productivity
insights
network

Firm financing and investment in a low interest rate environment

John Evemy (York), Craig Berry (MMU) and Edward Yates (Sheffield)

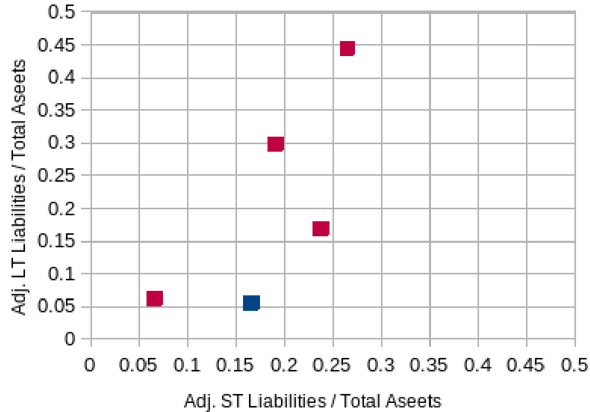
14th September 2020

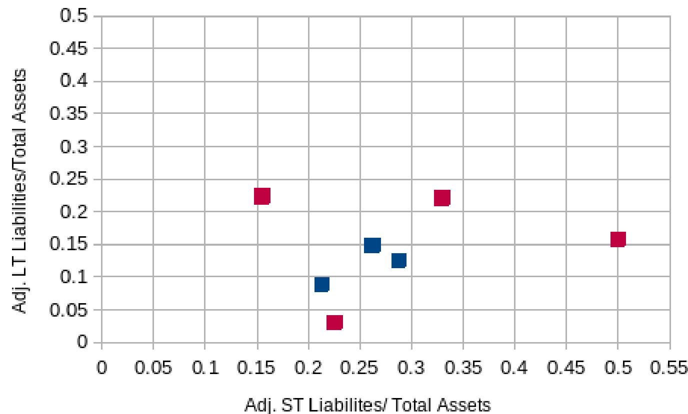
Overview

- Exploratory study on how monetary policy shaped firm funding and investment decisions in 2012-2016.
  - How do firm funding decisions (and thus low interest rates) shape investment decisions in terms of productivity?

1. Sample & Approach
2. Result 1 - Market & Bank finance funds expansionary but not productivity enhancing investment
3. Result 2 – Investment strategies drive financing decisions
4. Policy implications

Sample & Approach





Analysis of eight FTSE250 firms from two sectors from 2012 to 2016

- Identify investment strategies (Expanded / Enhanced production)
- Map firm funding decisions / response to monetary policy

Based on qualitative analysis of

- Annual reports
- Interviews and correspondence with directors

Selected using a "most different" approach to

- Sector capital intensity
- Average firm funding position

Economic and Social Research Council

productivity insights network

Funding Strategy and Investment

- Scalar, low margin firms tend to fund operations through short term liabilities
- Productivity enhancing firms tend to fund operations trough longer term labilities.
- The exception is equity funded firms which are a 'very much masters of their own destiny' (Director, F&B Firm)

	"Equity"	LT Funding	Mixed	ST Funding
F&B	Expanded Enhanced	Enhanced	Enhanced Expanded	Expanded
Constr.	Expanded Enhanced	Enhanced Expanded	Expanded Enhanced	Expanded

Response to low interest rates

- Firm funding decisions were mixed.
- Operational cashflow was the main source of investment funding
  - But this varied significantly between firms
- 5 firms chose to raise fresh long term debt
  - Primarily through US Private Placement Notes
  - Either to invest in expanded production or lengthen debt terms
- 3 chose to "divest to reinvest" (Director, F&B firm)
- 2 issued new stock
  - Either to fund an acquisitions or deleverage
- 1 borrowed short term to cover a cashflow shortfall

Importantly, underlying funding strategies did not appear to directly shape firm responses to interest rates.

Investment Strategies and Funding Decisions

Productivity focussed firms

- Deleveraged
- Refinanced existing debt at longer terms
- 'Divest to Reinvest'

Expansion focussed firms

- Refinance existing debt at longer terms
- Used low long term borrowing and capital costs to invest in
  - Acquisition of other firms
  - New facilities / sites

Low interest rates directly facilitated scalar, often lower margin, investments and acquisitions but did not directly facilitate productivity enhancing investment

	Food & Beverage	Construction
Enhanced Production	Cashflow Divestment	Cashflow Divestment
Expansionary Enhancement (Expansion with a strong focus on productivity gains)	Cashflow Divestment Stock Issue	Cashflow Stock Issue Long Term Debt
Enhanced Expansion (Expanded Production with a limited focus on productivity gains)	Cashflow Long Term Debt	Cashflow Long Term Debt
Expanded Production	Cashflow Long Term Debt	Cashflow Long & Short Term Debt Stock Issue / Placement

productivity insights network

Investor expectations and Scale

Investment strategies that drive funding decisions

- External finance is linked to expanded production not enhanced production

- Two reasons
  - Shareholder expectations
    - Productivity enhancing investment is "business as usual" and difficult to quantify and so should be funded from internal cash flow
    - Expanded investments are exceptional and so can be funded from fresh capital
  - Scale
    - Productivity enhancement tends to be incremental and so does not require as much external funding
    - Expanded production tends to be large single expenditures

Or to quote…

‘I believe that what differentiates investments funded from external finance [loan or capital raise] from those that are funded by retained profit can be very crudely summarised as :-

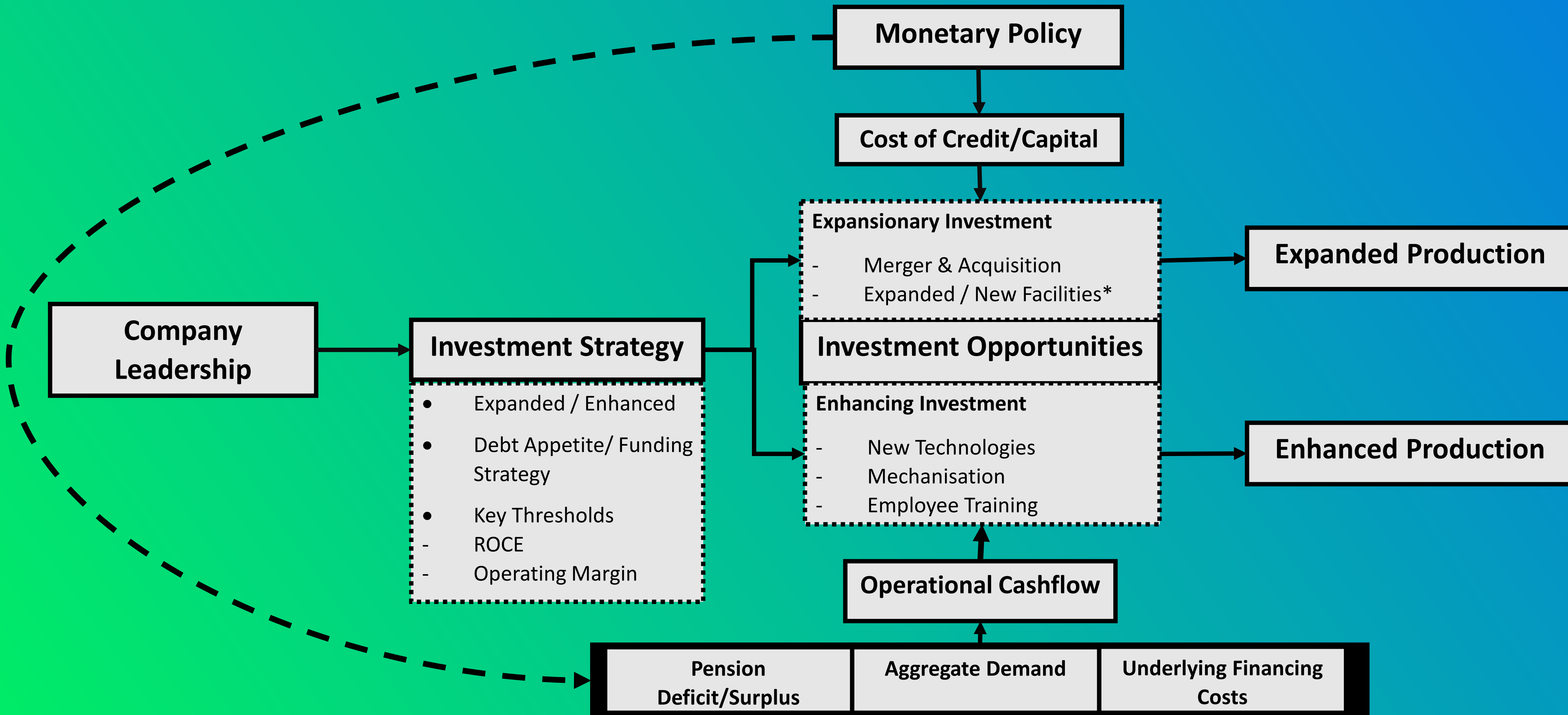
[1] the nature of the investment; is it “step change/inorganic” or “business as usual”, and

[2] the financial scale of the investment and the consequent pressure on liquidity.

Essentially, significant capital projects and/or major M&A are more likely to be funded externally, whereas optimising existing operational efficiency and effectiveness will, and should be, supported by retained profits and/or budgeted spend that sits within the annual business plan.’

(Personal correspondence, Director, Food and Beverage)

A MODEL



UKRI Economic and Social Research Council

productivity insights network

Policy Implications (1 of 3)

Two key findings from this study:

1. Extraordinary monetary policy directly incentivises expansionary and indirectly incentivises productivity enchaining investment

2. Short term, low margin firms tend to be more expansionary

Policy Implications (2 of 3)

Our findings imply:

- The use of monetary policy to drive economic activity post-2009 may have contributed to the productivity crisis
- Targeted credit policies limited in their ability to provide policy solutions
- Productivity gains are more likely to come from policies that improve cashflow rather than reducing credit costs
  - Directly supporting demand in the economy – firms want to be more productive, but only if funded from revenue not debt; or
  - Industrial policy grants/subsidies (i.e. cash income) may be a more reliable way of producing enhanced production strategies

Policy Implications (3 of 3)

Our questions for you:

- How do our findings relate to what we already know about contemporary firm funding and investment? What other sectors are worth considering?
- Is it possible to reorient monetary policy to support productivity? What kind of changes to the Bank of England's remit would this imply?
- Are we wrong to *expect* monetary policy to support productivity, given the overarching goal of economic stabilisation?
- Does it matter where the cash comes from? Do firms respond to subsidy the same way they respond to sales?
- Would corp. governance reform (workers on boards?) change the patterns we identified?
- Any questions for us? All comments and feedback very welcome! ☺