Free Cash-Flow, Issuance Costs and Stock Price Volatility*

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Abstract

We study the issuance and payout policies that maximize the value of a firm facing both agency costs of free cash-flow and external financing costs. We find that the firm optimally issues equity. Equity distributes no dividends until a target cash level is reached, while new equity is issued when the firm runs out of cash. We characterize the process modelling the number of outstanding shares and the dynamics of the stock prices. In line with the leverage effect identified by Black (1976), we show that both the volatility of stock returns and the dollar volatility of stock prices increase after a negative shock on stock prices.

Keywords: Issuance and Dividend Policies, Optimal Cash Management, Stock Price Volatility.
JEL Classification: G12, G35.

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