

Chapter 13

Financial Flexibility and Corporate Investment: Does Financial Flexibility Affect Sustainability of Firms?

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ABSTRACT

This chapter investigates the impact of financial flexibility (FF) on investments, which constitutes the basis for sustainable corporate development. Using a large database of 1,205 firms from three emerging countries in Europe—Poland, Russia and Turkey—for the time period between 2000 and 2016. The authors provide evidence that financial flexibility, achieved through conservative leverage policies, enhances companies' investments and positively contribute to corporate sustainability. Moreover, as the number of years of low leverage kept by firms increase so does the impact of financial flexibility on corporate investment. Besides financial flexibility, internal cash generation capacity of firms, and sales growth also improve the investment capability of firms, improving corporate sustainability. The results support the hypothesis that financial flexibility enhances companies' investment capability, which is an extremely essential tool for firms to have in their businesses.

INTRODUCTION

In perfect capital markets, companies are assumed to be able to invest in all profitable projects, and consequently they are able to capture all growth opportunities, hence there is no necessity for financial flexibility (FF). However, in real life scenarios, where the capital markets are imperfect, financial flexibility appears as a significant concept, because it becomes extremely crucial for companies to find necessary funding required for growth opportunities. Furthermore, empirical studies demonstrate that companies issue a lesser amount of bank borrowing when compared to what the main capital structure theories suggest, which constitutes a puzzle. It is claimed that the traditional capital structure theories do not take into account companies' requirement for financial flexibility. It is argued that companies

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choose to preserve financial flexibility as spare borrowing capacity (Marchica & Mura, 2009; Graham & Harvey, 2001; Gamba & Triantis, 2008; DeAngelo & DeAngelo, 2007; De Jong, Verbeek & Verwijmeren, 2012; Denis & McKeon, 2012). Therefore, financial flexibility explains the gap between what the classical capital structure theories suggest and the empirical findings.

Financial Flexibility (FF) is the “ability of a firm to access and restructure its’ financing at a low cost” (Gamba & Triantis, 2008). In line with this view, there are mainly two ways through which financial flexibility becomes significant for companies: avoiding financial distress costs in a negative shock situation and mitigating underinvestment complications.

Until recently, there are only a few studies conducted on financial flexibility; mainly because FF is not directly measurable and hard to quantify. Given the importance of the concept of financial flexibility which is expected to have a huge impact on corporate sustainability, the main purpose of this study is to fill this gap. Our objective is to classify the firms in our sample as flexible or not, based on their maintenance of low leverage for a minimum number of years, following which we aim to comprehend the impact of FF on corporate investment level, which constitutes the basis for sustainable development.

Our sample covers three emerging countries from Europe: Poland, Russia and Turkey; coinciding to 1,205 publicly quoted companies in total. Our sample includes market and accounting data for the time span between 2000 and 2016. For the calculation of the financial flexibility dummy used in the analysis, it is necessary that each company in our sample has a minimum of 4 years of observations in the 17-years’ time frame.

Following the methodology adopted by Marchica and Mura (2010), we classify firms in our sample as financially flexible or not based on their possession of Spare Debt Capacity (SDC) for a minimum number of years. A leverage equation is estimated with several control variables included in the estimation. The residuals of the leverage estimation captures the systematic deviation between observed and predicted leverage. According to Ferrando, Marchica and Mura (2017), “the demand for financial flexibility is indirectly captured by the negative deviations from estimated target leverage” and in accordance with this we classify a company as financially flexible if low leverage policy is sustained for three successive years (two, four and five successive years of SDC is also calculated for robustness purposes). Our findings show that almost 19% of the companies in our sample have financial flexibility (FF calculated with three years of SDC).

Following the classification of the flexible companies in our sample, in the next step of our analysis, we examine whether financial flexibility has any effect on the companies’ investment capability. In order to test this conjecture, we estimate an investment equation, with the inclusion of an FF dummy and also an interaction term between the FF dummy and the cash flow of the company. We hypothesize that the FF dummy will significantly and positively affect the investment level of companies. Consistent with our expectations, the impact of flexibility on investment is positive and significant for the three emerging countries in our sample.

The remainder of the study is arranged as follows. In the next section, we present the related literature on the topic, providing empirical findings on financial flexibility, following which we describe the empirical design used in the study encompassing the sample and dataset used; as well as the methodology that will be adopted throughout the study; and also identifying financially flexible firms. The results of the impact of FF on investment level will be analyzed in the following chapter, finalizing with the concluding remarks.

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