Corporate Financing and Investment: The Firm-Level Credit Multiplier*

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Abstract

We study the effect of asset liquidity ("tangibility") on firm policies in the presence of financing constraints. We do so in a real options framework that allows for the simultaneous determination of investment and financing. In the presence of financing imperfections, firms that operate more tangible assets have larger credit capacity. By expanding the firm's capital base, the investment process engenders a feedback effect in which investment (in tangible assets) helps relax financing constraints, which in turn allows for additional investment, easing financing further, and so on. Our model formalizes the endogenous mechanism through which asset tangibility amplifies the impact of shocks to the firm's opportunity set onto the firm's investment and financing across time — a *firm-level credit multiplier*. Examining a large sample of manufacturing firms over the 1971–2005 period, we find support for our model's prediction that asset tangibility boosts investment spending when firms face financing constraints. We also verify that this result is driven by firms' debt issuance activities. Consistent with our identification strategy, the credit multiplier is absent from samples of financially unconstrained firms and samples of financially constrained firms with low incremental (asset-based) debt capacity.

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