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Cost of Capital in an International Context: Institutional Distance, Quality, and Dynamics

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ABSTRACT

Cost of debt is a key cognitive anchor for managerial decisions and an important determinant of firm profitability. We extend international management research by analyzing the effects of institutional distance, institutional quality, and their dynamics on the cost of debt in the context of foreign direct investments (FDI). We test our conceptual model on a sample of companies making 3764 greenfield foreign direct investments from developed into less developed markets. Using hierarchical linear modeling, we show that the financial consequences of internationalizing into countries with weak institutions depend on both the institutional distance between countries, as well as their institutional quality. Furthermore, we find that recent changes in institutional quality form expectations about future development and ultimately influence post-investment financing costs.

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1. Introduction

When firms internationalize, a key question for management is the effect of the investment on the firms' cost of capital and specifically the cost of debt (Gallo, 2015). Cost of debt determines the availability of capital for future investments and the profitability of current operations. As investment decisions are based on the expected returns, corrected for the cost of raising capital (Fama and French, 2004), cost of debt is a crucial determinant in strategy formation (Sharpe, 1964). The literatures on underinvestment (Myers and Majluf, 1984) and asset substitution (Jensen and Meckling, 1976) attest to the pivotal importance of the cost of debt in international investment decisions (Mansi and Reeb, 2002; Reeb et al., 2001). In the field of finance, cost of debt is frequently explained using trade-off theory (Kraus and Litzenberger, 1973). From this theoretical perspective, the core determinants of cost of debt are tax benefits of debt on the one hand and “bankruptcy penalties” on the other (Kraus and Litzenberger, 1973 p.912). Tax benefits rather play a role in firms' reaction to the cost of debt (Goldstein et al., 2001). They are mostly associated with a company's domestic tax rate. Foreign tax rates certainly influence the location choice of an investment, but to a lesser extent the ex-post change in cost of debt. Hence, specifically an increasing probability of bankruptcy and the associated cost of financial distress are major drivers of the cost of borrowing for a company.

Finance literature identifies numerous determinants of cost of debt on the firm- as well as on the industry-level based on this model (Fama and French, 2002). Research on the country or cross-country level, however, remains scarce and theoretically underdeveloped. Empirically, the few existing studies focus either solely on a company's home or host country context (Chen et al., 2011; Hail and Leuz, 2009; Koedijk and Van Dijk, 2004; Qi et al., 2010), or solely on the differences between the two (Gray et al., 2013; Zhu and Cai, 2014). Theoretically, while making an important contribution to the literature, arguments do not relate to an

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overarching theoretical concept of the environment, but rather focus on selective influences and remain largely fragmented in their overall contribution. We believe that complementing trade-off theory with the institutional perspective from the field of international business provides a promising alley to develop a more consistent conceptual framework of country-level influences on the cost of debt.

The institutional perspective in international business (Berry et al., 2010; North, 2004; Peng et al., 2009; Scott, 1995) is guided by the assumption that not only firm or industry characteristics, but to equal extent, the institutional context matters for international investment and the risks associated with it. Literature conceptualizes this institutional context along three dimensions: institutional quality, institutional distance, and institutional dynamics. Institutional quality, i.e. the quality of formal and informal institutions within a country, has been a major research area in the field of IB and strategy for a long time (e.g. Filatotchev et al., 2013; Kostova and Roth, 2002). Scholars have shown that host (Bell et al., 2014; Henisz, 2000; Meyer et al., 2009; Moore et al., 2012) and home country institutional quality (Kogut et al., 2002; Vasudeva et al., 2013) significantly influence risk associated with firms' international activities. To a lesser degree, researchers theorized on the relevance of distance between the home and host countries' institutional contexts (e.g. Zaheer, 1995). Just recently, scholars have started to transfer this approach to the field of international finance and capital markets research (Bell et al., 2012; Bell et al., 2010). Lastly, the dynamics of institutional contexts have received least attention (Peng et al., 2008). This is surprising since investment decisions are driven by expectations about future risk and hence not (solely) by the current institutional setting, but also by the dynamics (development) of the institutional environment over time. Decision makers within and outside the firm base their assessment of risk associated with an international investment also on the trend of institutional development over time (improvement or deterioration) and the expectations they form because of observed changes (Jacowitz and Kahneman, 1995; Tversky and Kahneman, 1974). Research provides substantial empirical evidence of the impact of different dimensions of institutional context on risk associated with strategic decisions, such as foreign market entry mode, ownership choice, or other strategic foreign investment decisions (Brouthers, 2002; Capron and Guillén, 2009; Delios and Henisz, 2000; Hernández and Nieto, 2015; Hwang, 1989; Rueda-Sabater, 2000; Yiu and Makino, 2002). Given the conceptual relevance and the empirical evidence as a relevant determinant of risk, we integrate the institutional logic along the three lines with the trade-off perspective. Specifically, we reason that institutional contexts, i.e. their quality, distance, and dynamics, will also matter for the risk of bankruptcy in the trade-off perspective on international investments. Firms investing in foreign markets are always facing all three dimensions of institutional context as well as their interdependencies. Omitting one of the dimensions in the assessment of the institutional context may lead to biased conclusions. Consequently, the objectives of this paper are to develop a framework of institutional influences and their relevant interdependencies on the cost of debt associated with an international investment, and to test this framework empirically.

Our study makes the following important interdisciplinary contributions to theory in the fields of finance and international business (Cheng et al., 2009). First, by integrating trade-off theory from the field of finance with the institutional perspective from the field of IB, we extend the institutional perspective from the field of IB to the field of finance, and provide evidence that predictions based on this perspective also hold in the cost of capital logic. While classically rooted in factor markets, we thus expand the applicability of this perspective to a relatively new field, where applications of the institutional perspective so far are limited. Second, by combining both perspectives, we also contribute to trade-off theory from the field of finance. We do so by expanding the set of determinants of the bankruptcy risk, and by offering a conceptualization of institutional context based on the institutional perspective. As financial markets are often argued to be “efficient” across borders, we believe that this is an important addition and helps to build a more comprehensive framework that integrates institutional barriers and frictions. This is specifically relevant as we are among the first to provide a theory-based framework of institutional country-level indicators that matter for FDI financing.

We conduct our study in an environment in which companies from developed countries make greenfield investments in less developed countries, in order to get a clear and undistorted picture of the role of country risk in the cost of capital. This allows us to explicitly analyze the effect of an investment without firm-level confounding effects found in mergers and acquisitions. We use hierarchical linear modeling to account for firm-level and country-level effects while controlling for the impact of industries, time, and firm-level variables following Fama and French (2002).

2. Theory and hypotheses

Corporate strategy, finance and IB literature acknowledge close links between strategic decisions and financial constraints faced by the firm (Filatotchev and Piesse, 2009; Forssbæck and Oxelheim, 2008; Kochhar and Hitt, 1998). Similarly, finance literature provides theories that link financial resources with strategic decisions, investment behavior, and growth (Beck and Demirguc-Kunt, 2006; Beck et al., 2005). Yet, very little research has addressed the financial consequences of strategic decisions and even less the role of investment context therein.

The most prominent theories from the field of finance explaining the cost of capital are pecking order theory (Myers, 1977, 1984; Myers and Majluf, 1984) and trade-off theory (Kraus and Litzenberger, 1973). We base our theoretical reasoning on trade-off theory because it explicitly includes investment risk and the cost of financial distress. Pricing of equity is determined by investors' expected return on investment relative to the risk associated with it. Since creditors do not participate in the upside of an investment, their assessment is predominantly focused on risk. Risk is also the core element in our framework linking trade-off theory and institutional context. Hence, to have a clearer identification of risk effects, we focus on cost of debt rather than equity. The main drivers of debt ratios in trade-off theory are tax benefits of debt on the one hand and “bankruptcy penalties” on the other hand (Kraus and Litzenberger, 1973 p.912). The tax benefit is largely related to marginal tax rates at the global headquarter, not the financing of individual investment projects (Faulkender and Petersen, 2006). Also, the tax benefit mainly affects the way firms adapt the financial

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