

# **When Does the Market Matter? Stock Prices and the Investment of Equity-Dependent Firms\***

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## **Abstract**

We use a simple model of corporate investment to determine when investment will be sensitive to non-fundamental movements in stock prices. The key cross-sectional prediction of the model is that stock prices will have a stronger impact on the investment of firms that are “equity dependent” – firms that need external equity to finance their marginal investments. Using an index of equity dependence based on the work of Kaplan and Zingales (1997), we find strong support for this prediction. In particular, firms that rank in the top quintile of the KZ index have investment that is two-and-a-half times as sensitive to stock prices as firms in the bottom quintile. We also verify several other predictions of the model.

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## **I. Introduction**

Corporate investment and the stock market are positively correlated, both in the time series and in the cross-section. The traditional explanation for this relationship is that stock prices rationally reflect the marginal product of capital. This is the usual interpretation given to the relationship between investment and Tobin's  $Q$ , for example, as in Tobin (1969) and von Furstenberg (1977).

A very different explanation is suggested by Keynes (1936). Keynes argues that stock prices contain an important element of irrationality. As a result, the effective cost of external equity sometimes diverges from the cost of other forms of capital. This affects the pattern of equity issues and in turn corporate investment. This "equity financing channel" has been developed in work by Bosworth (1975), Fischer and Merton (1984), Morck, Shleifer and Vishny (1990), Blanchard, Rhee and Summers (1993) and Stein (1996).

It has proven difficult to determine the relative merits of these explanations. This is partly because the equity financing channel has not been articulated in a form that can be empirically distinguished from the traditional view. Empirical tests have had to focus on indirect implications of the two views, or else have had to impose structural assumptions on the data. For example, researchers taking the former approach have examined whether the stock market forecasts investment over and above other measures of the marginal product of capital, such as profitability or cash flow. If it does not, they argue, then the stock market is probably connected to investment only insofar as it reflects fundamentals.

This empirical strategy has yielded mixed results. Barro (1990, p. 130) attributes an important independent role to the stock market: "Even in the presence of cash flow variables, such as contemporaneous and lagged values of after-tax corporate profits, the stock market

variable retains significant predictive power for investment.” In contrast, Morck, Shleifer and Vishny (1990, p. 199) conclude from their analysis of firm-level data that “the market may not be a complete sideshow, but nor is it very central.” And Blanchard, Rhee and Summers (1993, p. 132) summarize their study of the aggregate data by stating that “market valuation appears to play a limited role, given fundamentals, in the determination of investment decisions.”

Another empirical strategy is to try to measure inefficiency directly as the difference between market prices and a structural model of efficient prices, and then test whether investment is sensitive to this measure of inefficiency. In a study of aggregate Japanese data, Chirinko and Schaller (2001) find evidence for an equity financing channel using this approach. As they point out, however, their conclusions depend on several structural assumptions.

In this paper we take a new approach. We return to the theory to derive several cross-sectional predictions that are unique to a specific equity financing channel. In particular, the model in Stein (1996) implies that *firms that are in need of external equity finance will have investment that is especially sensitive to the non-fundamental component of stock prices*. Intuitively, a firm with no debt and a stockpile of cash can insulate its investment decisions from irrational gyrations in its stock price. But an “equity-dependent” firm that needs equity to fund its marginal investments will be less likely to proceed if it has to issue undervalued shares. The theory thus identifies a specific equity financing channel that suggests *when* the market matters in the cross-section and, at the same time, *why* it matters.

We test several implications of this financing channel. To get started, we need a proxy for the concept of equity dependence. This concept requires some financing friction, or combination of frictions, which makes certain firms more reliant on outside equity at the margin. Standard corporate-finance considerations suggest that equity-dependent firms will tend to be young, and

to have high leverage, low cash balances and cash flows, high cash flow volatility (and hence low incremental debt capacity) and strong investment opportunities.<sup>1</sup> One off-the-shelf measure which satisfies most of these criteria is an index based on the work of Kaplan and Zingales (1997). This “KZ index” has already been adapted for use in large-sample empirical work by Lamont, Polk and Saa-Requejo (2001), so we can follow their methodology exactly. By taking this approach, as opposed to building our own measure of equity dependence from scratch, we hope to minimize any concerns about data mining.

Next, we rank firms according to this proxy for equity dependence, and test in a variety of ways whether those that are classified as most likely to be equity dependent have the strongest correlation between stock prices and subsequent investment. We find strong support for this prediction. In our baseline specification, firms that rank in the top quintile of the sample in terms of the KZ index have a sensitivity of investment to stock prices that is roughly two-and-a-half times as large as firms that rank in the bottom quintile.<sup>2</sup> Put differently, our results suggest that the investment of equity-dependent firms is in some circumstances more sensitive to  $Q$  than to cash flow. This is noteworthy because it is generally believed that the cash flow effect uniformly dominates the  $Q$  effect in investment equations.

We also examine whether these results for investment reflect the specific equity financing mechanism outlined in the model. This involves a test of whether the firms who are the most likely to be equity dependent also have the strongest correlation between stock prices and the

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<sup>1</sup> Morck, Shleifer and Vishny (1990) look for a financing channel using firm size as their only proxy for equity dependence. They argue that the “hypothesis predicts that the influence of the stock market should be particularly great for smaller firms, which rely to a greater extent on external financing” (p. 182). However, they find little evidence that the investment of smaller firms is especially sensitive to stock prices, and conclude that there is little support for the hypothesis. As we show, the use of a more fully developed measure of equity dependence leads to quite different conclusions.

<sup>2</sup> The result that investment is more sensitive to  $Q$  for high-KZ firms actually shows up in Kaplan and Zingales’ (1997) small 49-firm sample. However, their focus is on a different question – how investment-cash flow sensitivities vary with financial constraints – and they never discuss or interpret this particular finding.

volume of new equity issues. We find support for this hypothesis as well: Firms with high values of the KZ index also have equity issuance behavior that is more responsive to stock prices than their low-KZ counterparts.

Our results offer support for a specific equity financing channel in corporate investment. They also complement other evidence that the cost of external equity has an important, independent effect on corporate financing and investment decisions. For example, Ritter (1991), Ikenberry, Lakonishok, and Vermaelen (1995), Loughran and Ritter (1995), Speiss and Affleck-Graves (1995), and Baker and Wurgler (2000) find evidence that equity financing patterns depend on the cost of equity, and Baker and Wurgler (2002) use these results to motivate an alternative view of capital structure. Shleifer and Vishny (2001) argue that the cost of equity is a strong determinant of merger activity, explaining the form of financing in mergers as well as merger waves themselves. Whereas the capital structure findings could be viewed as financial phenomena without significant real effects, however, our results point to a specific channel through which market inefficiency may affect the real economy.

The paper is organized as follows. In Section II, we develop several testable hypotheses in the context of a simple model. The model provides some guidance as to how to measure equity dependence in practice, and provides a framework for thinking about competing hypotheses. In Section III, we describe the data, and in Section IV, we present the empirical results. Section V concludes.

## II. Hypothesis development

### A. A simple model

We use a simplified version of the model in Stein (1996) to develop several testable hypotheses about equity dependence and investment. For starters, consider a firm that can invest  $K$  at time 0, which yields a gross return of  $f(K)$  at time 1, where  $f(\cdot)$  is an increasing, concave function. The efficient-market discount rate is  $r$ , so the net present value of this investment is  $\frac{f(K)}{1+r} - K$ . The first-best level of investment  $K^{fb}$  is therefore given by  $\frac{f'(K^{fb})}{1+r} = 1$ .

The firm also has financing considerations. Its equity may be mispriced by some percentage  $\delta$  relative to the efficient-market value, either overpriced ( $\delta > 0$ ) or underpriced ( $\delta < 0$ ), while its debt is fairly priced.<sup>3</sup> The firm can issue equity  $e$  subject to the constraints that  $0 \leq e \leq e^{\max}$ . In other words, it cannot repurchase shares, and there is an upper bound on how much it can issue. Financing and investment are linked by a leverage constraint,  $e + W - K(1 - \bar{D}) \geq 0$ , where  $W$  is the firm's pre-existing wealth (such as cash on hand, or untapped debt capacity) and  $\bar{D}$  is the fractional debt capacity of the new assets. This constraint implies that the firm's debt ratio can fall below  $\bar{D}$  but cannot exceed it.<sup>4</sup>

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<sup>3</sup> The model interprets  $\delta$  as an irrational variation in the cost of external equity, but one could also view it as a rational gap between the cost of external and internal equity that reflects adverse-selection problems (Myers and Majluf (1984)). Moreover, some authors have argued that adverse-selection problems are mitigated in good times, which are generally associated with high stock prices (Lucas and McDonald (1990), Choe, Masulis and Nanda (1993), Bayless and Chaplinsky (1996)). Such an interpretation of  $\delta$  can lead to similar empirical predictions. Our own view is that the first story – based on market inefficiencies – is a more compelling way of thinking about the connection between equity issues and stock prices, and more consistent with the evidence from surveys and long-run stock returns following equity issues. However, we note that none of our tests seek to discriminate between these stories. In fact, both of them are based on the same idea: managers try to time the market by selling stock when they think it is overvalued, and by sitting out when they think it is undervalued. The only difference is whether investors fully account for this motive.

<sup>4</sup> These constraints simplify the exposition, but they can be dispensed with in a fuller model. For example, both repurchases and equity issues could be bounded endogenously by assuming that there are price-pressure effects that increase with the size of the repurchase or issue. The simple form of the leverage constraint can also be generalized by having costs of financial distress that increase continuously whenever the debt ratio exceeds  $\bar{D}$ . These generalizations are considered in Stein (1996).

Putting all this together, the firm's optimization problem is given by:

$$\max_{e,K} \frac{f(K)}{1+r} - K + \delta e, \quad (1)$$

subject to

$$e + W - K(1 - \bar{D}) \geq 0 \text{ and} \quad (2)$$

$$0 \leq e \leq e^{\max}. \quad (3)$$

Proposition 1 summarizes the solution to this problem.

**Proposition 1:** Assume that  $e^{\max} > K^{fb}(1 - \bar{D})$ . Then the possible outcomes are as follows:

- i) If  $\delta > 0$ , then  $K = K^{fb}$  and  $e = e^{\max}$ : An overvalued firm invests at the first-best level and issues as much equity as possible.
- ii) If  $\delta < 0$  and  $W - K^{fb}(1 - \bar{D}) \geq 0$ , then  $K = K^{fb}$  and  $e = 0$ : An undervalued firm with sufficient wealth  $W$  invests at the first-best level and avoids issuing equity.
- iii) If  $\delta < 0$  and  $W - K^{fb}(1 - \bar{D}) < 0$ , then  $K < K^{fb}$ : An undervalued firm with insufficient wealth underinvests. This case admits two subcases.
  - a) Define  $K^{ec}$  by  $\frac{f'(K^{ec})}{1+r} = 1 - \delta(1 - \bar{D})$ . If  $W - K^{ec}(1 - \bar{D}) < 0$ , then  $K = K^{ec}$  and  $e = K^{ec}(1 - \bar{D}) - W > 0$ : The firm issues equity, and both investment and the size of the equity issue are functions of the degree of undervaluation  $\delta$  and debt capacity  $\bar{D}$ .
  - b) If  $W - K^{ec}(1 - \bar{D}) \geq 0$ , then  $K = \frac{W}{1 - \bar{D}}$  and  $e = 0$ : The firm does not issue equity and invests as much as it can subject to its wealth  $W$  and the leverage constraint.

The proposition makes clear when investment depends on the non-fundamental component of stock prices. This happens only when two necessary conditions are satisfied: when the stock is undervalued, and when available wealth is so low that the firm would have to issue

undervalued equity to invest at the first-best level.<sup>5</sup> We therefore define a firm as “equity dependent” if  $W < K^{fb}(1-\bar{D})$ . The basic message of Proposition 1 is that for equity-dependent firms, market inefficiency can act like a financial constraint, discouraging investment when stock prices are too low.

### *B. Testable hypotheses*

We boil Proposition 1 down to three empirical hypotheses. In each case, the null hypothesis is the joint statement that stock prices reflect the net present value of investment and that financing is frictionless – i.e., the benchmark Tobin’s  $Q$  mechanism. The hypotheses that follow from the proposition, by contrast, maintain that stock prices have a non-fundamental component and that debt capacity can be a constraint.

**Hypothesis 1:** Define a firm as equity dependent if  $W < K^{fb}(1-\bar{D})$ . Equity-dependent firms display a higher sensitivity of investment to stock price than non-equity-dependent firms.

Hypothesis 1 is the primary focus of our empirical tests. As we state it, the hypothesis is not conditioned on whether firms are over- or undervalued. It effectively averages over region (i), where  $\delta > 0$ , and where equity dependence does not affect investment, and regions (ii) and (iii), where  $\delta < 0$ , and where equity dependence does matter for investment. Observe also that for the undervalued, equity-dependent firms in (iii.a), the magnitude of the sensitivity of

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<sup>5</sup> The conclusion that investment is sensitive to stock prices only when  $\delta < 0$  is a result of the one-sided nature of the leverage constraint. One could also constrain leverage not to fall *below* some critical value, in which case investment may vary with stock prices even when  $\delta > 0$ . The model of Shleifer and Vishny (2001) implicitly embodies such a feature—they assume that overvalued firms wishing to issue equity cannot simply park the proceeds in T-bills, and must do something concrete, like acquiring another firm, to justify the issue. Hence overvaluation leads to more investment in the form of mergers.

investment to  $\delta$  is governed by  $(1-\bar{D})$ , so that for a given starting value of  $K$ , firms with less debt capacity have investment that reacts more strongly to stock prices. The intuition is simple. When a firm has little wealth relative to its investment opportunities, it is forced to issue undervalued equity at the margin to keep the leverage constraint satisfied. This tends to discourage investment. And the lower is  $\bar{D}$ , the more equity must be issued for each marginal dollar of investment, hence the stronger is the negative effect on investment.

Proposition 1 also suggests various hypotheses that condition on  $\delta$  – which we outline next – but the unconditional statement in Hypothesis 1 is more straightforward to test empirically, so we make it the focus of our empirical efforts.

**Hypothesis 2:** When  $\delta < 0$ , Hypothesis 1 holds more strongly: Equity-dependent firms display a particularly high sensitivity of investment to stock price when  $\delta < 0$ .

Hypothesis 2 compares the undervalued, non-equity-dependent firms in (ii) to the undervalued, equity-dependent firms in (iii), especially (iii.a). It is a more direct implication of the idea that equity dependence matters for investment only when equity is undervalued – in the model, when equity is overvalued, all firms invest at the first-best level regardless of the degree of overvaluation. Therefore, conditioning on undervaluation should reveal a stronger effect of equity dependence.

Hypothesis 2 is trickier to test than Hypothesis 1, however, because it requires us to proxy for the absolute level of over or undervaluation. This is further complicated by the fact that what really matters are managers' *perceptions* of misvaluation. A variety of evidence suggests that managers are not particularly objective when it comes to assessing whether their firms are

fairly valued; indeed, they tend to be biased toward the view that their firms are chronically undervalued.<sup>6</sup> Thus, while we take a stab at testing Hypothesis 2, we view it more in terms of an auxiliary test of the model.

**Hypothesis 3:** When  $\delta < 0$ , equity-dependent firms display a higher sensitivity of equity issuance to stock price than non-equity dependent firms.

Hypothesis 3 is a financing analog to Hypothesis 2. It reflects the fact that in region (iii.a), the investment and equity issues of equity-dependent firms are tied together by the binding leverage constraint, and so both are sensitive to undervaluation. In contrast, the non-equity-dependent firms in region (ii) avoid issuing equity regardless of the degree of undervaluation. If this hypothesis can be confirmed in the data, it will provide additional evidence that our specific equity financing channel is driving any patterns in investment. Unfortunately, testing this hypothesis again requires a proxy for undervaluation, so again we view the results as somewhat provisional.

Note that our hypotheses involve simple comparisons between firms that are equity dependent and those that are not – that is, comparisons *across* the regions in Proposition 1. We can also ask what happens *within* region (iii.a) as firms become “more” equity dependent, i.e. as  $W$  falls further and further below  $K^{fb}(1-\bar{D})$ . The answer to this question depends on the form of the production function. Define the “degree” of equity dependence as  $\Phi = K^{fb}(1-\bar{D}) - W$ , and the percentage sensitivity of investment to stock prices as  $S = \frac{1}{K} \cdot \frac{dK}{d\delta}$ . (This measure of the sensitivity matches our empirical implementation, where we scale investment by existing assets.)

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<sup>6</sup> Heaton’s (1998) model is built on just this sort of managerial overconfidence.

It is straightforward to show that a sufficient condition for  $\frac{dS}{d\Phi}$  to be positive in region (iii.a) – and hence for the sensitivity  $S$  to become ever greater as  $W$  declines relative to  $K^{fb}(1-\bar{D})$  – is that  $Kf'''(K) + f''(K) < 0$ .<sup>7</sup>

When this condition is satisfied, there is a globally monotonic relationship between  $\Phi$  and the sensitivity of investment and equity issuance to the non-fundamental component of stock prices. When it is not satisfied, we are left with the weaker prediction that  $S$  must increase as  $\Phi$  moves from negative to positive values, but need not be monotonic in  $\Phi$  beyond that point. (To be clear, our three hypotheses are based on this weaker prediction.) This situation is reminiscent of the discussion by Kaplan and Zingales (1997, 2000) and Fazzari, Hubbard, and Petersen (2000) as to whether the sensitivity of investment to cash flow is monotonic in the degree of a different kind of financial constraint. Nevertheless, even if the sufficient condition is not satisfied, the hypotheses show that the theory is testable as long as we can plausibly identify some firms that are not dependent on equity at all – i.e., firms for which  $\Phi < 0$  – since the theory unambiguously predicts that the sensitivity of investment and equity issuance to stock prices will rise over at least this first part of the range of measured equity dependence. Whether these sensitivities continue to increase over the whole range is an empirical question, however, and not one for which the theory leaves us with strong priors.

### *C. Determining equity dependence in practice*

Our theory defines an equity-dependent firm as one in which  $W < K^{fb}(1-\bar{D})$ . This definition indicates that a firm is more likely to be dependent on equity when  $W$  is low (which

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<sup>7</sup> Among the production functions that satisfy this condition are the quadratic, and anything of the form  $f(K) = K/(K+A)$ , where  $A > 2K$ .

translates into low profitability, cash balances, or previously untapped debt capacity), when  $K^b$  is high (investment or growth opportunities are high), and when the incremental debt capacity of new assets  $\bar{D}$  is low.<sup>8</sup> Therefore, a sensible empirical measure of equity dependence should probably be: negatively related to operating cash flow; positively related to proxies for growth opportunities; positively related to actual leverage, net of cash on hand; and negatively related to the debt capacity of assets. Firm age may also be a factor, to the extent that young firms without established reputations may have a harder time raising bond-market finance (Diamond (1991)).

These observations motivate our interest in the empirical section of Kaplan and Zingales (1997), which contains an in-depth study of the financial constraints faced by a sample of 49 manufacturing firms. Using both subjective and objective criteria, they rank these firms on an ordinal scale, from least- to most-obviously financially constrained. Most useful for our purposes, they then estimate an ordered logit regression which relates their ranking to five simple Compustat variables. The regression attaches positive weight to growth prospects (proxied for by  $Q$ ) and leverage, and negative weight to operating cash flow, cash balances, and dividends. Thus, the parameters of this regression allow one to easily create a synthetic “KZ index” of financial constraints for a large sample of firms, as is done in Lamont, Polk and Saa-Requejo (2001).

The KZ index has some very attractive features from our perspective. It is an objective, off-the-shelf index that has already gained substantial currency as an indicator of financial constraints. By using it, as opposed to building our own measure from scratch, we hope to avoid any criticism of data mining. Moreover, relative to what is suggested by our theory, the KZ index seems at first glance to load up on each of the five included variables in the “right” way.

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<sup>8</sup> These first two factors closely parallel the notion of “financial dependence” in Rajan and Zingales (1998).

The index also has some disadvantages as a measure of equity dependence, however. The theoretical definition of equity dependence involves a measure of investment opportunities  $K^{fb}$  that is distinct from mispricing  $\delta$ . But the KZ index uses  $Q$  to measure investment opportunities, where  $Q$  is defined as the market-to-book ratio, and several authors have argued that market-to-book reflects mispricing as much as it reflects investment opportunities. This dual role for measured  $Q$  (the fact that it doubles as a proxy for both  $K^{fb}$  and  $\delta$ ) must be kept in mind when interpreting our results, since the model has the opposite implications for the effects of  $K^{fb}$  and  $\delta$ .

Another disadvantage of the KZ index is that it does not include every characteristic that could identify equity dependence. Firm age is a noteworthy omission. And given the important role that available debt capacity plays in our model, we would have preferred to include leverage *relative* to the firm's debt capacity, not simply the raw debt level. In some of our auxiliary tests, we supplement the KZ index with two more variables, firm age and the volatility of industry cash flow (a proxy for debt capacity), in an effort to further zero in on equity-dependent firms.

The definitional shortcomings partly stem from the fact that Kaplan and Zingales (1997) set out to measure financial constraints generally, not equity dependence. Though related, these concepts are not exactly the same. For example, one can imagine a high-KZ firm whose investment is sensitive to debt-market conditions, but that would not issue equity at any price. An important part of our empirical work is therefore to confirm that high-KZ firms actually do raise significantly more outside equity when stock prices go up.

#### *D. Competing hypotheses*

Our null hypothesis throughout the empirical section is that the stock market is efficient and that financing is frictionless. This leads to the benchmark  $Q$  specification, in which the

coefficient of investment on  $Q$  reflects technological adjustment costs.<sup>9</sup> The full statement of our null hypothesis is therefore that any cross-sectional differences in the sensitivity of investment to  $Q$  reflect cross-sectional differences in technological adjustment costs. This theory is silent about the sensitivity of equity issuance to  $Q$ .

An alternative hypothesis that is also distinct from ours is that any patterns we may find in the investment- $Q$  sensitivity are due to cross-sectional differences in measurement error. In particular, the effects predicted by our model would also show up if measurement error were more pronounced for firms that are less equity dependent. However, an important point to note is that such a pattern with respect to measurement error is precisely the *reverse* of that which has for many years been discussed in the large literature on liquidity constraints. For example, in his discussion of Fazzari, Hubbard, and Petersen (1988), Poterba (1988) argues that their results “could be explained on this view because  $Q$  is measured with more error for smaller firms, which tend to be lower-dividend firms” (p. 202). Erickson and Whited (2000) and Alti (2001) further develop this point; the latter builds a formal model to show why measurement error in  $Q$  is likely to be greater for younger, faster-growing firms. Clearly, if these arguments are correct, our approach stands on safe ground. The KZ index scores low-dividend, high-growth firms as being more likely to be equity dependent. If these attributes lead to more measurement error in  $Q$ , our tests will be biased toward being excessively conservative.

Nevertheless, it is at least possible to concoct measurement-error stories that go in the opposite direction. One way to partially address such stories, as well as the adjustment-costs null hypothesis, is by “unpacking” the composite KZ index. The definition of equity dependence leads to specific predictions for how *each* of the components of the KZ index should affect the

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<sup>9</sup> This model is treated in the surveys of the investment literature by Chirinko (1993) and Hubbard (1998).

sensitivity of investment to stock prices. If these predictions hold up in the data, advocates of the competing hypotheses would then have to explain why technological adjustment costs, or measurement error in  $Q$ , should be positively correlated with some of these variables and negatively correlated with others. Our further tests that look at how the sensitivity of investment to stock prices varies with firm age and debt capacity can be thought of in a similar spirit.

### III. Data

We study a large, unbalanced panel of Compustat firms that covers 1980 through 1999. The panel excludes financial firms (i.e., firms with a one-digit SIC of six), and firm-years with a book value under \$10 million, but otherwise includes all observations with data on investment, financing, equity dependence, and other investment determinants, as described below. The full sample includes 51,982 observations, for an average of 2,599 observations per year.

#### *A. Investment*

We consider four measures of investment. Our baseline measure is  $CAPX_{it}/A_{it-1}$ , the ratio of capital expenditures in year  $t$  (Compustat Annual Item 128) to start-of-year book assets (Item 6).<sup>10</sup>  $(CAPX_{it}+RD_{it})/A_{it-1}$  includes research and development expenses (Item 46), and  $(CAPX_{it}+RD_{it}+SGA_{it})/A_{it-1}$  further includes selling, general and administrative expenses (Item 189). We also examine the percentage change in book assets over the year,  $\Delta A_{it}/A_{it-1}$ . To reduce the influence of outliers, we Winsorize each of these variables the 1<sup>st</sup> and 99<sup>th</sup> percentile.<sup>11</sup>

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<sup>10</sup> We scale our measures of investment and cash flow by book assets. This contrasts with some of the literature (e.g. Fazari, Hubbard, and Petersen (1988) and Kaplan and Zingales (1997)), where the denominator is net plant, property, and equipment. Our approach matches our sample, which includes smaller and non-manufacturing firms with modest fixed assets, and our measures of investment, which include intangible assets.

<sup>11</sup> We have conducted a variety of robustness checks to determine whether our particular treatment of outliers makes any difference. As it turns out, all that matters is that we do something to tamp down the most extreme realizations

Panel A of Table 1 shows summary statistics for investment. The reported minimum and maximum values, like the other statistics, are post-Winsorization.

### *B. Financing*

We consider two measures of external financing activity. To measure equity issuance we use  $e_{it}/A_{it-1}$ , the ratio of external equity issues to start-of-year book assets. External equity issues are constructed as the change in book equity minus the change in retained earnings ( $\Delta\text{Item } 60 + \Delta\text{Item } 74 - \Delta\text{Item } 36$ ). Total external finance is measured as  $(e_{it} + d_{it})/A_{it-1}$ , which includes both equity and debt issues. Debt issues are constructed as the total change in assets minus the change in book equity ( $\Delta\text{Item } 6 - \Delta\text{Item } 60 - \Delta\text{Item } 74$ ). These variables are also Winsorized at the 1<sup>st</sup> and 99<sup>th</sup> percentile.

Panel B of Table 1 shows summary statistics for financing. These mean values are sensitive to major financing events such as acquisitions and divestitures, despite the Winsorization and the restriction on minimum book assets. The medians look more familiar. The medians are also stable across the 1980s and 1990s (not reported).

### *C. Equity dependence*

Following Lamont, Polk and Saa-Requejo (2001), we construct the KZ index for each firm-year as a linear combination of five variables:

$$KZ_{it} = -1.002 \frac{CF_{it}}{A_{it-1}} - 39.368 \frac{DIV_{it}}{A_{it-1}} - 1.315 \frac{C_{it}}{A_{it-1}} + 3.139 LEV_{it} + 0.283 Q_{it} \quad (4)$$

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of  $Q$ , which in the raw data attains a maximum value of 52.5. An alternative to Winsorizing is to replace the book value of equity in  $Q$  with 0.9 times the book value plus 0.1 times the market value, thereby bounding the transformed value of  $Q$  below 10. This procedure gives virtually identical results to those we report. (We thank Tuomo Vuolteenaho for suggesting this procedure.)

where  $CF_{it}/A_{it-1}$  is cash flow (Item 14+Item 18) over lagged assets;  $DIV_{it}/A_{it-1}$  is cash dividends (Item 21+Item 19) over assets;  $C_{it}/A_{it-1}$  is cash balances (Item 1) over assets;  $LEV_{it}$  is leverage ((Item 9+Item 34)/(Item 9+Item 34+Item 216)); and  $Q$  is the market value of equity (price times shares outstanding from CRSP) plus assets minus the book value of equity (Item 60+Item 74) all over assets.<sup>12</sup> We Winsorize the ingredients of the KZ index before constructing it. When we use this index to classify observations, we use its twice-lagged value in order to reduce any potential concerns about hardwiring.<sup>13</sup>

In some of our additional tests, we consider two other variables that may help to pinpoint equity-dependent firms.  $AGE_{it}$  is the number of years since the firm's IPO, defined as the current year minus the first year Compustat reports a non-missing market value of equity. As discussed above, this variable may be useful as a proxy for reputation and access to lending markets.  $Industry \sigma(CF/A)_i$  is the industry average standard deviation of cash flows. We calculate the standard deviation of cash flows across the subset of firm-year observations for each industry using the industry definitions in Fama and French (1997). This variable may help to capture variation in debt capacity that is missed by the KZ index.

Panel A of Table 2 shows summary statistics for the KZ index, its five ingredients, and the other two equity-dependence proxies. By multiplying the coefficients in equation (4) by the standard deviation of the components, one can see that the KZ index is especially sensitive to variation in dividends and leverage.

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<sup>12</sup> As with investment, we scale the components of the KZ index by assets rather than net plant, property, and equipment (Item 8), because our sample includes small and non-manufacturing firms. Although assets produce fewer outliers in the raw KZ index, our basic quintile results in Table 3 go through equally well with either denominator.

<sup>13</sup> None of our results are materially altered if we use the once-lagged value of the KZ index instead.

#### *D. Other investment determinants*

Following Fazzari, Hubbard, and Petersen (1988) and many others, our baseline investment equation includes year fixed effects, firm fixed effects, start-of-year  $Q$ , and contemporaneous cash flow.  $Q$  and cash flow are as defined above.

### **IV. Empirical results**

#### *A. Hypothesis 1: Investment*

We begin with a simple test of Hypothesis 1, which predicts that the investment of equity-dependent firms is more sensitive to their stock prices than that of non-equity-dependent firms. We use the entire pooled sample to determine quintile breakpoint values of the KZ index, and then assign each firm-year observation to a quintile according to its time  $t-2$  KZ index value.<sup>14</sup> For each KZ quintile, we then estimate the following investment equation:

$$\frac{CAPX_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + c \frac{CF_{it}}{A_{it-1}} + u_{it} . \quad (5)$$

Hypothesis 1 predicts that the coefficient  $b$  will generally increase as KZ increases.<sup>15</sup>

Figure 1 and Panel A of Table 3 show that there is indeed a strong relationship between KZ and the effect of stock prices on investment. The coefficient  $b$  rises from 0.009 in the first quintile to 0.025 in the fifth quintile. Thus, the firms that are most likely to be equity dependent –

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<sup>14</sup> An alternative approach is to set separate quintile breakpoints for each year. This forces the observations to be evenly distributed across KZ categories in every single year. This approach leads to results very similar to those we report below. Another feature of our methodology is that a firm's KZ quintile can vary from year to year. For example, if its leverage increases, it may move to a higher quintile. We have also tried assigning to each firm a permanent one-time value of the KZ index, based on the median value it takes within the sample. This alternative also leads to similar results.

<sup>15</sup> We have repeated all of the following investment regressions with specifications that include lagged investment on the right-hand side. This may be helpful in better capturing the dynamics of investment, and in reducing residual serial correlation. This specification change has little impact on our main results, however.

according to the KZ index – have a sensitivity of investment to stock prices that is over two-and-a-half times as large as firms that are unlikely to be equity dependent.

As an aside, it is interesting to look at how the coefficient  $c$  on the cash-flow term varies with the KZ index in Panel A of Table 3. Consistent with the small-sample results of Kaplan and Zingales (1997), we find no discernible pattern in this coefficient across the KZ quintiles. It is almost the same in quintile 1 (0.126) as in quintile 5 (0.133), and bounces around non-monotonically in between.

To get a better understanding of economic magnitudes, note from Table 2 that the standard deviation of  $Q$  in our sample is 0.91. Thus in the highest KZ quintile, the impact of a one-standard-deviation shock to  $Q$  is to alter the ratio of capital expenditures to assets by 0.023 ( $0.91 \times 0.025 = 0.023$ ). When compared to either the median or the standard deviation of this investment ratio (0.0598 and 0.0780, respectively), this effect is clearly substantial. As another benchmark, note that the standard deviation of the cash-flow-to-assets ratio is 0.117, so that in the highest KZ quintile, a one-standard-deviation shock to cash flow moves the investment ratio by 0.016 ( $0.133 \times 0.117 = 0.016$ ). Thus among the firms most likely to be equity dependent, stock prices have a slightly larger effect on investment than does cash flow. This contrasts with a general belief that cash flow dominates  $Q$  in these sorts of investment equations.

### *B. Hypothesis 2: Investment and valuation*

Hypothesis 2 predicts that the investment of *undervalued* equity-dependent firms is particularly sensitive to stock price. This is a more precise statement of the basic idea of the model, which is that undervaluation can induce a financial constraint on equity-dependent firms.

This hypothesis is more difficult to test than Hypothesis 1, unfortunately, because it requires us to find some proxy for misvaluation (or, specifically, a proxy for *perceived* mispricing).

One useful proxy for misvaluation may be the level of  $Q$  itself. Several authors have interpreted the market-to-book ratio as a proxy for mispricing (Lakonishok, Shleifer, and Vishny (1994), La Porta (1996), and La Porta, Lakonishok, Shleifer, and Vishny (1997)). While this interpretation remains controversial, there is rather clear support for the use of market-to-book as a proxy for *perceived* mispricing. This is suggested by several empirical studies. First, managers state in surveys that mispricing is an important factor in the decision to issue equity (Graham and Harvey (2001)). Second, managers actually do tend to issue equity when the market-to-book ratio is high (Marsh (1982), Korajczyk, Lucas, and McDonald (1991), Pagano, Panetta, and Zingales (1998), and others). Third, managers tend to be net sellers in their personal account when their firm's market-to-book ratio is high (Jenter (2001)). Put together, these results suggest that a sensible approach to testing Hypothesis 2 would use market-to-book, or  $Q$ , as a proxy for *perceived* mispricing.

We therefore split the full sample into two subsamples, one containing low valuation firm-years ( $Q < 2.00$ ) and another containing high valuation firm-years ( $Q > 2.00$ ). The choice of 2.00 is admittedly arbitrary, but it seems necessary to set the breakpoint above unity to reflect such facts as intangible assets, inflation, and the aforementioned tendency among managers to view their firms as chronically undervalued.

Figure 2 and the bottom panels of Table 3 show the sensitivity of investment to  $Q$  in each of these subsamples. The results are generally consistent with Hypothesis 2. In the low valuation sample, the sensitivity of investment to  $Q$  is strongly increasing in the KZ index, whereas the effect is small in the high valuation sample. Thus it appears that our results for the full sample

are almost entirely driven by the low valuation firms, as predicted by Hypothesis 2. Panel B of Figure 2 also shows that the sensitivity of investment to stock prices is lower in general in the high valuation sample. This is consistent with another feature of the model, that investment is a fixed constant when  $\delta > 0$  – or said more realistically, that investment is sensitive to stock prices in this region only to the extent that they reflect investment opportunities as opposed to perceived mispricing.

In Table 4 we test the robustness of these results to other measures of investment. To do this in a compact fashion, we pool the observations and run a series of interactive specifications of the form:

$$\frac{I_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + cQ_{it-1} \cdot KZ_{it-2} + dKZ_{it-2} + e \frac{CF_{it}}{A_{it-1}} + u_{it} \quad (6)$$

where  $I_{it}$  denotes one of four measures of investment.<sup>16</sup> The coefficient of interest in this case is  $c$ . Hypothesis 1 predicts that  $c$  will be positive, and Hypothesis 2 predicts that it will be particularly high in the low valuation subsample.

Table 4 indicates that all four measures of investment give qualitatively similar results. Another notable result is that  $d$ , the coefficient on the un-interacted  $KZ_{it-2}$  term, is always negative, and significantly so in the full sample and the low valuation subsample. Thus firms that are more likely to be equity dependent also tend to invest less. As Kaplan and Zingales (1997) point out, this is a basic implication of most any model of financial constraints, ours included.

Although the results of the valuation splits are consistent with Hypothesis 2, we are hesitant to make them our central focus. The reason is again a twist on the Poterba (1988) measurement-error critique. It is possible that  $Q$  is a poorer proxy for investment opportunities

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<sup>16</sup> We have also examined specifications that include interactions of  $Q$  and year dummies, so that the  $Q$ - $KZ$  interaction term captures only the effects of cross-sectional variation in the  $KZ$  index, and no time-series variation. This makes no perceptible difference to our results.

when it is high, so measurement error could also lead to the sort of differences that we observe in the valuation splits. This is why we view Hypothesis 1 as the most straightforward test of the model, and Figure 1 as the most compelling empirical result. Nevertheless, it is reassuring that the results are at least consistent with Hypothesis 2.

### *C. Decomposing KZ and the effect of other equity-dependence indicators*

One hypothesis that we have maintained, not derived, is that the KZ index is a useful measure of equity dependence. One way to examine this hypothesis is by decomposing our previous results, checking how each of the five components of the KZ index is affecting the  $Q$ -sensitivity. If each component works in the way suggested by our model, we can be more confident that the index is a useful measure of equity dependence. This exercise also sheds light on whether measurement error or technological adjustment costs are plausible explanations for the earlier patterns, as discussed below.

To perform the KZ index decomposition, we again pool all observations, and then run the following interactive specification:

$$\begin{aligned} \frac{I_{it}}{A_{it-1}} = & a_i + a_t + bQ_{it-1} + Q_{it-1} \cdot \left[ c_1 \frac{CF_{it-2}}{A_{it-3}} + c_2 \frac{DIV_{it-2}}{A_{it-3}} + c_3 \frac{C_{it-2}}{A_{it-3}} + c_4 LEV_{it-2} + c_5 Q_{it-2} \right] \\ & + \left[ d_1 \frac{CF_{it-2}}{A_{it-3}} + d_2 \frac{DIV_{it-2}}{A_{it-3}} + d_3 \frac{C_{it-2}}{A_{it-3}} + d_4 LEV_{it-2} + d_5 Q_{it-2} \right] + e \frac{CF_{it}}{A_{it-1}} + u_{it} \end{aligned} \quad (7)$$

We run this specification for each of our four measures of investment. The theoretical definition of equity dependence makes predictions for the signs of the interactions:  $c_1$  should be negative, as should  $c_2$  and  $c_3$ . In contrast,  $c_4$  should be positive. The only case for which the prediction is a priori ambiguous is  $c_5$ . If  $Q$  were only picking up variation in investment opportunities (i.e., were

proxying only for  $K^{fb}$ ), then we would expect  $c_5$  to be positive. But to the extent that  $Q$  also contains information about mispricing  $\delta$ , this will exert a negative influence on  $c_5$ .

Panel A of Table 5 shows that the predictions for  $c_1$ ,  $c_2$ ,  $c_3$  and  $c_4$  are largely borne out. The strongest results are for  $c_4$ , the interaction on the leverage term. Across all four definitions of investment,  $c_4$  is always very significantly positive, indicating a strong tendency for levered firms to have investment that is more sensitive to stock prices. The results for  $c_1$ ,  $c_2$  and  $c_3$  are generally weaker, but overall consistent with the theory. With respect to  $c_5$ , the interaction on the  $Q$  term, we obtain consistently negative and significant estimates. (In fact, this negative sign might have been anticipated based on our earlier valuation splits.) This is not what we would have expected if  $Q$  were a proxy only for growth opportunities. It could be driven by  $Q$ 's other role as a misvaluation indicator.

In Panel B we consider two other potential proxies for equity dependence that are not included in the KZ index: firm age and industry cash flow volatility. We re-estimate equation (7) augmented with these variables and their interactions with  $Q$ , denoting the interaction coefficients as  $c_6$  and  $c_7$ , respectively. We predict that  $c_6$  will be negative, on the premise that younger firms are more likely to be dependent on equity. And we predict that  $c_7$  will be positive, since higher cash flow volatility implies lower debt capacity, which again contributes to equity dependence. The results in Panel B strongly support these predictions. Both  $c_6$  and  $c_7$  have the expected sign for all measures of investment, and the estimates are always highly significant.

This exercise indicates that the earlier results for the composite KZ index reflect helpful contributions from each of four components: cash flow, dividends, cash on hand, and leverage, with leverage playing the strongest and most consistent role. However,  $Q$  is somewhat undermining the appeal of the KZ index for our purposes – we would get stronger results if we

threw  $Q$  out of the index. Given the theoretical ambiguities surrounding the use of  $Q$  in this context, this is probably not surprising. The results also cast doubt on generic measurement error or adjustment cost explanations: One would have to argue that measurement error or adjustment costs are simultaneously increasing in some of these variables and decreasing in certain others.

Overall, the results provide a detailed picture of the type of firm that is likely to have a high sensitivity of investment to stock prices: a young, non-dividend-paying firm, with a depressed stock price, low cash flow and cash balances, and with high leverage *relative* to the debt capacity of its assets. This picture fits the definition of equity dependence rather well.

#### *D. Hypothesis 3: Financing and valuation*

Our last hypothesis is that equity issuance by undervalued, equity-dependent firms is particularly sensitive to stock price. If so, this would be further evidence that our earlier results for investment are coming through the specific equity financing channel in the model. We test this hypothesis within the same regression framework as before, simply changing the dependent variable from investment to financing.

In Figure 3 and the first three panels of Table 6, the financing variable is equity issues over assets,  $e_{it}/A_{it-1}$ . Panel A of Table 6 indicates that for all firms, the sensitivity of equity issuance to stock prices rises from 0.024 in the first KZ quintile to 0.044 in the fifth quintile. Thus, averaging across all valuation levels, firms classified as most likely to be equity dependent have equity issuance that is much more closely tied to their stock prices. This is the same pattern that we found for investment.

Hypothesis 3 suggests that this pattern can be attributed primarily to the undervalued observations. To test this we again split the sample according to whether  $Q$  is above or below

2.00. Figure 3 and the middle panels of Table 6 show the results. As predicted, low-valued firms that score high on the KZ index have equity issues that are especially sensitive to stock price. In the top quintile of the low valuation sample, for example, the sensitivity is 0.078, which is substantially greater than the bottom quintile figure of 0.036 and substantially greater than any sensitivity in the high valuation sample. There is in fact no clear pattern in the high valuation sample, as with our earlier results for investment.

The model does not imply that equity-dependent firms finance 100% of their marginal investment with equity issues, of course. According to Proposition 1, in the relevant region of the parameter space (iii.a) the leverage constraint is binding, so at the margin new equity and debt are raised in proportions  $(1-\bar{D})$  and  $\bar{D}$  respectively. This suggests the testable prediction that equity-dependent firms should also be raising a significant amount of debt on the margin.

We examine this prediction using a total external finance variable that includes both equity and debt issues,  $(e_{it}+d_{it})/A_{it-1}$ . The results are in Panel D. They show that for firms in KZ quintile 5, the sensitivity of total external finance is 0.103, whereas for equity issues alone it is 0.044. This indicates that the sensitivity of debt to stock prices is 0.057 ( $=0.103-0.044$ ) for these firms. This confirms that both equity and debt issues are closely related to stock prices in high KZ firms, consistent with the model's prediction that equity-dependent firms issue equity and debt in lock step. For firms in KZ quintile 1, by contrast, stock prices have relatively weaker effects on either equity issues or debt issues.

The results here support Hypothesis 3 and help to reinforce further the case that the earlier investment results are being driven by the specific equity financing channel outlined in the model. As predicted by the model, equity issues are especially sensitive to stock prices

among low-valued, high-KZ firms, and debt issues appear to move roughly in lock step as these equity issues create debt capacity on the margin.

## **V. Conclusion**

A great deal of research has been devoted to understanding why stock prices are correlated with investment. The traditional view, embodied in the  $Q$  theory of investment, emphasizes the role of stock prices as indicators of investment opportunities. The alternative view emphasizes the existence of some equity financing channel in which the cost of external equity has an independent effect on investment. Empirical attempts to determine the relative merits of these two views have not been very successful, however. The main reason why is because the equity financing channel is usually not articulated in a form that yields distinct empirical predictions.

In this paper, we use a version of the Stein (1996) model to develop a specific, testable equity financing channel. The main cross-sectional prediction of the model is that firms that need external equity to finance their legitimate investment opportunities – “equity-dependent firms” – will have investment that is especially sensitive to the non-fundamental component of stock prices. This prediction reflects, in part, the idea that undervaluation increases the effective cost of external equity and therefore deters investment by equity-dependent firms. The model also offers other predictions that are distinct from the  $Q$  theory.

We test the model using an index developed by Kaplan and Zingales (1997) to identify equity-dependent firms. The main empirical result is that firms that rank in the top quintile of the KZ index have investment that is two-and-a-half-times as sensitive to  $Q$  as firms in the bottom quintile. We also find support for several other implications of the model. For example, the effect

of equity dependence is much stronger in a sample of firms that is more likely to be undervalued. In addition, equity issues by equity-dependent firms are also more sensitive to stock prices, consistent with the mechanism in the model.

The results complement other recent research on how the cost of external equity – particularly the component that is irrational, or perceived as such by managers – drives patterns in equity issues, capital structure, or merger activity. But they are of perhaps greater economic importance than those findings pertaining purely to financing patterns, because they suggest how stock market inefficiency may affect the real economy.

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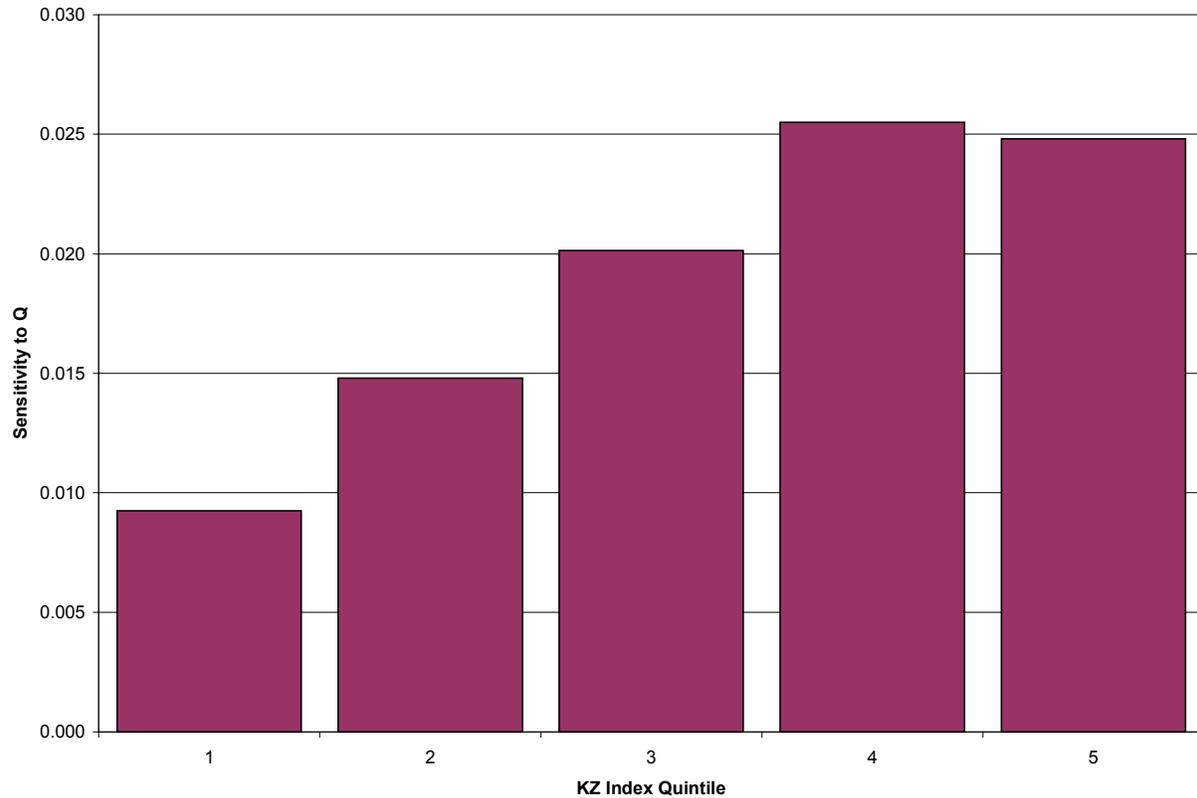
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**Figure 1. Equity dependence and investment.** Plot of the sensitivity of investment to market value by equity dependence quintile. We sort firms into five quintiles according to the Kaplan and Zingales (1997) index of financial constraints, performing separate regressions for each group. Year and firm fixed effects are included.

$$\frac{CAPX_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + c\frac{CF_{it}}{A_{it-1}} + u_{it}$$

We plot estimates of  $b$ . Investment is defined as capital expenditures over assets.  $Q$  is defined as the market value of equity plus assets minus the book value of equity over assets. Cash flow is defined as operating cash flow over assets.

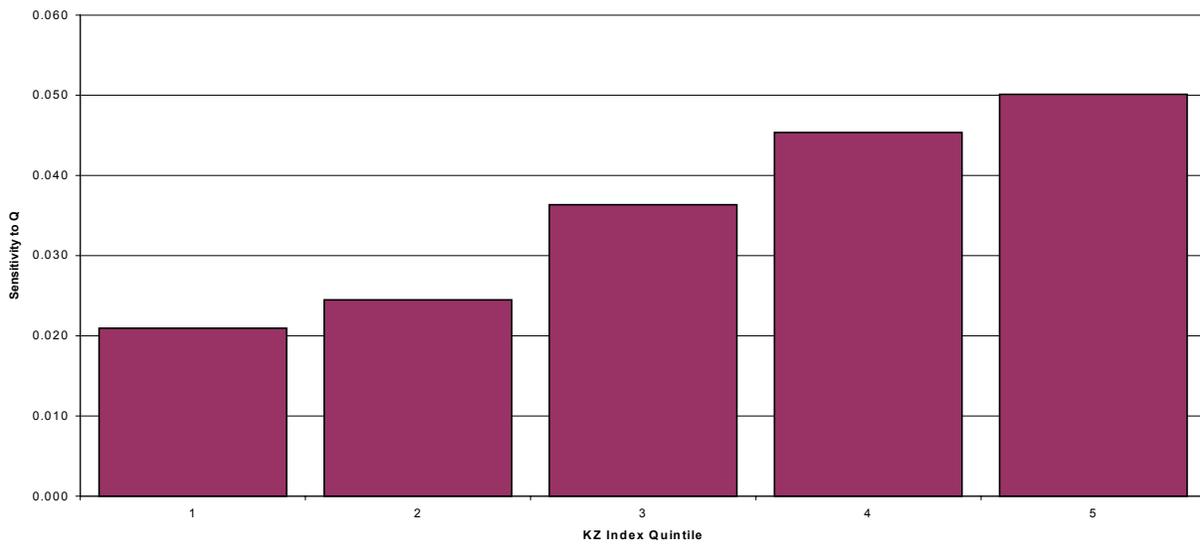


**Figure 2. Equity dependence and investment, by valuation level.** Plot of the sensitivity of investment to market value by equity dependence quintile and valuation level. We sort firms into five quintiles according to the Kaplan and Zingales (1997) index of financial constraints. Within each quintile, we sort firms by valuation level according to whether  $Q$  is below or above 2.00. We then perform separate regressions of each of these ten groups. Year and firm fixed effects are included.

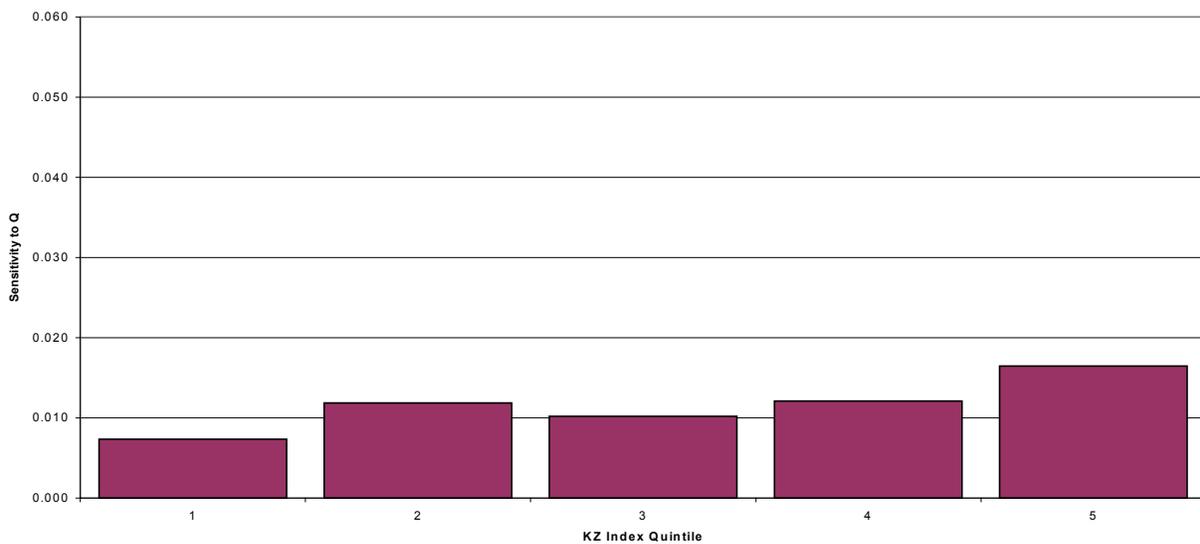
$$\frac{CAPX_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + c \frac{CF_{it}}{A_{it-1}} + u_{it}$$

We plot estimates of  $b$ . Investment is defined as capital expenditures over assets.  $Q$  is defined as the market value of equity plus assets minus the book value of equity over assets. Cash flow is defined as operating cash flow over assets. Panel A shows results for firms with  $Q$  below 2.00. Panel B shows results for firms with  $Q$  above 2.00.

A. Low valuation firms



B. High valuation firms

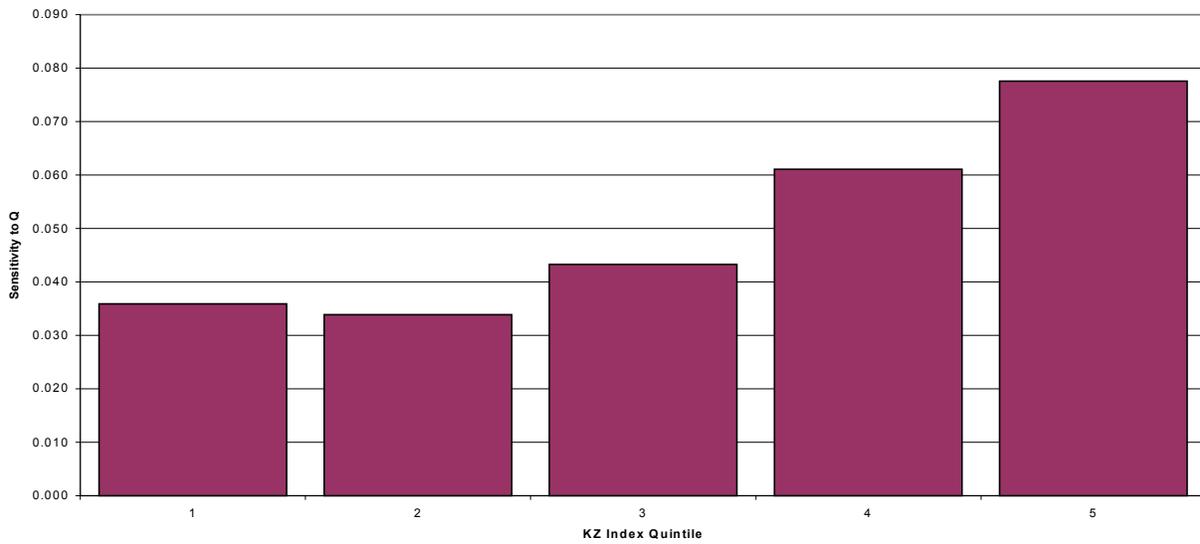


**Figure 3. Equity dependence and equity issuance, by valuation level.** Plot of the sensitivity of equity issuance to market value by equity dependence quintile and valuation level. We sort firms into five quintiles according to the Kaplan and Zingales (1997) index of financial constraints. Within each quintile, we sort firms by valuation level according to whether  $Q$  is below or above 2.00. We then perform separate regressions of each of these ten groups. Year and firm fixed effects are included.

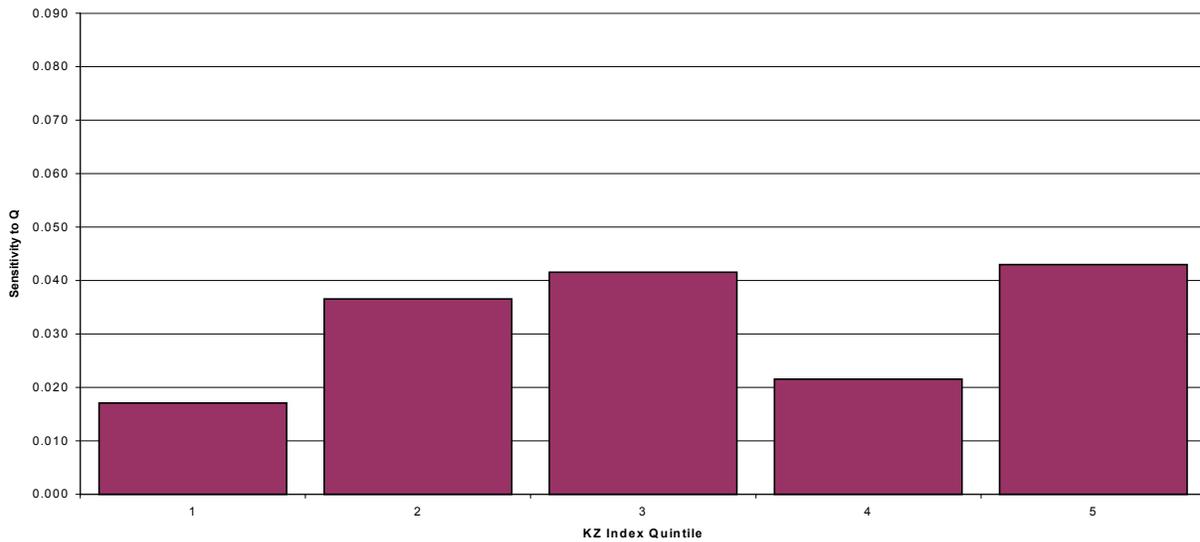
$$\frac{E_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + c \frac{CF_{it}}{A_{it-1}} + u_{it}$$

We plot estimates of  $b$ . Equity issues are defined as the change in book equity minus the change in retained earnings over assets.  $Q$  is defined as the market value of equity plus assets minus the book value of equity over assets. Cash flow is defined as operating cash flow over assets. Panel A shows results for firms with  $Q$  below 2.00. Panel B shows results for firms with  $Q$  above 2.00.

A. Low valuation firms



B. High valuation firms



**Table 1. Summary statistics of investment and financing.** In Panel A, investment is alternately defined as capital expenditures (Item 128) over assets (Item 6); capital expenditures plus research and development expenses (Item 46) over assets; capital expenditures plus research and development expenses plus selling, general, and administrative expenses (Item 189) over assets; and growth in assets. In Panel B, financing is defined separately as equity issues ( $\Delta$ Item 60+ $\Delta$ Item 74- $\Delta$ Item 36) (i.e. the change in book equity minus the change in retained earnings) over assets, and equity issues plus debt issues ( $\Delta$ Item 6- $\Delta$ Item 60- $\Delta$ Item 74) over assets. All variables are Winsorized at the 1<sup>st</sup> and 99<sup>th</sup> percentiles.

	<i>Full Sample</i>						<i>Subsample Means</i>	
	<b>N</b>	<b>Mean</b>	<b>SD</b>	<b>Median</b>	<b>Min</b>	<b>Max</b>	<b>1980-89</b>	<b>1990-99</b>
Panel A: Investment								
$CAPX_t/A_{t-1} \%$	51,982	8.20	7.80	5.98	0.18	44.70	8.76	7.77
$+RD_t/A_{t-1}$	51,982	11.37	10.41	8.42	0.24	58.14	10.90	11.72
$+RD_t+SGA_t/A_{t-1}$	51,982	40.02	28.85	34.17	1.62	143.48	39.06	40.74
$\Delta A_t/A_{t-1} \%$	51,982	11.08	28.10	6.38	-44.16	154.09	10.20	11.76
Panel B: Financing								
$e_t/A_{t-1} \%$	51,982	4.38	14.63	0.64	-16.31	93.73	2.95	5.48
$+d_t/A_{t-1}$	51,982	10.47	27.62	3.99	-34.74	164.53	8.35	12.09

**Table 2. Summary statistics of equity dependence and other investment determinants.** Equity dependence is defined using the Kaplan and Zingales (1997) index of financial constraints, as implemented by Lamont, Polk, and Saa-Requejo (2001). This index has five components: cash flow (Item 14+Item 18) over assets; cash dividends (Item 21+Item 19) over assets; cash balances (Item 1) over assets; leverage ((Item 9+Item 34)/(Item 9+Item 34+Item 216)); and  $Q$ .  $Q$  is defined as the market value of equity (price times shares outstanding from CRSP) plus assets minus the book value of equity (Item 60+Item 74) over assets. We also consider two additional measures of equity dependence, firm age and the industry standard deviation of cash flow over assets between 1980 and 1999. Industry definitions follow Fama and French (1997). Age is equal to the current year minus the IPO year, which is defined as the first year Compustat reports a non-missing market value of equity. All variables are Winsorized at the 1<sup>st</sup> and 99<sup>th</sup> percentiles except for firm age and the industry standard deviation of cash flow.

	<i>Full Sample</i>						<i>Subsample Means</i>	
	<b>N</b>	<b>Mean</b>	<b>SD</b>	<b>Median</b>	<b>Min</b>	<b>Max</b>	<b>1980-89</b>	<b>1990-99</b>
Panel A: Equity Dependence ( $t-2$ )								
<i>KZ Index</i>	51,982	0.71	1.58	0.71	-6.60	5.94	0.57	0.81
<i>CF<sub>t-2</sub>/A<sub>t-3</sub> %</i>	51,982	10.65	19.07	9.08	-40.18	137.26	10.50	10.76
<i>DIV<sub>t-2</sub>/A<sub>t-3</sub> %</i>	51,982	1.66	2.83	0.67	0.00	20.18	1.86	1.52
<i>C<sub>t-2</sub>/A<sub>t-3</sub> %</i>	51,982	14.00	26.03	5.05	0.01	185.73	11.00	16.28
<i>LEV<sub>t-2</sub> %</i>	51,982	35.31	25.64	34.26	0.00	124.13	35.74	34.98
<i>Q<sub>t-2</sub></i>	51,982	1.44	0.92	1.14	0.52	6.14	1.25	1.58
<i>AGE<sub>t-2</sub></i>	51,982	14.99	10.33	12.00	1.00	49.00	14.76	15.17
<i>Industry <math>\sigma(CF/A)</math></i>	51,982	138.20	211.05	60.16	10.94	863.50	136.96	139.14
Panel B: Other Investment Determinants								
<i>Q<sub>t-1</sub></i>	51,982	1.46	0.91	1.16	0.53	6.07	1.26	1.60
<i>CF/A<sub>t-1</sub> %</i>	51,982	8.19	11.70	9.18	-42.78	36.57	9.24	7.39

**Table 3. Equity dependence and investment, full sample and by valuation level.** Regressions of investment on market value and cash flow by equity dependence quintile. We sort firms into five quintiles according to the Kaplan and Zingales (1997) index of financial constraints, performing separate regressions for each group. Year and firm fixed effects are included.

$$\frac{CAPX_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + c \frac{CF_{it}}{A_{it-1}} + u_{it}$$

We report estimates of  $b$  and  $c$ . Investment is defined as capital expenditures over assets.  $Q$  is defined as the market value of equity plus assets minus the book value of equity over assets. Cash flow is defined as operating cash flow over assets. Panel A shows results for the full sample. Panel B shows results for firms with  $Q$  below 2.00. Panel C shows results for firms with  $Q$  above 2.00. T-statistics are heteroskedasticity-robust.

KZ index	N	$Q_{t-1}$		$CF_{t-1}/A_{t-2}$		R <sup>2</sup>
		b	[t-stat]	c	[t-stat]	
Panel A: All firms						
Quintile 1	10,397	0.009	[8.23]	0.126	[9.52]	0.58
2	10,396	0.015	[8.62]	0.109	[9.05]	0.60
3	10,397	0.020	[9.79]	0.172	[13.02]	0.59
4	10,396	0.026	[11.47]	0.160	[13.99]	0.58
5	10,396	0.025	[10.85]	0.133	[11.38]	0.56
Panel B: Low valuation firms						
Quintile 1	8,191	0.021	[6.35]	0.125	[7.93]	0.59
2	8,657	0.024	[7.89]	0.139	[9.49]	0.60
3	9,032	0.036	[10.04]	0.176	[11.83]	0.60
4	9,168	0.045	[10.89]	0.167	[13.39]	0.59
5	8,827	0.050	[9.87]	0.156	[11.55]	0.56
Panel C: High valuation firms						
Quintile 1	2,206	0.007	[4.16]	0.122	[4.83]	0.65
2	1,739	0.012	[2.78]	0.023	[0.68]	0.60
3	1,365	0.010	[1.99]	0.058	[1.28]	0.67
4	1,228	0.012	[1.99]	0.067	[1.32]	0.63
5	1,569	0.016	[3.57]	0.057	[1.63]	0.65

**Table 4. Equity dependence and investment, full sample and by valuation level.** Regressions of investment on market value, market value interacted with equity dependence, equity dependence, and cash flow. Year and firm fixed effects are included.

$$\frac{I_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + cQ_{it-1} \cdot KZ_{it-2} + dKZ_{it-2} + e \frac{CF_{it}}{A_{it-1}} + u_{it}$$

Investment is alternately defined as capital expenditures over assets; capital expenditures plus research and development expenses over assets; capital expenditures plus research and development expenses plus selling, general, and administrative expenses over assets; and growth in assets.  $Q$  is defined as the market value of equity plus assets minus the book value of equity over assets. The measure of equity dependence is the Kaplan and Zingales (1997) index of financial constraints, standardized to have unit variance. Cash flow is defined as operating cash flow over assets. Panel A shows results for the full sample. Panel B shows results for firms with  $Q$  below 2.00. Panel C shows results for firms with  $Q$  above 2.00. T-statistics are heteroskedasticity-robust.

	N	$Q_{t-1}$		$Q_{t-1} \cdot KZ_{t-2}$		$KZ_{t-2}$		$CF_t/A_{t-1}$		$R^2$
		b	[t-stat]	c	[t-stat]	d	[t-stat]	e	[t-stat]	
Panel A: All firms										
<i>CAPX/A</i>	51,982	0.018	[27.59]	0.002	[5.17]	-0.007	[-10.61]	0.137	[31.11]	0.54
+ <i>RD/A</i>	51,982	0.024	[27.58]	0.002	[4.92]	-0.009	[-10.82]	0.122	[19.65]	0.64
+ <i>RD+SGA/A</i>	51,982	0.043	[23.68]	0.004	[3.98]	-0.016	[-8.59]	0.279	[21.30]	0.81
$\Delta A/A$	51,982	0.067	[20.52]	0.012	[6.22]	-0.036	[-10.98]	1.151	[47.23]	0.31
Panel B: Low valuation firms										
<i>CAPX/A</i>	43,875	0.037	[26.32]	0.004	[4.19]	-0.010	[-7.86]	0.150	[30.21]	0.53
+ <i>RD/A</i>	43,875	0.042	[25.39]	0.005	[3.76]	-0.011	[-7.78]	0.152	[23.19]	0.59
+ <i>RD+SGA/A</i>	43,875	0.061	[18.17]	0.010	[4.06]	-0.022	[-7.59]	0.345	[24.47]	0.83
$\Delta A/A$	43,875	0.100	[16.88]	0.022	[4.62]	-0.045	[-8.00]	1.254	[47.66]	0.30
Panel A: High valuation firms										
<i>CAPX/A</i>	8,107	0.011	[10.16]	0.000	[0.21]	-0.002	[-0.71]	0.067	[6.26]	0.63
+ <i>RD/A</i>	8,107	0.018	[10.99]	0.000	[0.36]	-0.002	[-0.71]	0.009	[0.57]	0.71
+ <i>RD+SGA/A</i>	8,107	0.037	[10.82]	0.000	[0.17]	-0.003	[-0.40]	0.095	[2.69]	0.77
$\Delta A/A$	8,107	0.061	[9.05]	0.012	[3.16]	-0.050	[-3.76]	0.836	[12.77]	0.30

**Table 5. Equity dependence decomposition.** Regressions of investment on market value, market value interacted with the components of equity dependence, the components of equity dependence, and cash flow. Year and firm fixed effects are included.

$$\frac{I_{it}}{A_{it-1}} = a_i + a_t + bQ_{it-1} + Q_{it-1} \cdot \left[ c_1 \frac{CF_{it-2}}{A_{it-3}} + c_2 \frac{DIV_{it-2}}{A_{it-3}} + c_3 \frac{C_{it-2}}{A_{it-3}} + c_4 LEV_{it-2} + c_5 Q_{it-2} + c_6 \log(AGE_{it-2}) + c_7 \sigma \left( \frac{CF}{A} \right) \right] + \left[ d_1 \frac{CF_{it-2}}{A_{it-3}} + d_2 \frac{DIV_{it-2}}{A_{it-3}} + d_3 \frac{C_{it-2}}{A_{it-3}} + d_4 LEV_{it-2} + d_5 Q_{it-2} + d_6 \log(AGE_{it-2}) + d_7 \sigma \left( \frac{CF}{A} \right) \right] + e \frac{CF_{it}}{A_{it}} + u_{it}$$

We report *c*. Investment is alternately defined as capital expenditures over assets; capital expenditures plus research and development expenses over assets; capital expenditures plus research and development expenses plus selling, general, and administrative expenses over assets; and growth in assets. *Q* is defined as the market value of equity plus assets minus the book value of equity over assets. Panel A decomposes the effect of the Kaplan and Zingales (1997) index into its five components: operating cash flow over assets; dividends over assets; cash balance over assets; leverage; and *Q*. Panel B adds two additional measures of equity dependence, firm age and the industry standard deviation of cash flow over assets between 1980 and 1999. All components of equity dependence are standardized to have unit variance. The first row indicates the sign the variable takes in the Kaplan and Zingales (1997) index. The second row indicates the predicted sign. T-statistics are heteroskedasticity-robust.

	$CF_{t-2}/A_{t-3}$		$DIV_{t-2}/A_{t-3}$		$C_{t-2}/A_{t-2}$		$LEV_{t-2}$		$Q_{t-2}$		$\log(AGE_{t-2})$		$Industry \sigma(CF/A)$	
	$c_1$	[t-stat]	$c_2$	[t-stat]	$c_3$	[t-stat]	$c_4$	[t-stat]	$c_5$	[t-stat]	$c_6$	[t-stat]	$c_7$	[t-stat]
<i>KZ Index</i>	–		–		–		+		+					
<i>Prediction</i>	–		–		–		+		+/-		–		+	
Panel A: KZ index variables														
<i>CAPX/A</i>	0.001	[2.00]	-0.001	[-1.81]	-0.001	[-4.24]	0.003	[6.46]	-0.002	[-8.11]				
+ <i>RD/A</i>	-0.000	[-0.51]	-0.001	[-1.39]	-0.001	[-1.23]	0.003	[5.45]	-0.002	[-6.89]				
+ <i>RD+SGA/A</i>	-0.004	[-3.81]	0.002	[1.57]	0.000	[0.00]	0.010	[7.58]	-0.001	[-1.85]				
$\Delta A/A$	-0.003	[-1.47]	-0.007	[-3.75]	-0.001	[-0.42]	0.015	[6.04]	-0.004	[-2.54]				
Panel B: Additional measures of equity dependence														
<i>CAPX/A</i>	0.001	[1.68]	-0.000	[-0.76]	-0.001	[-4.23]	0.002	[4.99]	-0.002	[-7.48]	-0.003	[-6.07]	0.008	[7.56]
+ <i>RD/A</i>	-0.000	[-0.67]	-0.000	[-0.68]	-0.001	[-1.28]	0.003	[4.25]	-0.002	[-6.61]	-0.003	[-4.00]	0.008	[6.62]
+ <i>RD+SGA/A</i>	-0.004	[-3.85]	0.002	[2.02]	-0.000	[-0.29]	0.009	[6.97]	-0.002	[-2.19]	-0.004	[-2.67]	0.006	[3.52]
$\Delta A/A$	-0.003	[-1.60]	-0.006	[-2.96]	-0.001	[-0.44]	0.014	[5.52]	-0.003	[-1.91]	-0.011	[-3.79]	0.012	[3.08]

**Table 6. Equity dependence and financing.** Regressions of financing on market value and cash flow, by equity dependence quintile and valuation level. We sort firms into five quintiles according to the Kaplan and Zingales (1997) index of financial constraints, performing separate regressions for each group. Year and firm fixed effects are included.

$$Financing_{it} = a_i + a_t + bQ_{it-1} + c\frac{CF_{it}}{A_{it-1}} + u_{it}$$

We report estimates of  $b$  and  $c$ . Financing is alternately defined as equity issues over assets and as equity plus debt issues over assets.  $Q$  is defined as the market value of equity plus assets minus the book value of equity over assets. Cash flow is defined as operating cash flow over assets. Panel A shows results for equity issues for the full sample. Panel B considers equity issues by firms with  $Q$  below 2.00. Panel C considers equity issues by firms with  $Q$  above 2.00. Panel D shows results for total external finance, equity plus debt, for the full sample. T-statistics are heteroskedasticity robust.

KZ index	N	$Q_{t-1}$		$CF_t/A_{t-1}$		$R^2$
		b	[t-stat]	c	[t-stat]	
Panel A: External Equity – All Firms						
Quintile 1	10,397	0.024	[6.64]	0.056	[1.43]	0.41
2	10,396	0.035	[6.85]	0.076	[2.03]	0.43
3	10,397	0.040	[6.49]	0.154	[4.13]	0.43
4	10,396	0.040	[6.45]	0.144	[4.21]	0.39
5	10,396	0.044	[6.69]	0.087	[2.62]	0.40
Panel B: External Equity – Low Valuation Firms						
Quintile 1	8,191	0.036	[6.06]	0.100	[2.85]	0.37
2	8,657	0.034	[4.57]	0.174	[5.06]	0.34
3	9,032	0.043	[6.29]	0.211	[5.89]	0.33
4	9,168	0.061	[7.43]	0.179	[5.39]	0.33
5	8,827	0.078	[6.73]	0.130	[4.10]	0.30
Panel C: External Equity – High Valuation Firms						
Quintile 1	2,206	0.017	[2.56]	-0.089	[-0.80]	0.58
2	1,739	0.037	[2.60]	-0.144	[-1.08]	0.41
3	1,365	0.042	[2.13]	-0.169	[-1.00]	0.41
4	1,228	0.022	[1.02]	-0.053	[-0.29]	0.32
5	1,569	0.043	[2.62]	0.002	[0.01]	0.36
Panel D: External Equity Plus Debt – All Firms						
Quintile 1	10,397	0.037	[5.90]	0.183	[2.21]	0.27
2	10,396	0.061	[7.01]	0.107	[1.48]	0.32
3	10,397	0.075	[7.84]	0.274	[3.87]	0.33
4	10,396	0.081	[7.59]	0.323	[5.19]	0.31
5	10,396	0.103	[9.38]	0.153	[2.56]	0.28