

LESSONS FROM THE FINANCIAL CRISIS

CHAPTER 70

The Long-Term Cost of the Financial Crisis

MURILLO CAMPELLO

Baltz Professor of Finance at the University of Illinois and a Faculty Research Fellow of the National Bureau of Economic Research

JOHN R. GRAHAM

D. Richard Mead professor of finance at the Fuqua School of Business and co-director of the Center for Finance at Duke University

CAMPBELL R. HARVEY

Professor of Finance at Duke University and a Research Associate of the National Bureau of Economic Research

Most introductory finance courses start by assuming that capital markets are perfect and that companies and banks are able to borrow and lend freely. In this hypothetical setting, corporate executives are free to make decisions that maximize the value of their companies and stock prices.

We are well aware that capital markets are not perfect. There are significant obstructions that prevent companies from making optimal choices and maximizing shareholder value. But, just how severe are these imperfections? And, how big of an obstacle are real-world constraints in regard to limiting opportunities to corporate executives? These are hard questions to answer because unlike in medical science, economic researchers are rarely able to conduct a controlled experiment that treats some companies, while administering a placebo to other firms. Instead, financial economists often study exogenous shocks to the corporate sector, to see how companies with different characteristics are affected, and to get a feel for the magnitudes and effects of real world capital market imperfections.

In the fall of 2008, world financial markets were in the midst of a credit crisis of historic breadth and depth. As devastating as this crisis has been to the livelihood of many, it also represents an enormous shock to the corporate sector that can aid economic research. We study this shock to learn about the ability of the corporate sector to adapt to adverse circumstances, and to better understand how the availability of liquidity affects corporate decision making. Liquidity can be thought of as the oil that lubricates the economic machinery. When liquidity dries up, to what extent does this cause the economic infrastructure to seize up and destroy corporate value?

To better understand how the credit crisis has affected the corporate sector, in a November 2008 joint effort with *CFO* magazine, we surveyed 1,050 chief financial officers (CFOs) in the United States, Europe, and Asia. We asked these corporate financial leaders for detailed information about how their companies are managing the liquidity needs of their firms. We find striking results that financially constrained firms are quickly burning through their cash reserves and are having great difficulty finding new sources of funding. The current lack of liquidity is causing these companies to make drastic cuts to capital spending, hiring, and research and development, and indeed threatens the very survival of many companies.

THE ISSUES

We begin by benchmarking how much cash companies have on their balance sheets in November 2008 versus how much cash they had in November 2007. In the United States, the typical firm had cash and liquid assets equal to about 15 percent of asset value in 2007. The crisis has not affected cash holdings of unconstrained firms, which remain steady at 15 percent of asset value in 2008. In stark contrast, the cash reserves at financially constrained companies have fallen by one-fifth, from 15 percent to about 12 percent of book assets. (We classify a company as being financially constrained if its CFO says the firm has been affected by the cost or availability of external financing.) A similar pattern of cash burn for constrained firms is evident in Europe and Asia. In Europe, constrained firms typically hold less cash than in the United States, while in Asia they hold more. Yet, constrained firms' cash holdings fell around 23 percent in Europe and 11 percent in Asia. All of these patterns are depicted in Exhibit 70.1. This evidence implies that the ongoing credit crisis is affecting some firms greatly, while affecting less the most profitable companies in the economy.

The speed with which constrained companies around the world are burning through cash reserves is alarming. This problem could be severe if these companies have limited access to other untapped sources of liquidity. We therefore investigate corporate access to bank lines of credit. It is generally difficult to gather representative data on line of credit (LC) access. Much of the data available are restricted to public U.S. corporations, so this analysis is novel.

We asked financial executives about the size of the LCs to which they have access. We compare line of credit access now (during the crisis) to their lines of credit in the fall of 2007. The typical firm in the United States has a prearranged line of credit of approximately 19 percent (unconstrained firms) to 27 percent (constrained firms) of total book asset value. The differences are more dramatic in Europe and Asia, where constrained firms have committed credit lines greater than 30 percent of asset value. We find no significant changes in the access to lines of credit in the United States (across either constrained or unconstrained firms). In Europe, constrained firms are using 21 percent more LCs than before, while in Asia they are using 10 percent less. Unconstrained firms in those non-U.S. economies have not changed their use of LCs.

We next asked the firms what they do with the proceeds when they draw down lines of credit. About half of CFOs around the world say that they use the funds for daily operations or short-term liquidity needs. Companies that are financially

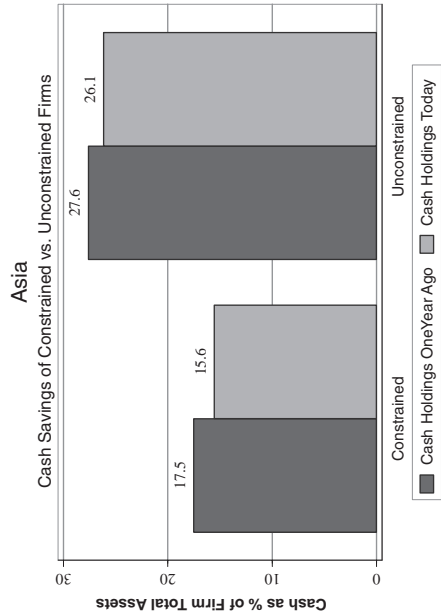
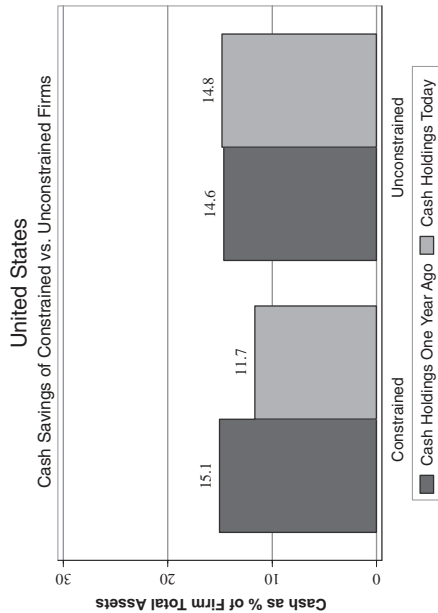
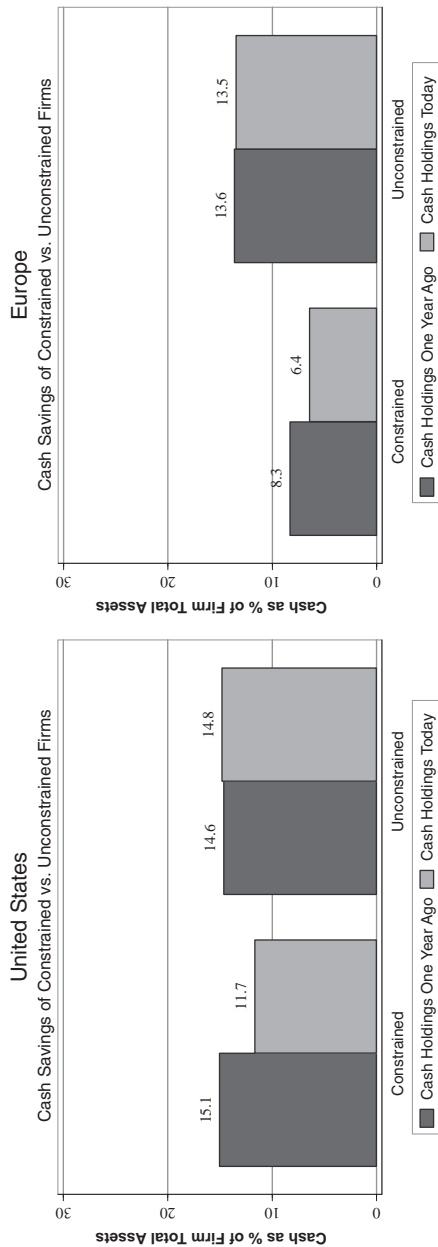


Exhibit 70.1 Firms' Cash Savings Behavior (Ratio of Cash and Liquid Securities to Total Assets) Now and One Year Ago
 Responses are averaged across sample partitions based on financial constraints.

constrained use their LCs significantly more than do unconstrained counterparts as a way to fund normal business activities.

More surprisingly, 13 percent of constrained U.S. firms indicate that they have recently drawn on their credit lines so they could have cash for future needs. This purely precautionary use of LCs hints at the following astounding finding. One out of every six constrained U.S. firms has drawn down on its credit line now, just in case its banks might deny a line of credit in the future. That is, there has been a bank run on lines of credit, with many companies drawing on LCs just in case they may not have access in the future. Harvard University professors Victoria Ivashina and David Scharfstein have shown that the amount of this run on LC borrowing has been large enough to offset the overall tightness of available funding pervading the financial sector. Said differently, there has been so much just-in-case use of bank lines of credit by financially constrained companies that it appears to have crowded out normal borrowing opportunities, even though the total volume of borrowing remained high throughout 2008. This effect is slightly stronger in Asia, where 18 percent of surveyed constrained firms report this behavior, while in Europe, that proportion equals 15 percent. By comparison, only about 6 percent of unconstrained firms in the United States, Asia, and Europe say they are drawing on their credit lines for fear that their banks will restrict access to their outstanding lines of credit. These patterns are depicted in Exhibit 70.2.

As robust as credit drawdowns have been, some firms have resisted using their LCs, and we inquire why. The most common explanation is that CFOs want to preserve borrowing capacity in case it is needed in the future. The second most common explanation for not fully drawing on the credit line is to maintain a strong reputation in the eyes of financial institutions. This preserving reputation explanation is significantly stronger among public firms and speculative U.S. firms. In Europe, preserving reputation in the eyes of bankers is significantly stronger among financially constrained companies.

So far, we have documented that around the world, companies that are financially constrained have burned through cash during this past year of financial crisis and have more actively managed lines of credit, including drawing down on them just in case their banks limit future access to credit lines. We next examine the degree to which these credit problems have seeped into the real sector, affecting the operating and investment decisions of corporations, with a close eye on the effects on financially constrained firms.

To study this issue, we examine the pro forma plans of companies conditional on whether they are financially constrained. We find that most companies plan to cut employment, research and development (R&D) spending, capital investment, marketing expenditures, and (on average) dividends in 2009. The results are significantly worse for financially constrained firms. Constrained companies headquartered in the United States planned to dramatically reduce employment (by 11 percent), R&D spending (by 22 percent), capital investment (by 9 percent), marketing expenditures (by 33 percent), and dividends (by 14 percent) in 2009. Constrained firms in Europe are cutting employment by 8 percent, R&D spending by 5 percent, capital investment by 10 percent, and marketing expenditures by 11 percent, while their dividends are being slashed in half. We see similar patterns in Asia as well; except that all firms there (constrained and unconstrained) are not forecasting cuts in employment.

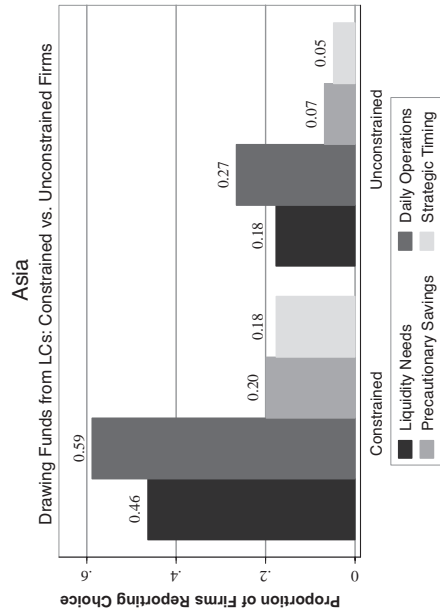
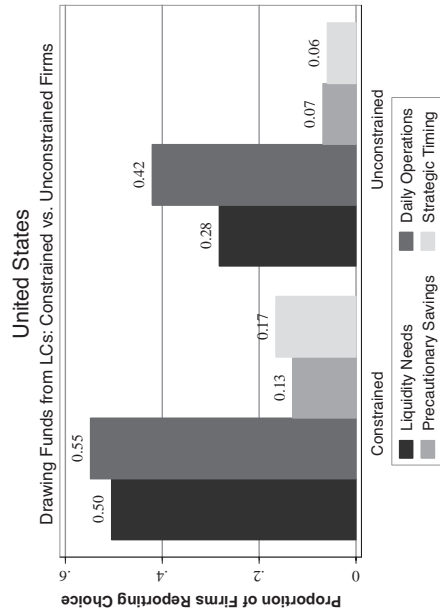
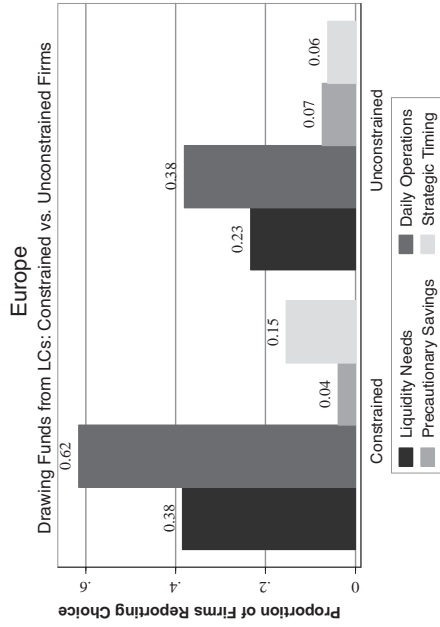


Exhibit 70.2 Firms' LC Management Behavior (Reasons for Withdrawing Funds from Existing LCs)
 Responses are averaged across sample partitions based on financial constraints.

We also study the long-run value implications of slashing corporate investment. Most first-year corporate finance courses demonstrate how a company's managers can maximize stockholder value by choosing positive net present value projects. All this means is that if the returns on an investment outearn the cost of capital required to fund the project, it creates value for the firm. These value-enhancing investments in turn increase shareholder wealth as the stock market capitalizes the increased value into the stock price. Therefore, if the credit crisis is causing companies to cancel value-enhancing projects, this real world constraint is destroying stockholder value.

To investigate this issue, we ask companies about the extent to which credit constraints limit their ability to pursue positive net present value investments. We start by benchmarking how often companies say they have to bypass attractive ($NPV > 0$) investment projects because of financial constraints. In the United States, in normal credit markets, 46 percent of constrained companies say that they pass up attractive investment opportunities because of financial constraints. Recall that these are firms that declared themselves to be constrained in late fall 2008. Undoubtedly, some of these firms would be constrained and some not constrained in normal times. One interpretation of our result is therefore that 46 percent of these firms are constrained during normal times (which limits their ability to pursue attractive projects in normal times). The 46 percent of self-declared constrained firms that say they pass up attractive investments is significantly greater than the 20 percent of unconstrained firms that say the same. In Europe and Asia, too, more than twice as many constrained firms pass up value-enhancing projects because of credit constraints. In particular, 44 percent of the constrained European firms in our survey say they bypass profitable opportunities because of the cost or availability of credit, compared to only 18 percent of the unconstrained firms in that continent. In Asia, the same comparison is 47 percent for constrained firms versus 20 percent for unconstrained ones.

Because we conducted our analysis during a severe credit crisis, we are able to investigate the effects of financial constraints on investment during extreme circumstances. A surprising 86 percent of constrained U.S. firms say that they bypass attractive investments during the credit crisis because of difficulties in raising external finance, about twice as great as the proportion of unconstrained firms that say the same. Again, these numbers are mirrored in Europe and Asia (80 percent versus 36 percent in Europe, and 69 percent versus 29 percent in Asia).

We next inquire about how firms fund attractive investments when they are unable to borrow in financial markets. About half of U.S. firms say that they rely on internally generated cash flows to fund investment under these circumstances, and about 4 in 10 say that they use cash reserves. Notably, 56 percent of constrained U.S. firms say that they cancel investment projects when they are unable to fund them with external funds, significantly greater than the 31 percent of constrained firms that say the same. Once again, we find these same results in Europe and Asia. In Europe, for example, 69 percent of the constrained firms in our survey say they will cancel their investment plans (compared to 33 percent of unconstrained firms). In Asia, that same comparison suggests a cancellation rate of 41 percent across constrained firms and only 16 percent across their unconstrained counterparts. To our knowledge, this is the first time that constraint-driven project cancellation has been documented in economic research.

These numbers are dramatic and document that real-world constraints are a severe detriment to the ability of companies to pursue value-maximizing policies. We also find evidence of another significant disruption to optimal investment that is imposed by severely disrupted credit markets. Not only do companies cancel investment because of tight credit markets, some sell assets to obtain cash. We find that the vast majority of financially constrained firms have sold assets in order to fund operations in 2008: exactly 70 percent of the constrained respondents in our U.S. survey say that they are selling more assets now in 2008 than previously, compared to 37 percent of the unconstrained respondents in order to obtain funds. We also find evidence of heavy use of asset sales across constrained firms in Europe (61 percent) and Asia (43 percent).

CONCLUSION

The focus of the current credit crisis is on the immediate implications, such as reduced profits and increased unemployment. In contrast, we show that there are worrisome long-term economic consequences of the crisis through its effect on financially constrained firms.

Using a survey of over 1,000 CFOs in the United States, Europe, and Asia, we show that firms are cutting back or canceling projects that they know add to firm value. The elimination of profitable projects is especially acute for firms that face financial constraints.

One of the basic tenets of finance is that projects that enhance firm value should be pursued. Financial constraints potentially prevent the funding of these projects. The current credit crisis is an ideal setting to measure the impact of constraints on value creation.

Turning down or canceling profitable projects is a lesser-known cost of the current financial crisis. In the scramble for short-term cash flow, firms are sacrificing long-term value. This implies lower future growth opportunities and lower future employment growth.

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ABOUT THE AUTHORS

Murillo Campello is the Baltz professor of finance at the University of Illinois and a faculty research fellow of the National Bureau of Economic Research. Campello's research interests include corporate finance, financial intermediation, financial markets, and applied contract theory. His recent scholarly work has focused on corporate liquidity management and credit markets imperfections. Campello currently serves as an associate editor at the *Review of Financial Studies*, the *Journal of Financial Intermediation*, and the *International Review of Finance*. Campello earned his Ph.D. in finance from the University of Illinois in 2000.

Dr. John R. Graham is the D. Richard Mead professor of finance at the Fuqua School of Business and co-director of the Center for Finance at Duke University. He is a recipient of the Best Teacher and Outstanding Faculty awards at Duke. His past work experience includes working as a senior economist at Virginia Power, and he is a past or current director of the American Finance Association, Western Finance Association, and Financial Management Association. Graham has published more than 30 articles and book chapters on corporate taxes, cost of capital, capital structure, financial reporting, and payout policy, and this research has won a half dozen best paper awards. He is co-editor of the *Journal of Finance* and has been an associate editor of the *Review of Financial Studies* and *Financial Management*. Since 1997, he has been the director of the *Global Business Outlook*, a quarterly CFO survey that assesses business climate and topical economics issues around the world. Graham is lead author on the textbook *Corporate Finance, Linking Theory to What Firms Do*.

Campbell R. Harvey is a professor of finance at Duke University and a research associate of the National Bureau of Economic Research. He is a graduate of the University of Chicago. Harvey is the editor of the *Journal of Finance*, past president of the Western Finance Association and serves on both the board of directors and the executive committee of the American Finance Association. Harvey has received nine Graham and Dodd Awards, Scrolls, and Roger F. Murray Prizes for excellence in financial writing and has published more than 100 scholarly articles. His 8,000-word hypertextual financial glossary is used by sites such as the *New York Times*, *Forbes*, *Bloomberg*, the *Washington Post*, and *Yahoo*. Professor Harvey's blog at <http://dukeresearchadvantage.com/author/charvey/> includes an entry from 2005 in which he stated "Many banks are operating like hedge funds, taking advantage of internal (cheap) credit lines. The bank's shareholders have no idea what is going on." He warned of an oncoming "contagious systemic" crisis.