



Business group affiliation, ownership structure, and the cost of debt[☆]



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ABSTRACT

This paper examines the relation between business group affiliation and the cost of debt capital. The co-insurance effect associated with business groups can reduce the cost of debt, while expropriation by controlling shareholders can raise the cost of debt. We find that firms affiliated with major Korean business groups (i.e., *chaebols*) enjoy a substantially lower cost of public debt than do independent firms, consistent with the co-insurance argument. We also examine several factors that influence the relation between group affiliation and the cost of debt, including a firm's uncertainty about the future payoffs of debtholders, pledgeable income, group-level resources, and position in the group structure. The results are all consistent with the co-insurance explanation. Our study highlights that the role of business groups in the debt market is distinct from the role of ownership structure.

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1. Introduction

Diversified business groups controlled by families are common around the world (La Porta et al., 1999; Morck et al., 2005). A divergence between control and ownership in business groups through pyramidal ownership structures and cross-holdings facilitates various “tunneling” activities by controlling owners. Therefore, a substantial body of literature has viewed a business group as a device through which controlling shareholders expropriate minority shareholders for their private benefit (Bae et al., 2002; Baek et al., 2006; Bertrand et al., 2002; Claessens et al., 2002; Johnson et al., 2000a,b). However, the fact that business groups are still prevalent and thrive in many countries (e.g., The Economist, 2011) raises a fundamental question: why and how do business groups survive and continue to prosper (Almeida and Kim, 2012; Ferris et al., 2003; Masulis et al., 2011)? This study attempts to offer a partial answer to this question by examining the role of business groups with respect to debt financing.

A recent study by Lin et al. (2011a) shows that a wider divergence between control and ownership leads to a higher borrowing cost, reflecting the risk of expropriation by controlling shareholders. Thus, one might expect similar results for business groups in that

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they will be associated with higher costs of debt. However, as documented by Gopalan and Jayaraman (2012), the role of business groups is distinct from that of ownership concentration or control-ownership divergence. With respect to debt financing, a particularly important feature of business groups is that they enable member firms to share risks by smoothing out income flows and reallocating resources (Ferris et al., 2003; Khanna and Yafeh, 2005, 2007). This risk sharing effect or co-insurance effect can reduce default risk and the cost of debt financing (Gopalan et al., 2007). Given these counter-arguments, it is an empirical question whether business groups play a positive or negative role in debt financing.

To examine the role of group affiliation in the debt market, we examine the Korean bond market. We use a single-country analysis for several reasons. First, a within-country analysis can use a clear and consistent definition of business groups, while group definitions vary substantially across countries (Claessens et al., 2006; Khanna, 2000).¹ Second, as firms in the same country face the same institutional environment, a single-country analysis can mitigate endogeneity problems (Joh, 2003, p. 289). For example, many studies have shown that much of the cross-country ownership differences and group structures can be explained by country-level factors such as legal institutions and capital availabilities (La Porta et al., 1999; Masulis et al., 2011). Third, many Korean firms belong to business groups known as *chaebols*, playing an important role in the economy.² A chaebol's ownership is highly concentrated and the potential for wealth expropriation is high because of the country's weak legal protection (Djankov et al., 2008). Finally, the debt market is economically significant in Korea as firms have relied heavily on debt as their primary source of financing.³ In summary, the characteristics of chaebol firms and Korean institutions offer an ideal setting in which to examine the relation between group affiliation and the cost of debt.⁴

Using a sample of corporate bonds issued in Korea between 2001 and 2007, we find that firms affiliated with business groups, chaebols, enjoy a 48 basis point lower cost of public debt relative to independent firms, consistent with the co-insurance effect, even after controlling for several variables that influence the cost of debt.⁵ Furthermore, when the control-ownership divergence is controlled for so as to separate out the effect of ownership structure (Lin et al., 2011a), the effect of group affiliation becomes even greater (62 basis points). This finding suggests that the incremental role of business groups is substantially positive in the debt market when the negative effect of ownership structure on the cost of debt is removed. This is in sharp contrast to the detrimental effects of business groups on minority shareholders documented in several studies that focus on the equity market (e.g., Bae et al., 2002; Baek et al., 2006; Joh, 2003).

We next examine several factors that influence the relation between group affiliation and the cost of debt. The objective of such tests is to examine whether the effect of group affiliation becomes particularly stronger in situations where the ex ante benefit of co-insurance is high. We expect that the economic value of co-insurance should be greater for firms with high uncertainty about the future payoffs of debtholders and with low pledgeable income. We also expect that the co-insurance effect will be greater for firms belonging to a business group with more resources, which could be potentially used to support financially troubled member firms. We also predict that a firm's position in the group structure will be related to the degree to which it benefits from the co-insurance effect. Specifically, firms at the bottom of the pyramid are expected to benefit more from the co-insurance effect as these younger and riskier firms with low pledgeable income are more likely to be bailed out by other stronger member firms. In contrast, group affiliation will imply less benefit for firms used by the family to control other group firms (i.e., central firms) than non-central firms because central firms are likely used to support weak member firms in financial trouble (Almeida et al., 2011). All of the empirical results are consistent with our predictions, strongly supporting the co-insurance explanation.

We emphasize that group membership could be endogenously determined and that this endogeneity is an important challenge to our finding. For example, if only good credit quality firms are deliberately selected by the families to be included in the group, this selection can explain our finding of a low cost of debt capital for group-affiliated firms. To alleviate the concern, we use several approaches including a propensity score matching approach, examining firms that are newly added to groups, and several interaction tests. More importantly, our results are robust after addressing the issue of endogenous formation of business groups. Section 5.7 describes in detail how we address the concern.

We note that some of our findings are also consistent with several alternative stories. For example, it is possible that a lower cost of debt capital for chaebol-affiliated firms is due to political favoritism from the Korean government toward chaebol firms (Faccio et al., 2006). It is also possible that group affiliation is associated with less likelihood of being financially constrained, thereby leading to a lower cost of debt capital (Hoshi et al., 1991; Lin et al., 2011b; Shin and Park, 1999). However, the results of several tests to examine these possibilities indicate that our findings are not driven by these alternative explanations. The results

¹ Khanna (2000) suggests that within-country results on business groups are more reliable than cross-country results since (1) group definitions are country-specific, (2) there is a greater consensus about group definition in some countries than in others, and (3) there are varying degrees of "tightness" of control across countries. Moreover, alternative ways of identifying business groups could lead to different empirical findings. For example, Gopalan and Jayaraman (2012, p. 151) show that their results for countries with high investor protection are sensitive to alternative definitions of business groups.

² In this paper, we use business groups and chaebols interchangeably. In the literature, chaebols are often identified as a subset of business groups typically characterized by dominant family control. We analyze the effect of non-family business groups in Section 5.8.3.

³ For example, the size of the country's bond market, in terms of bonds outstanding at the end of 2011, is US\$1.3 trillion, which is almost equivalent in size to its equity market and approximately 118% of its GDP. In addition, the bonds issued by the corporate sector represent a significant 57% of outstanding bonds, making South Korea the third largest market in Asia after Japan and China (Source: Asian Bonds Online).

⁴ Korean data have also been used extensively in other studies on business groups (Almeida et al., 2011; Bae et al., 2002, 2008, 2012; Baek et al., 2004, 2006; Joh, 2003; Kim and Yi, 2006; Shin and Park, 1999). However, the role played by business groups in the cost of debt financing has not yet attracted research attention.

⁵ The result that group affiliation is associated with a lower cost of debt is also consistent with the idea that controlling families' large and undiversified ownership mitigates the agency cost of debt, thereby reducing the cost of debt (Anderson et al., 2003).

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