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When do peers matter?: A cross-country perspective

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A B S T R A C T

We assess the importance of industry peers for a firm's own decision making strategy, using a rich sample of data covering 47 countries and 87 different industries between 1990 and 2011. Following the instrumental variable approach suggested by Leary and Roberts (2014), we find that, similar to U.S. firms, foreign firms do follow their peers when they make financial policy decisions. A standard deviation increase in peer firms' average leverage leads to about 5 percentage point increase in a firm's own leverage. We also find evidence that firms are more likely to follow their peers when investor protection laws including information disclosure and minority shareholder protection are weak, when creditor rights laws are strong, and when equity markets are more developed, suggesting that peers matter the most when firms have the greatest need to learn and to demonstrate their quality. These results hold even when we perform the analysis on a matched sample of firms.

1. Introduction

Until recently, the academic literature assumed that firms made financial decisions in isolation, considering only their own characteristics and ignoring those of other firms. However, current research has shown that peer firms play an important role in determining firms' decision making strategies. To the best of our knowledge, Leary and Roberts (2014) are the first to address this topic empirically.

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They explore peer effects[1] in financial policy decision-making and show that U.S. firms follow their industry peers when they determine capital structure levels. That is, when one firm makes changes to its financial policies, other firms operating in its industry adjust their financial policies accordingly. In turn, the firm adjusts to the changes made by its peers. Leary and Roberts (2014) find that in the U.S. a standard deviation increase in peer firms' average leverage leads to a 10 percentage point increase in a firm's own leverage, which is an economically significant effect. They further show that smaller, unrated, non-dividend-paying and financially constrained firms with less experienced and lower paid CEOs are the ones who follow the leaders in the industry. This suggests that peer effects are present when firms have "the greatest learning motive and perhaps the greatest need to build reputation" (Leary and Roberts, 2014).

After this first attempt to quantify the importance of peer firm decisions in addition to their characteristics, a stream of related papers emerged. Popadak (2013) examines 7156 dividend change events in the U.S. between 1975 and 2011 and shows that managers adjust the timing and levels of their firms' dividends based on the dividend policies of their industry peers. She further shows that investors can earn 7.4% per year for the whole sample period if they adjust their portfolios according to dividend signals. Chen and Chang (2013) look at 2855 U.S. firms between 1980 and 2011 and find that peer firms' cash holdings are an important determinant of a firm's cash holding levels, especially when a firm is financially constrained or when it has high R&D levels. Kaustia and Rantala (2013) use a sample of NYSE-listed U.S. firms between 1983 and 2009 to show that firms are more likely to split their stocks if their sell-side analyst-based peers split their stocks and especially if those peer stock splits are profitable. The probability of splitting after a peer stock split is equivalent to that after a 45% stock price increase during the previous year. Billett, Garfinkel and Jiang (2016) is the first study to report of a supply-side effects in transmitting peer-to-peer financial policies. It reveals the role of capital supply, information, and intermediaries connecting peer firms' financial policy. Further, it shows that constrained firms' equity issuance decisions depends on peers' recent SEO activities and that common financial intermediaries strengthen the transmission of peer effects.

The above discussion shows that the decisions of peers are essential for the decision-making process of a firm and that they can be material to various stakeholders. Therefore, understanding peer effects is important.[2] Nevertheless, the current literature has focused on peer effects in a single country, the U.S., ignoring the potential importance of country-level characteristics in shaping peer effects. Evidence that the findings on peer effects can be generalized to multiple markets around the world can help understand how many firms make decisions. More importantly, exploring when and where firms follow their peers can shed light on the motives for mimicking.

The academic literature suggests multiple motives for following one's peers among which reputational, learning, strategic, and behavioral ones.[3] The reputational motive suggests that managers mimic their peers in order to improve their reputation in the labor market. Also, firms can build reputation in order to improve their cost or access to financing. The learning motive presumes that firms can use the information of their peers' actions to make better decisions themselves. The strategic motive suggests that firms may collude against competitors. The behavioral motive suggests that certain behavioral biases can make executives follow their peers. Although we do not distinguish between the various motives, we use them to build our hypotheses and explain our results. The strategic and behavioral motives are unlikely to persist, so they are difficult to detect. Therefore, we focus on the reputational and learning ones.[4]

[1] According to Manski (1993), in different disciplines peer effects are also referred to as 'social norms', 'peer influences', 'neighbourhood effects', 'conformity', 'imitation', 'contagion', 'epidemics', 'bandwagons', 'herd behaviour', 'social interactions', or 'interdependent preferences'.

[2] It is important to mention here that 'peer effects' refers to a situation in which a firm takes an action solely because its peers took the same action. It is not to be confused with 'common (correlated) effects', which refers to a situation where firms behave similarly due to a common reason, or 'contextual effects', which refers to a situation where firms behave similarly due to the fact that they exhibit similar characteristics. See Manski (1993), Lin et al. (2015), Popadak (2013), Delis and Mylonidis (2015), and Masciandaro et al. (2013) for more detailed distinction.

[3] See Popadak (2013) for a short overview of each of the mentioned motives.

[4] It is important to mention here that firms that mimic their peers do not necessarily do so to improve or to exhibit their quality. Low quality ('bad') firms can appear to be of high quality ('good') by simply mimicking 'good' firms and not by learn-

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