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Investor base and corporate borrowing: Evidence from international bonds☆

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ABSTRACT

We examine international bond issues by US firms to study the benefits of investor taste for cross-border security issuances. We proxy for firms' international investor taste with the fraction of prior international bond holding in firms' domestic and international bonds and find that international investor demand increases with such taste. Moreover, the offering yield spreads on international bonds are lower than domestic offering yield spreads for these internationally recognized firms and they have higher probability of issuing internationally. Such international recognition may occur, for instance, if the diversification benefits of adding the security to investor's portfolio outweigh the negative effects of higher renegotiation costs for international compared to domestic investors.

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1. Introduction

One of the key questions in international finance is what drives cross-border flows. These have taken various forms over time. Over the period 1970–90, international capital flows were mainly in the form of international bank lending and foreign direct investment such as cross-border M&As (Adler and Dumas, 1975; Errunza and Senbet, 1984). In the 1990s, after the wave of financial liberalization, direct portfolio investment took over as the main form of international capital flows (Bekaert and Harvey, 2000; Stulz, 2005).

Different explanations for cross-border flows have been put forward. On the one hand, they have been attributed to optimal portfolio rebalancing, whereby investors diversify across countries at different stages of the economic cycle (e.g., Tille and Van Wincoop, 2010). On the other, gravity models have been used to explain capital flows in terms of information and transaction costs, relying on proxies such as the size of the market and trading costs (Portes and Rey, 2005), an approach which stresses the importance of the distance between the firm and the investor to proxy for information asymmetry (e.g., Brennan and Cao, 1997).

In this context, a key question is whether and how firms are willing to reduce information asymmetry by issuing international securities, and thus reduce transaction costs for investors who seek portfolio diversification. The literature has so far been largely mute on this point, empirically as well as theoretically. The focus of this paper is to bridge the gap by investigating this question in a setting that, to the best of our knowledge, links investor-level international bond ownership to international firm issues for the first time. It provides empirical evidence that accessing the international capital markets allows firms to attract financing at a lower cost.

We focus on US firms, whose international bond offering has been massive over the last decade. Fig. 1 shows that the net corporate debt raised by US non-financial firms internationally increased from \$1.8 bn (6% of total changes in US corporate debt) in 1994 to \$173.3 bn (54% of total changes in US corporate debt) in 2007, with the total outstanding amount raised rising from \$48 bn to \$730.6 bn.[1] The rise is even more apparent for financial firms. Over the same period, the fraction of international bond ownership in US corporations grew from 7.8% in 1994 to 24%

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[1] Aggregate statistics come from the US Department of Treasury International Capital System (for international bond ownership) and Bank of International Settlements (for international issues of securities).

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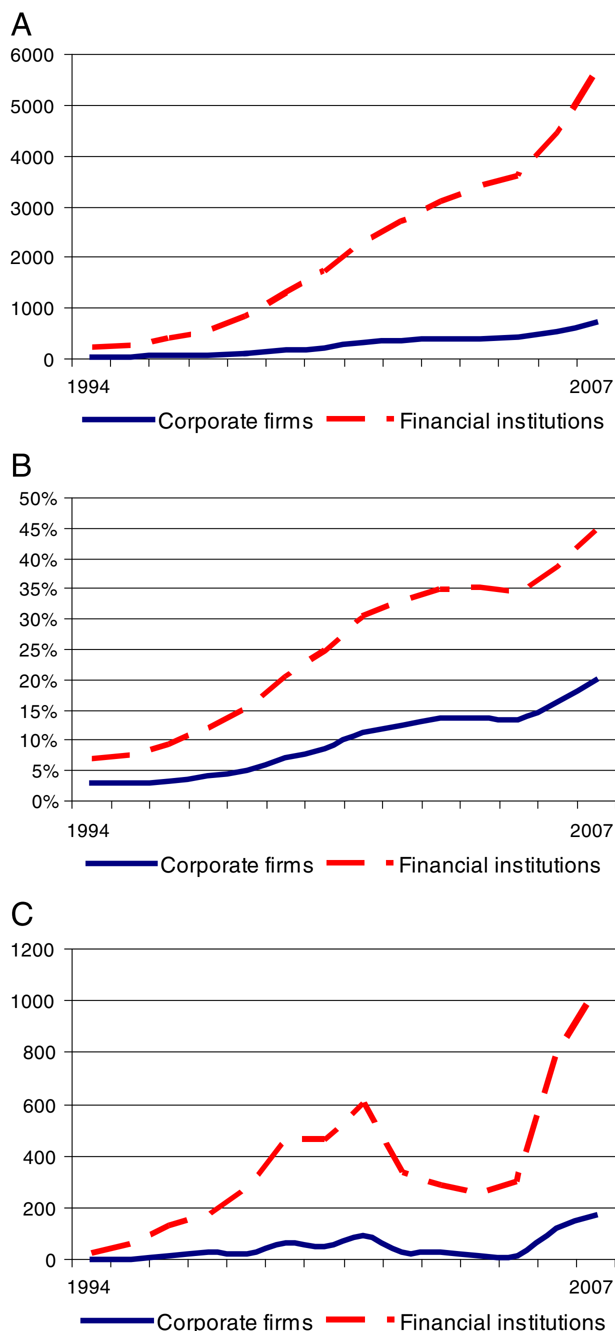

Fig. 1. A. Outstanding International Debt by US Firms ($bn). B. Outstanding International Debt by US Firms (% All Outstanding Debt). C. Net New Issues of International Debt by US Firms ($bn).

in 2007. In contrast, in 2007, US firms raised only $17.6 bn of equity in the markets outside of the US.

We argue that in the international markets firms face a trade-off between diversification and the cost of renegotiation. International investors offer sizable diversification-related benefits to US firms as they are less sensitive to US-related macroeconomic risk. Thus borrowing from international investors lowers the cost of borrowing. Conversely, since international investors are more geographically dispersed, and are located further away from the issuer's headquarters in countries with different laws and traditions governing creditor rights (Kim et al., 2011), there is less ability to renegotiate debt should such a need arise, and this increases the cost of borrowing. The firm's optimal position in this trade-off is driven by international investor taste for public bonds. Hence the positive effects of the attention given to a firm's bonds in a particular country more than offset concerns about renegotiating ability. The greater the international taste for a firm's securities, the bigger the incentive to issue internationally. The concept of investor taste is related to "investor recognition" which has gained traction in the academic literature since Merton (1987). However, despite the prominence of this hypothesis, it has been a challenge to show that firms actively raise international financing to respond to investor demand.

These considerations feed into our testable hypotheses: First, that there is higher demand among international investors for the bonds of internationally recognized firms ("higher taste"). Second, the stronger the international investor taste for a firm's bonds, the lower its cost of issuing international bonds. And third, that this prompts more internationally recognized firms to issue more international bonds.

This mechanism is similar to what is referred to in corporate finance and banking as "relationship lending". Commercial banks develop a special long-term relationship with repeat borrowers. This provides them with access to inside information that allows the bank to better monitor the firm (e.g., Diamond, 1984; Mayer, 1988; Sharpe, 1990; Boot, 2000; Boot and Thakor, 2000). Bank monitoring, even if aimed simply at recovering the loan, improves overall firm governance. Banks "acquire private information about loans and enhance the value of investment projects" (Diamond, 1984). This relationship with the bank lowers the moral hazard problem on the borrower side. However, such a relationship also creates a moral hazard on the side of the lender ("hold-up"). A prerequisite for the hold-up of the borrower is the lack of actual or potential lenders to replace the bank.

The equivalent of the special relationship in the bond market is the international investor taste for the bonds of a firm. This form of investor recognition enhances trust, which in turn allows the firm to get a lower rate. However, in the case of bond ownership, this is less likely given the more competitive nature of the bond market. Indeed, since there are multiple bondholders, the "special relationship" translates into interest rate smoothing without degenerating into the borrower hold-up problem that the bank lending relationship may generate (Boot and Thakor, 2000).

We test these hypotheses by focusing on the international issuance of bonds by US firms in the period from 1998 to 2006. We proxy for international investor taste using the fraction of international investors in the firm's previously issued bonds.[2] International bond ownership is positively related to the extent to which international investors value holding the firm's bonds compared to domestic investors. It is negatively related to renegotiation costs, as the latter increase with the fraction of distant lenders. A US firm can thus choose to cater to its investors and issue international securities if it perceives strong international demand for its domestic securities. Critically, international ownership does not simply correspond to previous international issuances. Indeed, the very first international bond issuance may itself be triggered by the prior *international* investment in the firm's *domestic* bonds. Firms that have never issued international securities may observe an increase in investments by international institutions in their domestic bonds, and start issuing internationally.

We start by looking at the investor demand. We find that the average international investor demands more bonds if the issuing firm already is appreciated in the investor's home country. As a proxy for taste from the investor's perspective we use "peer" bond ownership in the firm — i.e. the fraction of bond ownership by other institutional investors from the same country as the investor. These investors should have similar diversification needs and the ability to renegotiate debt of US firms. One standard deviation higher peer ownership is related to a 1.5% larger purchase in terms of the face value of the bond, while the average international investor owns 0.9% of the bonds of the firm — i.e. one

[2] Previous literature has used ownership type to infer investor recognition (e.g., individual ownership in Amihud et al., 1999), or the quality of governance (e.g., institutional ownership in Nikolov and Whited, 2013).

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