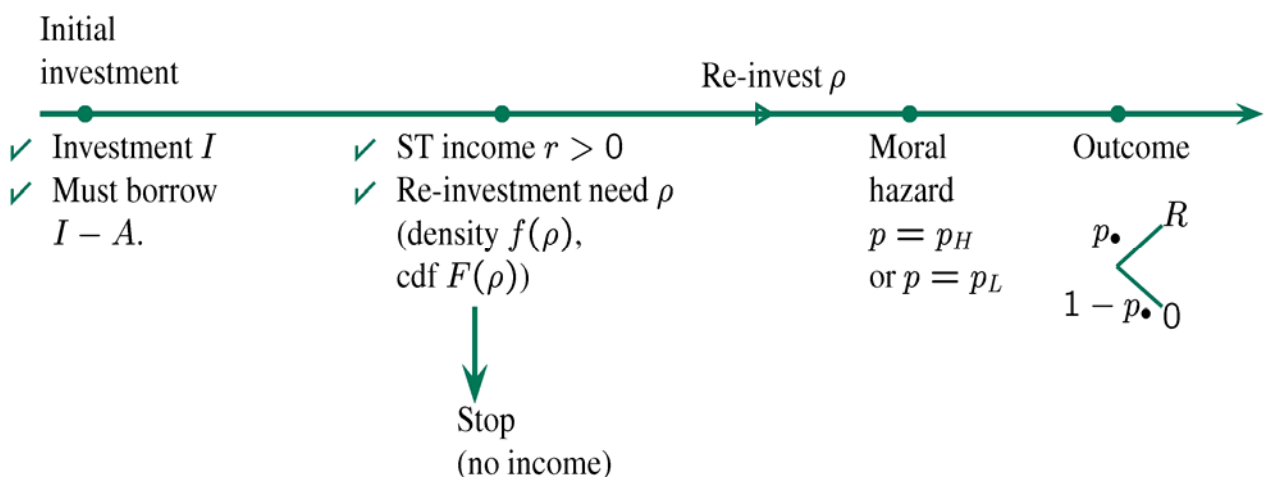


Liquidity management

- Multistage financing
- An intermediate date between the financing stage and the realization of the project outcome.
- Following up on the discussion of the liquidity/accountability tradeoff in chapter 4.
- The borrower needs to prepare for a liquidity shock.
- The borrower should hoard reserves.
 - Holding liquid securities
 - Credit line
 - Retentions
- Hoarding of reserves is an insurance mechanism
 - True even if borrower is risk neutral
 - Value of funds higher in bad states than in good states, because of credit rationing.
 - Borrower wants to transfer wealth from good states to bad states – which is what an insurance contract does.

Basic model

- Fixed investment, with a stochastic need for reinvestment at an intermediate date.



- Date 0: Investment I , own assets A , borrowing need $I - A$.
- Date 1 – the intermediate date:
 - Investment yields a short-term return r ; deterministic and verifiable.
 - Continuation requires a *reinvestment* of size $\rho \geq 0$, *ex ante* unknown: probability distribution $F(\rho)$, density $f(\rho)$.
 - The value of ρ becomes known at date 1.
 - No reinvestment means liquidation of the firm, liquidation value 0.
- Date 2 – in case of reinvestment at date 1: Investment returns R if success, 0 if failure. Success probability p depends on borrower's effort: $p = p_H$ if she behaves, $p = p_L < p_H$ if not.
- Risk neutrality. Limited liability. Competition among lenders.
- Contract: $\{r_b, R_b, \rho^*\}$
 - r_b and R_b – what borrower receives at dates 1 and 2.
 - ρ^* – the cutoff reinvestment requirement: continue if and only if $\rho \leq \rho^*$.
- Borrower's net utility equals net present value of the project:

$$U_b(\rho^*) = [r + F(\rho^*)p_H R] - [I + \int_0^{\rho^*} \rho f(\rho) d\rho]$$
 - Second term: expected total investment
- Borrower's incentive constraint:

$$R_b \geq \frac{B}{\Delta p}$$
- Borrower receives 0 at date 1: $r_b = 0$.
 - All of r is payed out to outside investors.
 - Zero r_b increases R_b and alleviates the incentive problem at date 2.
- Expected pledgeable income:

$$\mathcal{R}(\rho^*) = r + F(\rho^*)p_H \left[R - \frac{B}{\Delta p} \right] - \int_0^{\rho^*} \rho f(\rho) d\rho$$
 - Investors must cover all the reinvestment

- NPV is maximized at $\rho^* = p_H R = \rho_1$.
 - $U_b'(\rho^*) = f(\rho^*)p_H R - \rho^* f(\rho^*)$.
 - For $\rho^* < \rho_1$, the expected gain from rescuing the project is larger than the cost.
- Pledgeable income is maximized at $\rho^* = p_H \left[R - \frac{B}{\Delta p} \right] = \rho_0$.
 - For $\rho^* > \rho_0$, the cost to the investors from continuing is larger than what they expect to get in return.

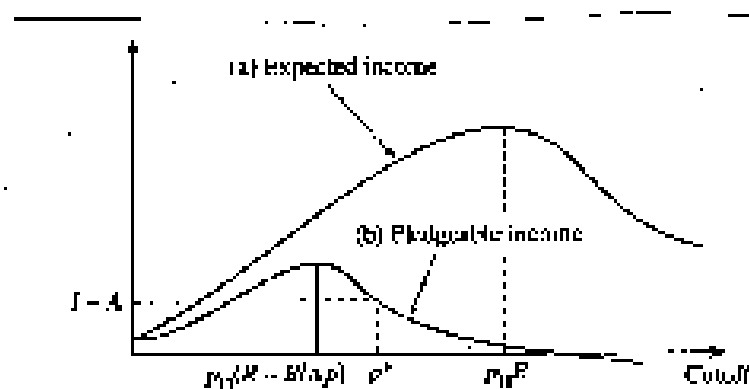


Figure 5.2, p. 204

- Three cases
 - Efficient cutoff: $\mathcal{A}(\rho_1) \geq I - A$.
 - The NPV-maximizing cutoff leaves enough for the investors: $\rho^* = \rho_1$.
 - Too much liquidation: $\mathcal{A}(\rho_1) < I - A \leq \mathcal{A}(\rho_0)$
 - $r_b = 0$, $R_b = B/\Delta p$, and
 $\rho^* \in [\rho_0, \rho_1)$ solves $\mathcal{A}(\rho) = I - A$
 - Credit rationing at date 1: In order to secure funds at date 0, the borrower accepts a reduced reinvestment cutoff at date 1.
 - No funding: $I - A > \mathcal{A}(\rho_0)$
 - Even maximizing pledgeable income is not enough.

Maturity at a cash rich firm

- *Cash rich firm*: $r > \rho^*$; high short-term returns.
- Implementing the optimal contract
 - Short-term debt: $d = r - \rho^*$.
 - Long-term debt: $D = R - \frac{B}{\Delta p}$ (to be paid if continuation)
 - Note: erratum for footnote 7 on p. 204; see:
http://press.princeton.edu/tirole/tirole_errata3.pdf
- A theory of *maturity structure* of debt
 - Stronger firms have larger A , and subsequently (weakly) higher ρ^* and therefore less short-term debt.
 - The more current debt a firm has, the lower is its A , and the more short-term its future debt will be.
- Short-term debt vs dividend

Credit lines for cash poor firms

- *Cash poor firm*: $r < \rho^*$. The extreme case: $r = 0$.
- With $r = 0$, there are no short-term returns to cover (in part) the liquidity needs at the intermediate date.
- Can a wait-and-see strategy work?
 - At date 1, the value of ρ is known. But the outside investors are not able to supply more funds than what the firm is worth to them, so the firm will only get funding if
$$\rho \leq p_H \left[R - \frac{B}{\Delta p} \right] = \rho_0.$$
 - This is not optimal, since $\rho^* \in [\rho_0, \rho_1]$.
- It is better to *hoard reserves* at date 0 to face the liquidity shock at date 1.
 - *Liquidity management* is necessary.

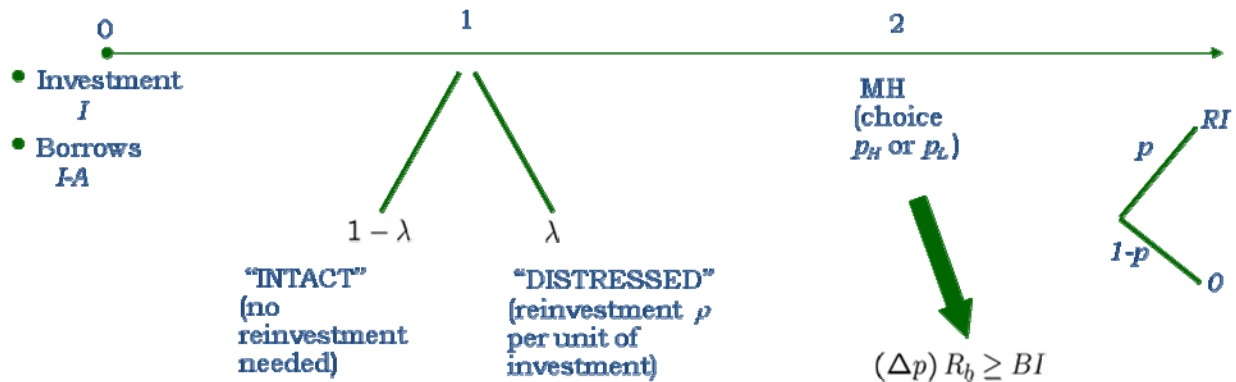
- Two ways to hoard reserves:
 - Borrowing $I + \rho^*$ at date 0, with a covenant that no further claims be issued at date 1, so that initial claimholders are not diluted.
 - Securing a *line of credit* equal to $\rho^* - \rho_0$, with a right to dilute initial claimholders in order to get ρ_0 in new funds at date 1.
 - A line of credit is an agreement providing credit up to a certain amount.
 - The line of credit must be *non-revokable*; otherwise, the lender would not want to abide with the agreement in cases where $\rho \in (\rho_0, \rho^*)$.

Growth opportunities

- An alternative scenario: if you do not reinvest at the intermediate date, you don't have to close down; but if you do reinvest, you increase the prospects of your project.
 - Reinvestment increases probabilities of success from p_H and p_L (depending on borrower efforts) to $p_H + \tau$ and $p_L + \tau$, where $0 < \tau < 1 - p_H$.
- Better growth opportunities (higher τ) call for longer maturities, that is, less short-term debt.

The liquidity-scale tradeoff

- Liquidity management with a variable investment.
- The entrepreneur now faces a choice between a larger investment and more liquidity.
- Variable-investment model.
- First a simple version – two values of the per-unit liquidity shock
 - 0, with probability $1 - \lambda$: the firm is *intact*.
 - ρ , with probability λ : the firm is *in distress*.



- Initial investment I . Continuation, which requires a reinvestment ρI if the firm is in distress at date 1, is subject to moral hazard.
- Project yields RI at date 2 if success, 0 otherwise.
- Success probability p_H or p_L .
- Private benefit from misbehaving BI .
- Assumption: $\rho_0 < c < \rho_1$, where $c \equiv \min\left\{1 + \lambda\rho, \frac{1}{1 - \lambda}\right\}$.
 - No liquidity shock: $\lambda = 0$, and so $c = 1$.
- Borrower receives R_b if success, 0 otherwise, where $R_b \geq \frac{B}{\Delta p}$.
- If distress: abandon or pursue the project?

- Abandon project if distress
 - Investors' breakeven constraint

$$(1 - \lambda)\rho_0 I = I - A$$

- Entrepreneur's net utility = NPV

$$U_b^0 = [(1 - \lambda)\rho_1 - 1]I = \frac{(1 - \lambda)\rho_1 - 1}{1 - (1 - \lambda)\rho_0} A = \frac{\rho_1 - \frac{1}{1 - \lambda}}{\frac{1}{1 - \lambda} - \rho_0} A$$

- Compare with case without liquidity shock: $\lambda = 0$.

- Pursue project if distress
 - Investors' breakeven constraint

$$\rho_0 I = (1 + \lambda\rho)I - A$$

- Entrepreneur's net utility = NPV

$$U_b^1 = [\rho_1 - (1 + \lambda\rho)]I = \frac{\rho_1 - (1 + \lambda\rho)}{(1 + \lambda\rho) - \rho_0} A$$

- Pursuing the project in case of distress at date 1 is better than abandoning it if:

$$U_b^1 \geq U_b^0 \Leftrightarrow 1 + \lambda\rho \leq \frac{1}{1 - \lambda} \Leftrightarrow \rho \leq \frac{1}{1 - \lambda}$$

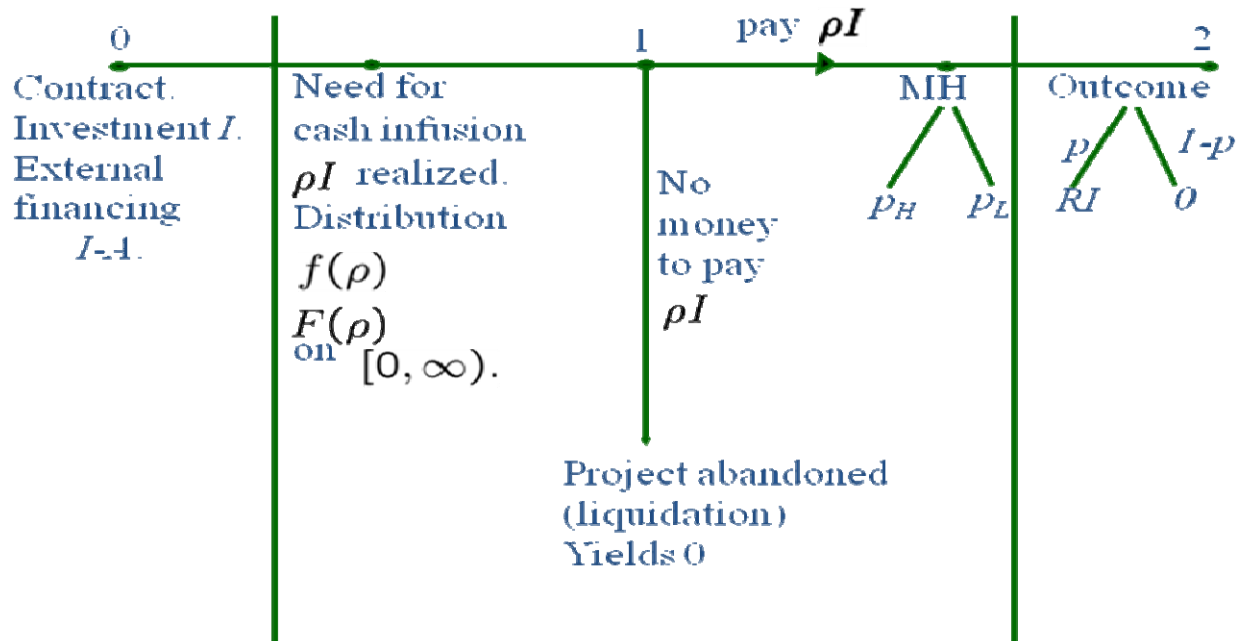
- Withstanding the liquidity shock is optimal if it is
 - low: ρ is low
 - likely: λ is high.

- If $\rho_0 < \rho \leq \frac{1}{1 - \lambda}$, then *liquidity management* is required.

- For example: a credit line.

A continuum of liquidity shocks

- Continuous investment, continuous shock.
- At date 1, continuation requires a reinvestment ρI , where $\rho \geq 0$.
 - Per-unit-of-investment cost overruns.
 - Probability distribution $F(\rho)$, density $f(\rho)$.



- $NPV(\tilde{\rho})$ – net present value for a given cutoff $\tilde{\rho}$.

$$NPV(\tilde{\rho}) = \{F(\tilde{\rho})p_H R - [1 + \int_0^{\tilde{\rho}} \rho f(\rho) d\rho]\} I$$
- Assumption: There exists some $\tilde{\rho}$ such that $NPV(\tilde{\rho}) > 0$.
- Question: What is the optimal cutoff rule ρ^* ?

- Incentive constraint if continuation: $R_b \geq \frac{BI}{\Delta p}$

- Breakeven constraint with cutoff at ρ^* :

$$F(\rho^*)p_H(RI - R_b) \geq I - A + \int_0^{\rho^*} \rho I f(\rho) d\rho$$

- Borrowing capacity:

$$I \leq k(\rho^*)A = \frac{1}{1 + \int_{\rho_0}^{\rho^*} \rho f(\rho) d\rho - \rho_0 F(\rho^*)} A$$

- Recall the equity multiplier without liquidity shock: $k = \frac{1}{1 - \rho_0}$
- Liquidity shocks reduce the equity multiplier: $k(\rho^*) < \frac{1}{1 - \rho_0}$.
- Due to competition among creditors, borrower obtains NPV(ρ^*).

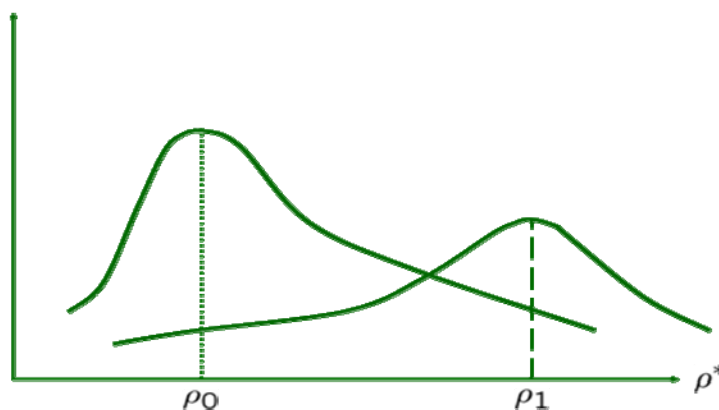
$$U_b = \{F(\rho^*)\rho_1 - [1 + \int_{\rho_0}^{\rho^*} \rho f(\rho) d\rho]\} I \Leftrightarrow$$

$$U_b = m(\rho^*)k(\rho^*)A,$$

where

$$m(\rho^*) = F(\rho^*)\rho_1 - 1 - \int_{\rho_0}^{\rho^*} \rho f(\rho) d\rho$$

- The *margin* per unit of investment: $m(\rho^*)$
- The borrower must trade off the margin and the equity multiplier
 - Maximizing $m(\rho^*)$ would maximize profit and yield $\rho^* = \rho_1$. But $k'(\rho_1) < 0$.
 - Maximizing $k(\rho^*)$ would maximize pledgeable income and yield ρ_0 . But $m'(\rho_0) > 0$.



- Write the borrower's net utility as

$$U_b = \frac{\rho_1 - c(\rho^*)}{c(\rho^*) - \rho_0} A, \text{ where: } c(\rho^*) = \frac{1 + \int_{\rho_0}^{\rho^*} \rho f(\rho) d\rho}{F(\rho^*)}$$

- Note: $F(\rho^*)c(\rho^*) = 1 + \int_{\rho_0}^{\rho^*} \rho f(\rho) d\rho$
 - $c(\rho^*)$ is the *expected cost per unit of effective investment*
- Maximizing U_b is tantamount to minimizing $c(\rho^*)$.

- Minimizing $c(\rho^*)$:

$$c'(\rho^*) = \frac{\rho^* f(\rho^*)F(\rho^*) - [1 + \int_0^{\rho^*} \rho f(\rho) d\rho] f(\rho^*)}{[F(\rho^*)]^2}$$

$$c'(\rho^*) = \frac{f(\rho^*)}{F(\rho^*)} [\rho^* - c(\rho^*)].$$

- The optimal cutoff is implicitly defined by:

$$\rho^* = c(\rho^*)$$

- In equilibrium, the borrower's net utility is

$$U_b = \frac{\rho_1 - \rho^*}{\rho^* - \rho_0} A$$

- The optimum cutoff lies between the expected per-unit-of-investment pledgeable income and income:

$$\rho_0 < \rho^* < \rho_1$$

- *Trading off size and liquidity*: Increasing the cutoff above ρ^* would be good for profit but would also increase the demand for liquidity.

Risk management

- Suppose there is some residual uncertainty ε in the reinvestment requirement at date 1, such that $E(\varepsilon | \rho) = 0$.
- Consequences are adverse if liquidity falls short of a reinvestment
- Calls for buying insurance even if the entrepreneur is risk neutral.
- Tirole, Sec. 5.4

Endogenous liquidity shocks

- The entrepreneur may incur efforts to reduce – or even eliminate – the need for reinvestments. How to provide her with incentives to do this?
- A simple situation:
 - Before date 1, the borrower can incur effort costs c that will eliminate reinvestment needs completely: $\rho = 0$ with probability 1. If not, then ρ is drawn from the distribution $F(\rho)$ as before.
 - If the firm is cash poor – little or no income r at date 1 – the optimal contract has a covenant that no more funds shall be reinvested. But is this credible?
 - If the borrower does *not* incur costs c and the liquidity needs turn out to be $0 \leq \rho \leq \rho_0$, then it is in both lender's and borrower's interest to renegotiate the original contract.
 - This scope for renegotiation reduces the borrower's incentives to incur the effort costs c .
 - *Soft budget constraint.*
- More generally: Suppose the borrower can act at date 0 in a way that would improve the project, and that information arrives at date 1 that indicates whether or not she did so.
 - Moral hazard at both dates 0 and 1 (with respect to outcomes at dates 1 and 2).
 - Examples
 - Short-term income r stochastic *and* dependent on date-0 efforts
 - The project, if abandoned at date 1, has a liquidation value L that is stochastic and dependent on date 0 efforts
 - The project's date-2 return can be improved through efforts at date 0, and information about these improvements may be available before the reinvestment decision is made.
- Here: short-term income affected stochastically by date-0 efforts.

Endogenous intermediate income

- Variable-investment model.
- The usual stochastic return RI at date 2, subject to date-1 moral hazard.
- An investment of I at date 0 returns rI at date 1, where r is verifiable, and $r \in [0, r^+]$.
- Exerting effort affects the probability distribution of r .
- If the entrepreneur works at date 0, then r is distributed according to $G(r)$, with density $g(r)$. If the entrepreneur shirks at date 0, then r is distributed according to $\tilde{G}(r)$, with density $\tilde{g}(r)$.
- The likelihood ratio

$$l(r) = \frac{g(r) - \tilde{g}(r)}{g(r)}$$

- *The monotone likelihood ratio property (MLRP):* $l'(r) \geq 0$.
 - Implying that the distribution of r improves if the entrepreneur works: $G(r) \leq \tilde{G}(r)$, $\forall r$.
- Private benefit at date 0 if entrepreneur shirks: B_0I .
- Benchmark: Credibility is not an issue – the “no soft budget constraint” (NSBC) case.
- Contract: $\{\rho^*(r), \Delta(r)\}$, where
 - $\rho^*(r)$ is the state-contingent cutoff
 - $\Delta(r) \geq 0$ is the borrower’s state-contingent “extra rent” per unit of investment:

- If continuation,

$$\Delta(r) = p_H \left(R_b - \frac{BI}{\Delta p} \right),$$

what the borrower receives over and above the minimum required to preserve date-1 incentives.

- If liquidation, $\Delta(r)$ is cash compensation.

- Lenders' breakeven constraint (IR_l):

$$\left\{ \int_0^{r^+} \left[r + F(\rho^*(r))\rho_0 - \int_0^{\rho^*(r)} \rho f(\rho) d\rho - \Delta(r) \right] g(r) dr \right\} I \geq I - A$$

- Borrower's date-0 incentive constraint (IC_b):

$$\left\{ \int_0^{r^+} \left[F(\rho^*(r))(\rho_1 - \rho_0) + \Delta(r) \right] [g(r) - \tilde{g}(r)] dr \right\} I \geq B_0 I \Leftrightarrow$$

$$\left\{ \int_0^{r^+} \left[F(\rho^*(r))(\rho_1 - \rho_0) + \Delta(r) \right] l(r) g(r) dr \right\} I \geq B_0 I$$

- The optimal contract maximizes borrower's net utility subject to the two above constraints, with respect to $\{\rho^*(r), \Delta(r), I\}$. We ignore the choice of I for the moment.

$$U_b = \left\{ \int_0^{r^+} \left[r + F(\rho^*(r))\rho_1 - \int_0^{\rho^*(r)} \rho f(\rho) d\rho - 1 \right] g(r) dr \right\} I$$

- Lagrangian multipliers: μ for IR_l and ν for IC_b .
- Pointwise maximization.

○ For each r , find the optimal pair $\{\rho^*(r), \Delta(r)\}$

- Fix r . First-order conditions with respect to $\rho^*(r)$ and $\Delta(r)$:

$$\{f(\rho^*)\rho_1 - \rho^*f(\rho^*) + \mu[f(\rho^*)\rho_0 - \rho^*f(\rho^*)] + \nu[f(\rho^*)(\rho_1 - \rho_0)]l(r)\} \\ \times g(r)I = 0$$

$$\{-\mu + \nu l(r)\}g(r)I = 0$$

\Leftrightarrow

$$\rho^*(r) = \frac{\rho_1 + \mu\rho_0}{1 + \mu} + \frac{\nu(\rho_1 - \rho_0)}{1 + \mu} l(r)$$

$$\mu = \nu l(r)$$

○ But the constraint $\Delta(r) \geq 0$ may be binding. Therefore,

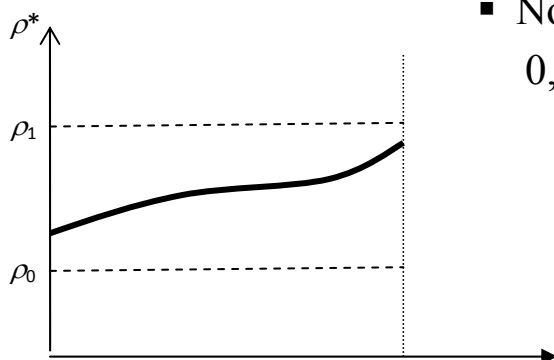
- either: $\Delta(r) > 0 \Rightarrow \mu = \nu l(r) \Rightarrow \rho^* = \rho_1$,
- or: $\Delta(r) = 0 \Rightarrow -\mu + \nu l(r) \leq 0 \Rightarrow \rho^* \leq \rho_1$.

- $E_{G(\cdot)}[l(r)] = \int_0^{r^+} \frac{g(r) - \tilde{g}(r)}{g(r)} g(r) dr = \int_0^{r^+} g(r) dr - \int_0^{r^+} \tilde{g}(r) dr = 0$
- This implies: $E[\rho^*(r)] = \frac{\rho_1 + \mu\rho_0}{1 + \mu}$
 - In expectation, the cutoff is a weighted average of ρ_1 and ρ_0 , and $\rho_1 < E[\rho^*(r)] < \rho_0$; as in the case without date-0 moral hazard, the firm *trades off size and liquidity*.
- We can write:

$$\rho^*(r) = E[\rho^*(r)] + \lambda l(r),$$

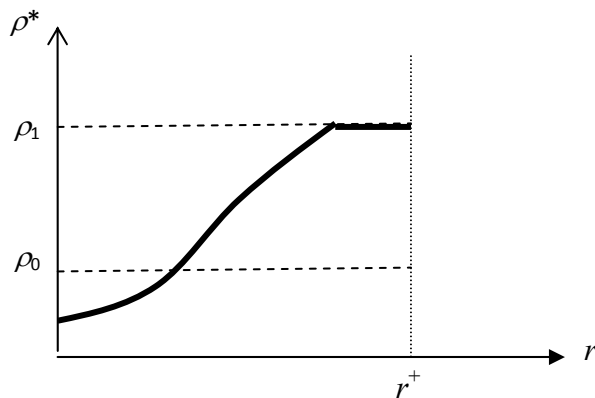
$$\text{where: } \lambda = \frac{\nu}{1 + \mu} (\rho_1 - \rho_0) > 0.$$

- By assumption (MLRP): $l'(r) \geq 0$. Therefore: $\frac{d\rho^*}{dr} \geq 0$.
- The continuation rule is more lenient, the higher is the date-1 income r .
- Two possibilities:
 - $\rho^*(r)$ increases moderately
 - because the date-0 incentive problem is small
 - date-0 private benefits B_0 not very high, so that the borrower's date-0 incentive constraint is not very restrictive, making ν low;
 - date-0 liquidity shocks being mainly outside the borrower's control, so that $l(r)$ stays close to 0.
 - or because the date-1 incentive problem is small
 - date-1 private benefits B small, or $\Delta p/p_H$ large, again making ν low.



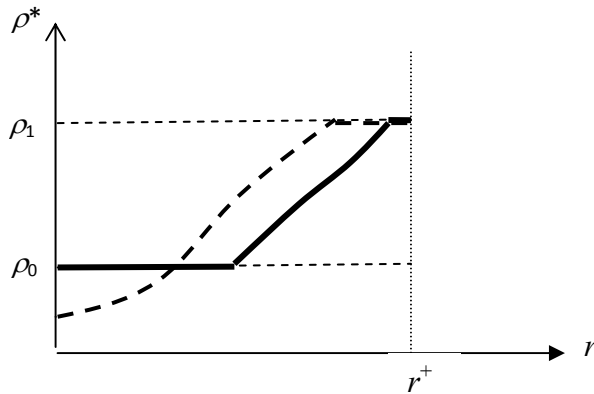
- No extra rent to the borrower: $\Delta(r) = 0, \forall r$.

- $\rho^*(r)$ increases steeply
 - because one or both of the two moral hazard problems are more serious
 - When intermediate income is high, first-best can be reached: $\rho^* = \rho_1$.
 - Extra rent to the borrower at high r : When intermediate income is high, she gets to keep some of it.
 - At a low intermediate income, we may even have $\rho^* < \rho_0$.



- *Soft budget constraint*: $\rho^* < \rho_0$ is not credible.
 - The parties will renegotiate a contract whenever r is realized and $\rho^*(r) < \rho_0$.
 - Formally, same problem as before, with an added constraint: $\rho^* \geq \rho_0$.
 - When incentive problems are small, so that there is only a moderate increase in $\rho^*(r)$ in the NSBC case, there is no change in the optimal contract.
 - When incentive problems are greater, the constraint $\rho^* \geq \rho_0$ binds for small values of r .

- Increasing ρ^* in order to satisfy the credibility constraint at low values of r calls for decreasing it for higher values of r , in order to keep satisfying the lenders' breakeven constraint.



- Credibility problems at low values of r decreases continuation – and reduces efficiency – at larger values.

Free cash flow

- Tirole, Sec. 5.6.
- If the firm has more cash than it needs, there are incentives for *overinvestment*. It has been argued that debt may mitigate this problem.
- Back to the discussion of the liquidity-scale tradeoff.
- But now there is a deterministic short-term income rI , which is fully pledgeable.

- Lenders' breakeven constraint with cutoff at ρ^* :

$$rI + F(\rho^*)p_H(RI - R_b) \geq I - A + \int_0^{\rho^*} \rho I f(\rho) d\rho$$

- Everything as if the unit investment cost is $(1 - r)$ rather than 1.
- Cutoff implicitly given by:

$$\rho^* = c(\rho^*) = \frac{1 - r + \int_0^{\rho^*} \rho f(\rho) d\rho}{F(\rho^*)}$$

- Cutoff ρ^* is now *decreasing* in the short-term income r .
 - A high r makes it possible to reduce continuation in order to increase the borrowing capacity.
- The *free-cash-flow* assumption: $r > \rho^*$.
 - The entrepreneur would like to commit herself not to reinvest the amount $(r - \rho^*)I$.
 - This calls for *short-term debt*, that is, debt to be paid at the intermediate date.
 - In more general settings, short-term debt may not fully resolve the free-cash-flow problem.