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## **DO MARKET IMPERFECTIONS GIVE RISE TO FINANCIAL CONSTRAINTS OR GROWTH TYPE COMPATIBILITY?**

### **Abstract:**

It is commonly believed that market imperfections impose financing constraints on corporate investment and impede economic growth. But neoclassic theory insists that investment opportunities have an overriding effect on corporate investment despite market imperfections. This paper shows that market imperfections do not hinder corporate investment to the extent that growth type compatibility of investment and financing effectively mitigates asymmetric informational problems. Our study deals with listed firms which, unlike private firms, have access to external finance in the capital markets.

What we call growth type compatibility characterizes the equilibrium in which investment styles (characterized by R&D versus fixed asset investment) and optimal financing arrangements (equity versus debt financing) go hand in hand with corresponding firm growth types. High-growth type firms have dominant asymmetric information on growth opportunities and low-growth type firms have dominant asymmetric information on assets-in-place. Distinct growth types constitute distinct informational imperfections.

Growth type compatibility starts with the premise that firms with a particular growth type attract and accommodate a certain type of competitively available human capital (or knowledge capital). This gives rise to persistently distinct corporate investment styles and optimal financial policies in response. Wu and Au Yeung (2009, 2012) find that growth type compatibility contributes to the persistence in both leverage ratios and propensity to pay dividends.

Using Compustat data on US firms, this paper shows that high and low firm growth types constitute persistently distinct informational imperfections. Growth type is positively correlated with investment style (measured by  $R\&D/[Capex+R\&D]$ ), both being persistent over time and negatively affecting the sensitivity of investment to cash flow. At the same time, the growth-type-aligned investment style positively affects the sensitivity of equity-and-debt-financing-differential to market conditions, reflecting a growth-type-aligned pecking order in financing. These findings suggest the effect of growth type compatibility rather than that of financing constraints. The persistence of high and low growth types indicates that informational imperfections do not necessarily impose meaningful financing constraints on listed firms in well-functioning capital markets.

### **Keywords:**

Investment, Informational Imperfections, Growth Type, Financing Constraints

**JEL Classification:** D92, G30, G31