

Corporate America's cash pile-up a reaction to refinancing risk

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Why has corporate America been awash in record levels of cash? Numerous theories are offered as to why firms amass: Firms themselves are riskier, volatile, pessimistic and have record profits, to name a few.

But an overlooked reason, according to new research by SMU Cox Rauscher Chair William Maxwell and co-authors Jarrad Harford and Sandy Klasa, is that firms are holding more [cash](#) on their balance sheets because of refinancing risk. Cash is a hedge for firms in case they cannot raise the funds they may need if credit conditions are tight or another type of shock hits.

The authors' paper "Refinancing Risk and Cash Holdings" is forthcoming in the *Journal of Finance*.

U.S. firms' long-term debt maturities have shortened. The authors indicate that the typical firm in 2008 with long-term debt had 66.3 percent more long-term debt due within three years than the same firm in 1980, the period of the study. In other words, firms are needing to roll over their debt sooner than in previous decades, which presents the risk that they cannot access capital markets to finance their activities. Numerous firms experienced exactly that phenomenon post-financial crisis.

According to Maxwell, firms are holding more cash because of the way in which they access capital. "If you are a B credit-rated firm, you can get a 10-year note or loan, versus an A-rated firm receiving a 20- to 30-year note. In finance, when a balloon loan or bond is coming due, it is called a bullet," Maxwell explains. "In 10 years time, when the 'bullet' is coming due, what happens if you cannot refinance? If capital markets turn against you, you're done. The A-rated firm rolls over its debt regularly. The smaller, B-rated firm does not have this capacity." This is how refinancing risk manifests.

Today [bank loans](#) and notes to firms have shorter maturities, which offer more potential for [refinancing](#) risk. So firms have been changing their policies on cash to manage this risk. They stash. "If a firm gets caught in a bad cycle or shock, it is not the face amounts or percentage of debt you have outstanding that matters, it is a function of when the repayment is coming due," says Maxwell. Average bond maturities for U.S. corporations during the time period 1985 to 1989 was 16.6 years, reducing to 11.3 years from 2005 to 2008. Similarly, the average bank loan or note maturity over the same periods went from 5 years to 3.8 years. The demand and supply-side of money are all intertwined, notes Maxwell.

Market is watching

According to the research, the market rewards the firm holding ample cash with shorter maturity debt through higher valuation, particularly when credit markets are tight. The firm that invests wisely also gets market approval. Firms have to hold cash for the right reasons though. According to Standard & Poor's Capital IQ, 202 firms of the S&P 500-stock index have \$1 billion or more in cash. There are record levels of firms in this billionaires club and record amounts amassed versus decades past.

There are good and bad reasons for holding cash, says Maxwell. For example, what if there is an economic downturn, and a firm needs to make a \$1 billion capital investment every year. The BB-rated firm may not be able to access capital markets during or after an economic shock. Consider the case of two firms. One has cash because it refinanced a year before a shock; one does not. The firm with liquidity can make investments. Maxwell alludes to an analogy of the internationally competitive bicycle race the Tour de France: "When do competitors separate themselves? When they are peddling uphill. Firms also use headwinds or hard times to separate themselves from the pack."

Getting wisdom

Firms did wise up since the last crisis by amassing cash. However some investors are pushing back. "The practice has become extreme in cases like Apple, with excessive cash on the balance sheet," says Maxwell. "They do not need so much cash to fund their operations and invest in opportunities." The financial crisis impacted firms' psyches similar to individuals' psyches and pocketbooks. "We all think differently than we did before the financial crisis," he says. "Everyone is putting more cash away."

Given that firms are more flush these days, how and when should they spend it? To this question Maxwell responds: "Cash should be used as a

hedge in a rainy day. Most firms did learn this lesson from the recent financial crisis. You do not go bankrupt because your net income is negative; you head for bankruptcy when you cannot pay your bills. Liquidity helps pay the bills and allows firms to take advantage of opportunities. If some calamity hits—and in general they do every 5 years to 7 years—the firm can weather the headwinds."

Maxwell describes current credit conditions as never-before loose. "If you can raise money now, do it," he concludes. "It is ridiculously cheap money. The QE (quantitative easing) programs are like a huge binge—with firms drinking shot after shot of cheap money. It is not like a glass of wine with dinner; these are tequila shots." It may feel great when you are doing it, but then tomorrow comes.

More information: [www.afajof.org/SpringboardWebA ...fa/file/Presentation%20Slides/Forthcoming/9557.pdf](http://www.afajof.org/SpringboardWebA...fa/file/Presentation%20Slides/Forthcoming/9557.pdf)

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