



The international effect of managerial social capital on the cost of equity[☆]



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ABSTRACT

We examine the effect of managerial social capital on the firm's cost of equity capital. We argue that social ties alleviate information asymmetry and agency problems, which in turn leads to a decrease in the cost of equity. Using a large panel of companies from 52 countries over the period 1999–2012, we document that social capital inversely affects the cost of equity. Our evidence suggests that the association between social capital and the cost of equity capital is stronger in underdeveloped financial markets and those characterized by weak legal protection. The marginal effect of social capital is also stronger for constrained firms with profitable investment opportunities. Our results are robust to alternative model specifications and tests for endogeneity.

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1. Introduction

The distortionary forces of financial market frictions, such as asymmetric information and agency problems, limit a firm's access to external finance (Myers and Majluf, 1984; Rajan and Zingales, 1998; Stein, 2003) and create a wedge between the internal and external costs of funds. Mechanisms that mitigate these forces have important implications for the firm's cost of capital. Prior research tests the effects of various mechanisms such as institutions and securities regulations (Hail and Leuz, 2006; Khurana et al., 2006), cross-listing (Hail and Leuz, 2009), voluntary disclosure (Francis et al., 2004), and corporate governance (Chen et al., 2009, 2011) on the cost of funds for firms. Our study expands that research by examining whether social capital resident in managerial social networks is one such mechanism that can reduce the cost of equity financing.

Social capital is defined as the information, trust, and norms of reciprocity inherent in a social network (Woolcock, 1998). Social capital is broadly discussed in disciplines such as economics, sociology, political science, and anthropology (e.g., Dasgupta, 2005; Fafchamps, 2002; Knack and Keefer, 1995; Portes, 1998; Putnam, 1993; Schneider, 2006), but has received only limited attention

in finance. This study reinforces the growing awareness among finance researchers that managerial social capital matters in corporate finance practices. We examine the effects of managerial social capital on a firm's cost of equity financing. Particularly, we study whether social capital in managerial networks with financiers affects the firm's cost of equity capital, and how that relation is influenced by various country, firm, and network characteristics. Further, we explore the mechanism through which social capital reduces the cost of equity.

Social capital eases potential inefficiencies in the financial markets through information-sharing, trust, and contract enforcement channels. Social capital facilitates the sharing of information and reduces information asymmetry within a network (e.g., Cohen et al., 2008, 2010; Kuhnen, 2009; Hong et al., 2004, 2005). Prior evidence suggests that firms which reduce information asymmetry through disclosure enjoy a lower cost of capital (e.g., Francis et al., 2004; Hail, 2002; Verrecchia, 2001; Botosan, 1997). The fundamental problem facing financial market investors willing to transact concerns trust. As the means for creating trust (Dasgupta, 1988), social capital induces cooperative and efficient behavior within a social structure. Trust reduces the need for costly monitoring enabling economic agents to accomplish financial transactions at a lower cost.

Social capital facilitates honest dealing in transactions by imposing punishment through reputation loss (Kandori, 1992; McMillan and Woodruff, 2000). Consequently, socially connected parties demand less price protection from possible expropriation

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and breach. [Fafchamps \(1996\)](#) and [Platteau \(1994\)](#) discuss punitive mechanics for breach available through social capital. Because social capital provides mechanisms for information sharing and punishment through reputation loss, it also reduces agency cost between a firm and its investors by increasing the expected cost of expropriation. Consistent with these conjectures, [Engelberg et al. \(2012\)](#) show that social connections between banks and borrowers reduce borrowing costs. Also firm performance improves following completion of deals that contain a social connection, suggesting that social networks lead to better information flow and monitoring. This evidence leads to our claim that social capital reduces information asymmetry and agency problems, which in turn lowers the cost of equity.

We expect the marginal benefits of social capital in reducing the cost of equity to be stronger when greater frictions or distortions exist in the capital market. Consequently, we argue that social capital with financiers is more valuable in countries with weak legal protection of shareholders or in countries with underdeveloped financial markets. In addition, we contend that social capital has a stronger effect on the cost of equity financing for financially constrained firms. Those firms are small, young, and less visible with more pronounced information asymmetry and agency issues.

We test our predictions using a panel of companies from 52 countries for the period 1999–2012. We measure social connections using the data from the BoardEx databases ([Engelberg et al., 2012](#); [Fracassi, 2012](#)). BoardEx by Management Diagnostics Limited contains relational links between executives based on prior overlap in employment, education, and memberships in non-profit organizations. We measure social capital by counting the number of social connections between corporate executives and directors with their counterparties in financier firms. We estimate the cost of equity capital as the ex ante cost of equity based on four different models introduced by [Claus and Thomas \(2001\)](#); [Gebhardt, Lee and Swaminathan \(2001\)](#); [Easton \(2004\)](#), and [Ohlson and Juettner-Nauroth \(2005\)](#). Our regressions include controls for the risk-factors and firm characteristics shown in prior research to affect the cost of equity financing.

Our results are consistent with theoretical predictions. We find a significant negative association between social capital and the implied cost of equity. In addition, we find that the inverse association between social capital and the cost of equity is stronger in underdeveloped financial markets and in markets characterized by the weak legal protection of investors. The marginal effect of social capital on reducing the cost of equity is also stronger for financially constrained firms with profitable investment opportunities. These results are robust to alternative model specifications and variable measurement. Our findings are also robust to various controls for endogeneity including the placebo test and the instrumental variable method.

Our paper makes important contributions to the existing literature. First, the study adds new understanding to the cost of capital literature. Prior research has shown the effects of various factors (e.g., institutions and securities regulations, cross-listing, voluntary disclosure) on the cost of capital. We provide the analysis of the effect of a previously unexamined factor – social capital – on the cost of capital, and document that social capital negatively affects a firm's cost of obtaining equity capital.

Second, our study is related to the emerging literature on the effect of social capital on corporate decision-making and capital markets. For instance, [Engelberg et al. \(2012\)](#) show that social connections between banks and borrowers reduce borrowing costs. [Cai et al. \(2012\)](#) document a positive relation between a firm's social connections and trading costs. [Cohen et al. \(2008\)](#) find social networks to be an important mechanism for the information flows that shape asset prices in the mutual fund industry. [Cai and Sevilir \(2012\)](#) find that social connections improve information

flow between a target and an acquirer. Our study focuses on the influence of social capital on the firm's cost of equity. It directly contributes to our understanding of the influences of social capital on corporate finance policies and decisions.

2. Background and hypotheses development

2.1. Social capital and its channels of influence

Social capital can be broadly defined as the information, trust, and norms of reciprocity inherent in a social network ([Woolcock, 1998](#)). Social networks are the media through which social capital is created, maintained, and used. The importance of social capital for organizations stems from the resource dependency theory ([Pfeffer and Salancik, 1978](#); [Pfeffer, 1987](#); [Finkelstein, 1997](#)). The central theme of this theory is that firms face resource scarcities and manage resource environment by maintaining external linkages to organizations on which they depend for critical resources. Prior research (e.g., [Burt, 1983](#); [Lang and Lockhart, 1990](#); [Westpal et al., 2006](#)) shows that corporate executives maintain informal ties to leaders of other organizations in order to reduce uncertainty about the access to needed resources.

Social capital exerts causal influence on the practices of corporate finance through the information-sharing, trust, and contract enforcement channels. Through the information-sharing channel, social capital facilitates the sharing of information that would otherwise be difficult to exchange. Information is likely to be given a higher value and reliability if it originates from social acquaintances. In addition, the cost of information acquisition within a social network is low because the information can be acquired passively during social interactions.

Social capital induces cooperative and efficient behavior within a social structure through trust. Trust is the fundamental problem financial market participants face because virtually every transaction encompasses an element of trust ([Arrow, 1972](#)). Trust is important because financial transactions can be accomplished at a lower cost in a high-trust environment. Trust reduces the need for costly monitoring enabling economic agents to operate more efficiently. Trust also minimizes the negative consequences of incomplete contracts and therefore affects the contracting costs of external financing ([Grossman and Hart, 1986](#)). In addition, trust makes it easier for financial market participants to renegotiate their contractual obligations, thereby providing flexibility in responding to external shocks ([Bigsten et al., 2000](#)).

Social capital facilitates honest dealings among parties in transactions by imposing a reputational loss on parties that are dishonest ([Kandori, 1992](#); [McMillan and Woodruff, 2000](#)).¹ This ability to punish and reward represents yet another manner by which social capital reduces the need for costly monitoring. Socially connected parties can engage in exchanges that are not governed by detailed contracts because social capital provides a complementary mechanism for contract enforcement. In addition, social capital offers an alternative for dispute resolution through voluntary cooperation that can further reduce the need for costly formal legal remedies. Consequently, socially connected parties engaging in financial or other transactions demand less price protection against possible expropriation and breach.

2.2. Hypothesis development

We develop a set of hypotheses regarding the causal effect of social capital on the cost of equity capital. First, we hypothesize that social capital with financiers reduces a firm's cost of equity for several reasons.

¹ [Kreps \(1990\)](#) presents a formal analysis of reputation in economic games.

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