Dilutive Financing*

Hanjoon Ryu†

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Abstract

This paper presents a dynamic model of firm financing where firms use financial slack to reduce rent extraction by financiers possessing bargaining power. Financing is lumpy because it is optimal to bargain infrequently. Moreover, firms typically finance 'early' before exhausting internal funds to bargain when their outside options are better. Firms with better prospects maintain greater financial slack. Firms with good financing alternatives always keep funds that exceed investment needs, whereas firms lacking such alternatives delay financing until funds are depleted – and occasionally forgo investment – to avoid paying excessive rents. Investment irreversibility magnifies financing rents given low productivity.

JEL Classification: E22, E44, G32

Keywords: Financing; financial slack; dynamic bargaining; investment irreversibility; equity dilution; cash-holdings.

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*I am extremely grateful to Adriano A. Rampini and S. "Vish" Viswanathan for their patient guidance and invaluable support. I have also greatly benefited from discussions with David W. Berger, John R. Graham, Yingni Guo, Gregor Jarosch, Matthias Kehrig, Paymon Khorrami, Andrea Lanteri, Konstantin W. Milbradt, Wendy A. Morrison, Cecilia Parlatore, Christine Parlour (discussant, FIRS 2025), and Yi (Daniel) Xu. I thank conference and seminar participants at FRB Richmond-UVA-Duke Joint Macro Research Workshop 2025 (PhD Session), Econometric Society World Congress 2025, Finance Theory Group Summer Conference 2025, Financial Intermediation Research Society Conference 2025 (PhD Session), Macro-Finance Society Workshop 2025 (PhD Poster Session), American Finance Association Annual Meeting 2025 (PhD Poster Session), Economics Graduate Student Conference 2024, and Duke University (Economics Department and Fuqua Finance) for their insightful comments. All errors are my own.

†Duke University, Department of Economics. Email: hanjoon.ryu@duke.edu.