The Economic Costs of Financial Distress*

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Abstract

We estimate the economic costs of financial distress using local real estate shocks. We identify these effects by exploiting variation in real estate assets and financial leverage across suppliers. We find that clients reduce their reliance on suppliers that are highly levered and own more real estate assets in response to declines in real estate prices. More affected suppliers suffer a 10% larger decline in sales for the same client and year than less affected suppliers. The effect is more pronounced in more competitive industries, for durable and less specific goods, and when switching costs are low. Our results suggest that indirect costs of financial distress are economically important.

JEL classification: G31, G32, G33, L11, L14
Keywords: Financial distress, Economic distress, Real estate shocks

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