



Equity market liberalization and firm growth

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Abstract

In a sample of 686 investable firms from 26 emerging market countries, I show that equity market liberalizations do not result in an increase in externally-financed growth rates for participating firms. In fact I find mostly to the contrary. These findings are in line with recent work which shows that firms issue less and not more equity capital post-liberalization, and suggest the gains from equity market liberalizations may not be attributable to a reduction in financing constraints.

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1. Introduction

The decision by countries to liberalize their equity markets has attracted much academic attention. With some exceptions (see Rodrik, 1998), this line of inquiry has shown equity market liberalizations in a good light. For example, at the firm-level, equity market liberalizations serve to increase investment and improve operating performance (see Bae and Goyal, 2010; Mitton, 2006), heighten firm visibility, improve corporate governance (see Bae et al., 2006), and increase firm value (see Bae and Goyal, 2010; Mitton and O'Connor, 2012; O'Connor, 2012). At the country-level, equity market liberalizations result in increased investment and economic growth (see Bekaert et al., 2005, 2007, 2010).

However, the central theoretical prediction of equity market liberalizations has largely been ignored in empirical work. Equity market liberalizations refer to instances where restrictions on the foreign ownership of domestic equity are removed. As a result, we should then expect to observe greater equity issuance, potential changes in debt issuance and shifts in debt

maturity structure, and eventually a relaxation in financing constraints, post-liberalization.¹ While the literature provides *indirect* evidence to suggest this is the case (e.g. the “investable premium” of Mitton and O'Connor (2012) and the improvement in operating performance experienced by investable firms as documented by Mitton (2006) are both consistent with a relaxation in financing constraints), recent *direct* tests suggest this may not be so. Flavin and O'Connor (2010) and McLean et al. (2011) examine the capital issuance activity of investable firms. Surprisingly, neither documents a significant *increase* in equity issuance once firms become investable. Flavin and O'Connor (2010) uncover no significant change in net equity issuance. McLean et al. (2011) document a significant *decrease*.² Together, these findings suggest if anything, equity market liberalizations result in a *decrease*, and not an *increase* in the use of external equity financing, but does result in increased firm growth, as shown by Mitton (2006). Therefore, the findings of Mitton (2006), Flavin and O'Connor (2010), and McLean

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¹ While there is no direct theoretical link between equity market liberalizations and corporate debt issuance, equity market liberalization may promote greater debt issuance e.g. greater use of long-term debt, if investors are now more willing to invest in firms that now have foreign investors. Schumkler and Vesperoni (2006) document a shift toward short-term debt for firms after stock market liberalizations. Flavin and O'Connor (2010) find to the contrary using a firm-specific (and presumably less noisy) measure of equity market liberalizations i.e. the investable measure.

² The difference in the findings between the studies of Flavin and O'Connor (2010) and McLean et al. (2011) may be attributable to the different sample periods examined by each. The former examine the capital issuance behavior of investable (and cross-listing) firms up to and including the year 2000. The latter include all years up to and including 2008.

et al. (2011) suggest that investable firms grow, and they finance this growth mainly using internal and not external funds. In this paper, I test this proposition. That is, I examine the link between firm growth and the contribution made by external finance to that growth around the time in which firms first become investable.

To do so, I begin with the constrained or predicted growth rates of Demirguc-Kunt and Maksimovic (1998). These measures *predict* the maximum growth rate that a firm can achieve given access to internal funds and short-term external debt financing only (denoted as SFG_t), or internal funds, short and long-term debt financing (denoted as SG_t), respectively. With these *predicted* growth rates, I calculate the difference between a firm's *actual* and *predicted* growth rate, since the difference is an indirect measure of access to external financing for firms, and is a direct measure of a firm's externally-financed growth rate (EFG). Equity market liberalizations should result in an increase in externally-financed growth rates for investable firms. In this paper, I test this proposition.

To do so, I form a panel of 686 investable firms, and 2104 firms in total from 26 emerging market countries. Using a series of firm-fixed effects regressions which span the period from 1980 to 2000, I document a *decrease* in externally-financed growth rates for investable firms. My findings, together with those of Flavin and O'Connor (2010) and McLean et al. (2011), suggest the *relative* contribution made by external financing (i.e. long-term debt and equity financing) vis-à-vis internal financing, to firm growth, as documented by Mitton (2006), is less because firms use less external financing once they become investable.

Collectively, these findings serve to better inform our understanding of equity market liberalizations. First, they do not suggest firms do not benefit from becoming investable. Ample evidence exists to suggest otherwise. What they do suggest is the source(s) of the gains documented in the literature does not result from greater risk sharing and a decline in financing constraints. The gains result most likely from improvements in a firm's information environment resulting from corporate governance improvements (see Bae et al., 2006). The experience of investable firms contrasts with the experience of some firms cross-listing in the U.S. because the "cross-listing premium" is a function of, among others, improved governance (see Doidge et al., 2004, 2009; Lang et al., 2003), reduced financing constraints (see Reese and Weisbach, 2002; Lins et al., 2005; Khurana et al., 2008), and greater recognition (see King and Segal, 2009). Finally and as already alluded to by McLean et al. (2011), my finding's do suggest that investable firms use less external finance once they become investable because they are likely to be mature firms with little need for external financing. The fact that firms continue to grow, while simultaneously using less external financing once they become investable, suggests this is likely to be the case. Investability does not reduce financing constraints because investable firms are, at least around the time of first becoming investable, unlikely to be financially-constrained and in need of additional external finance.

The paper proceeds as follows. In the next section, I outline measures of externally-financed growth. Section 3 describes the sample of firms. Section 4 presents and discusses the empirical

findings. Section 5 presents some robustness exercises, while Section 6 concludes.

2. Measures of externally financed growth

To construct measures of externally-financed firm growth rates, I adopt Demirguc-Kunt and Maksimovic's (1998) application of a firm-based financial planning model. This approach has been used by, among others, Khurana et al. (2008). The following draws heavily on Khurana et al. (2008). To construct a firm's externally-financed growth rate (EFG) at time t involves two steps. In the first step, a firm's "constrained or predicted growth rates" is calculated. These growth rates represent the maximum growth that a firm can achieve if the firm relies solely on say, internal funds, internal funds and short-term debt, and internal funds and short and long-term debt financing, respectively. The second step involves using these "constrained or predicted growth rates" to calculate a firm's externally-financed growth rate. Externally-financed growth represents the difference between a firm's *realized* growth rate (normally measured yearly using either sales or asset growth) and the firm's "constrained or predicted growth rate" (Step 1). If equity market liberalizations result in greater externally-financed growth rates for firms, then we would expect to see an increase in the difference between a firm's realized growth rates and their "constrained or predicted growth rate".

Demirguc-Kunt and Maksimovic (1998) build on the "percentage of sales" approach to financial planning and derive three "constrained or predicted growth rates", which they denote as IG_t , SFG_t , and SG_t . IG_t is the maximum growth that a firm can achieve if it relies solely on internal funds. SFG_t is the maximum growth rate that a firm can attain by using both internal cash-flows and short-term debt. SG_t is the maximum growth rate achievable using internal funds, short and long-term debt external financing. I use the latter two.³

Begin with the expression for the external financing need (EFN) of a firm, which is:

$$EFN_t = [g_t \times \text{Assets}_t] - [(1 + g_t) \times (E_t \times b_t)] \quad (1)$$

The external financing need of a firm at time t is the difference between the product of assets at time t (Assets_t) times sales growth at time t (g_t) and the product of earnings after interest and taxes (E_t), the proportion of earnings retained for reinvestment at time t (b_t), and 1 plus sales growth at time t . A firm has an external financing need if $[g_t \times \text{Assets}_t] > [(1 + g_t) \times (E_t \times b_t)]$, i.e. the required investment of a firm growth at rate g_t [$g_t \times \text{Assets}_t$] is not covered by internal funds $[(1 + g_t) \times (E_t \times b_t)]$. Using this expression for a firm's external financing need, we can then continue to derive two measures of constrained firm growth. The first, denoted as SFG_t , is the maximum growth rate that a firm can attain by using both internal cash-flows and short-term debt. If we further assume a constant short-term debt to assets ratio to ensure a feasible growth estimate for the firm, then SFG_t

³ For a variety of reasons, emerging market firms typically use short-term debt as their major source of external financing (see Opazo et al., 2009).

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