagreements regarding the determinants of corporate financial policies in emerging countries (Fernandes, 2011; Fan et al., 2012). A better understanding of the effect of financial flexibility on firm behavior in emerging countries is important given the rapid globalization of the world economy in recent years. Firms with international operations have become relatively common nowadays and there is evidence that even large multinational firms are not immune from the risks associated with the underdeveloped capital markets in developing economies (Fee et al., 2009). Thus, an understanding of the effect of financial flexibility in emerging countries has important practical implications for international firms that have a presence in these countries. Finally, given that the adverse effects of negative exogenous shocks are likely heightened during a financial crisis, our fourth objective in this study is to examine the effect of financial flexibility on emerging firms during the global financial crisis of 2007–2009.

Following prior studies, a firm is defined as financially flexible if it has at least three consecutive years of unused debt capacity. Using a sample of 8604 unique firms from 33 emerging countries over the period 1991–2010, we find that 5868 firms are associated with financial flexibility whereas 2736 firms are never financially flexible according to the primary measure of financial flexibility used in this study. Simple univariate comparisons of firm characteristics suggest that financially flexible firms are more profitable and have a higher sales growth rate than never financially flexible firms. Financially flexible firms also have higher levels of cash holdings and lower leverage ratios. In

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