

"Dilutive Financing"

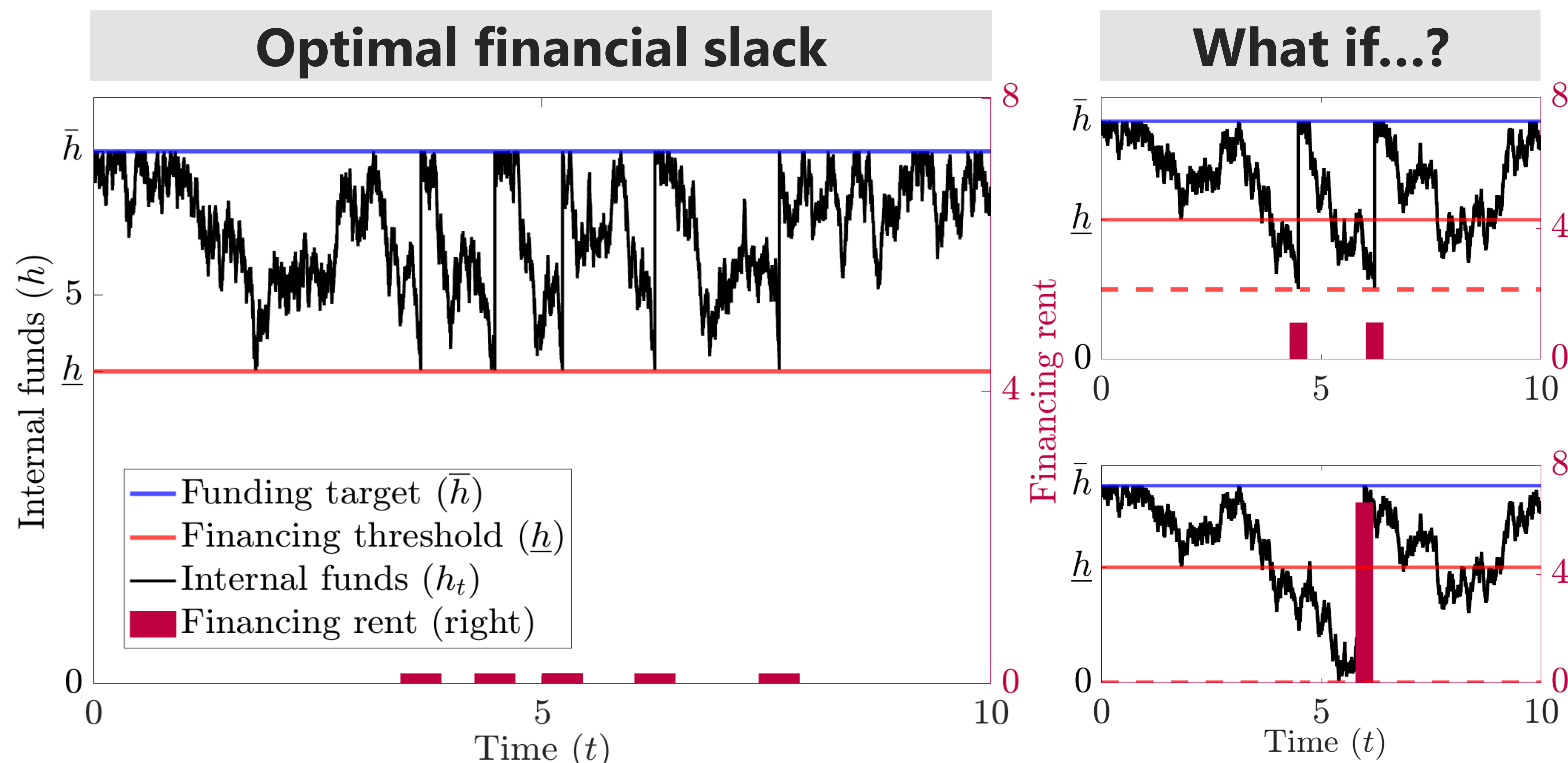
Financial slack* is firms' BARGAINING TOOL against financiers



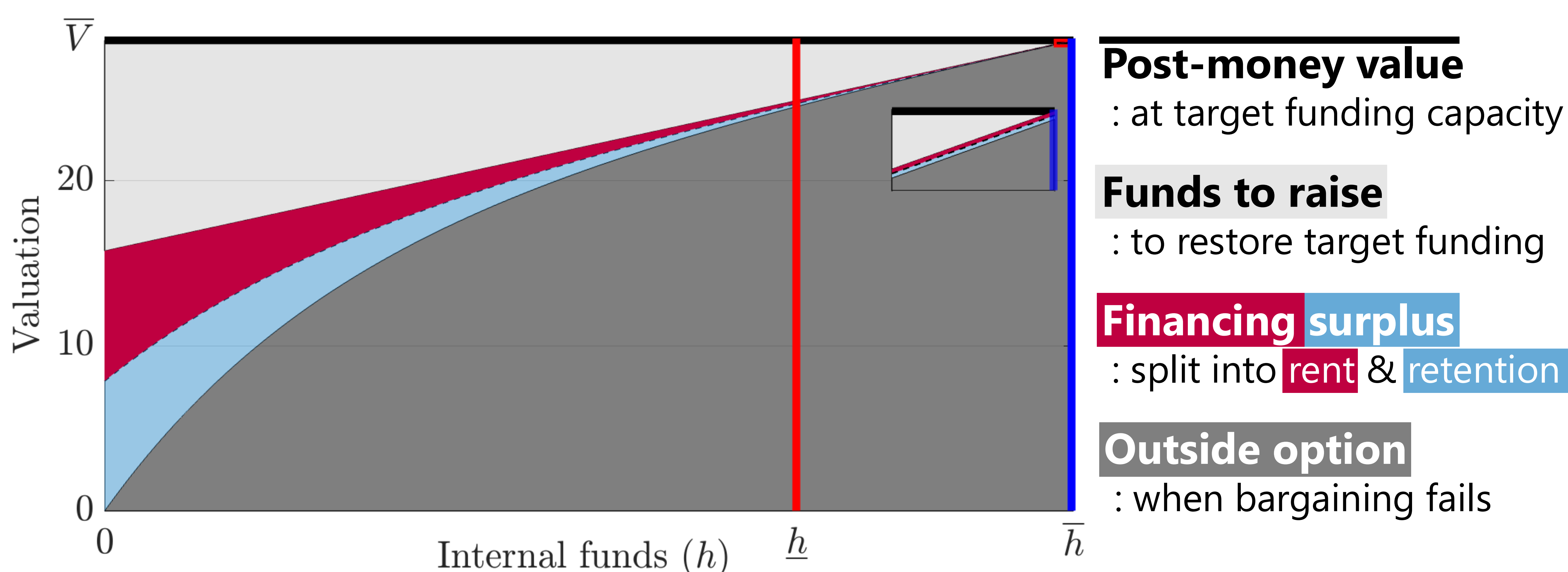
*'Financial slack': **unused capacity** for cheap internal funding (e.g. cash-holdings, room for short-term debt issuance, etc.)

Main Analysis

Only friction : firms raise funds from financiers having **bargaining power**



How do firms reduce financing rent?



Funding cushion (\underline{h}) : Strengthens firms' **outside option** at bargaining

- Gives firms time to find **alternative financiers** before bankruptcy
- Better **outside option** → Less surplus from financing → Less **financiers' rent**

Core Mechanism

Simple two-period setup

A *project* matures at the end, with *payoff* \bar{v}

Requires a unit input per period, $\bar{v} > 2$

- Two *outsiders*, one per period, can produce
- *Nash bargaining* splits surplus by $(\theta, 1 - \theta)$

Storage of input has a marginal *carry cost* β

I. Lumpy financing

Twice	Period 1	Period 2	Terminal
Social	-1	-1	\bar{v}
Equity	$\theta(v_0^2 - 1)$	$v_0^2 := \theta(\bar{v} - 1)$	\bar{v}

Once	Period 1	Period 2	Terminal
Social	$-2 - \beta$	0	\bar{v}
Equity	$\theta(\bar{v} - 2 - \beta)$	\bar{v}	\bar{v}

Bargain once, not twice, if $(1 - \theta)(\bar{v} - 1) \geq \beta$

II. Early financing (i.e. 'cushion')

Given one input at beginning, **when** to bargain?

In second period : $0 + \theta(\bar{v} - 0 - 1) =: v_0^2$

- Outside option is **losing the project**

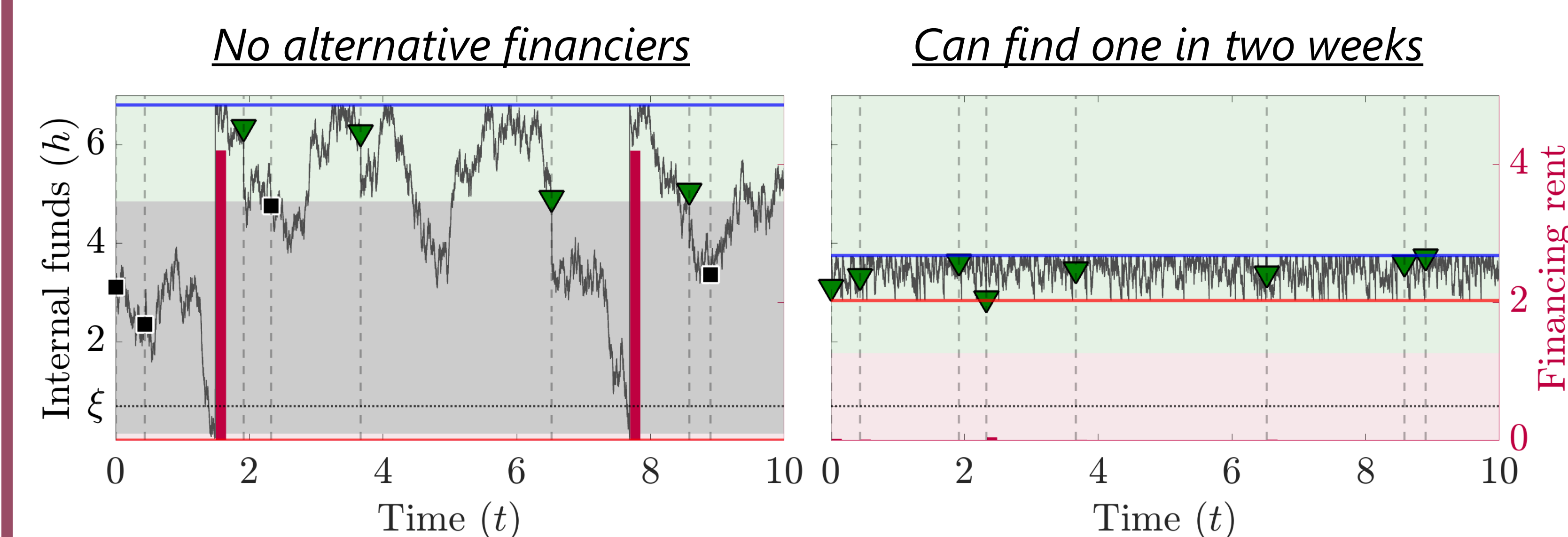
In first period : $v_0^2 + \theta(\bar{v} - v_0^2 - 1 - \beta)$

- Outside option is **second-period bargaining**

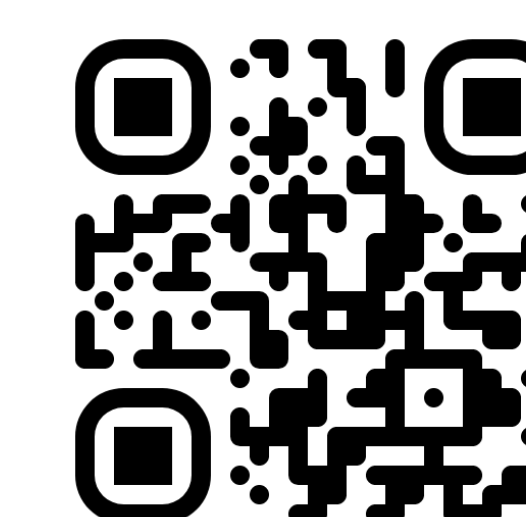
Bargain early, not late, if $(1 - \theta)(v_0^2 - 0) \geq \theta\beta$

Key Predictions

1. High '*price-earnings*' → more **financial slack**
 - *More value is at stake* upon bargaining
2. **Counterintuitive** effect of *access to financing*



- Robust access to financing induces funding cushion in *large excess* of *investment needs* ξ



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Job market in AY 2025-2026