

# Capital Supply Uncertainty, Cash Holdings, and Investment\*

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## ABSTRACT

We develop a model of investment, payout, and financing policies in which firms face uncertainty regarding their ability to raise funds and have to search for investors when in need of capital. We show that capital supply uncertainty leads firms to value financial slack and to adjust their policies to the level of their cash reserves, notably when choosing between retention and payout, between internal or external financing of investment, and between speculation and hedging. In the model, investment and payout do not always increase with slack for constrained firms and the choice between internal and external funds does not follow a strict pecking order. In addition, the use of inside and outside cash are related to a number of firm characteristics, such as asset tangibility, cash flow volatility, access to capital markets, or agency costs.

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