Financial Strength and Product Market Behaviors: The Real Effects of Corporate Cash Holdings

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Abstract

This paper empirically studies how corporate cash holdings affect product market decisions. Using U.S. intra-industry data from 1971 to 2005, the analysis reveals that larger relative-to-rivals cash reserves lead to systematic future market share gains that obtain at the expense of industry rivals. Noteworthy, this “competitive” effect of cash turns out to be magnified when rivals face tighter financing constraints and when firms intensively interact in their product market. From a different perspective, the analysis further demonstrates that firms’ cash policy plays a significant pre-emptive role that distorts rivals’ financial and real decisions. Specifically, consistent with a deterrence effect of deep pockets, I find that incumbents’ cash reserves significantly curb the entry of potential competitors. In a similar vein, cash holdings considerably hamper the expansion of rivals by constraining both their investment and acquisition policies. Overall, my results provide compelling evidence firm’s cash policy encompasses a substantial and valuable strategic dimension.