Internationalization and investment-cash flow sensitivity: Evidence from Taiwan

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1. Introduction

The primary goal of this study was to investigate how the degree of internationalization affects firms' investment-cash flow sensitivity (ICFS) using a sample of Taiwanese listed firms. Our empirical results indicate that a higher degree of internationalization tends to lower its ICFS. Moreover, our findings also suggest that there is no significant difference between group-affiliated firms and unaffiliated firms in the relationship between internationalization and firms' ICFS. The findings contribute to the financial literature by clarifying internationalization, ICFS and business groups.

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Internationalization is one of the most crucial growth strategies for firms; it can enhance firm performance by allowing learning from local markets and extending host market advantages to foreign markets. Even though firms can gain from internationalization, internationalization costs accompany the benefits of international expansion. For example, the managerial complexity of multinationality often increases the degree of information asymmetry between insiders and outsiders (investors) and, in turn, increases the firm’s agency problems (Duru & Reeb, 2002; Lu & Beamish, 2004). These effects can also lower the firm’s value and internationalization influences the firms’ ICFS but also investigated how firms’ business group affiliation influences the relationship between firms internationalization and ICFS. In doing so, we were able to accurately identify the relationship among group business, internationalization and ICFS.

1 George, Kabir, and Qian (2008) define business group as follows: “Business groups are usually a collection of many unaffiliated firms bound together with common ties and formal and informal relationships. Although a business group functions as a single informal organization, each of the firms under its control is a separate legal entity. Most of these firms have well-defined production facilities and are listed on a stock exchange”.
raise the costs of external financing. Yan, Yang, and Jiao (2010) investigated the investments of diversified firms and focused on how firms are affected by various capital market conditions using six macro-related indices. Their empirical results reinforced the effectiveness of the internal capital markets for the diversified firms of US conglomerates, especially diversified firms that are more financially constrained in external markets. Differing from the research of Yan et al. (2010) on industrial diversification, the primary goal of this study was to further investigate the effects of firm internationalization on corporate investment policy is the agency problem, which results in the conflict between managers pursuing their own benefits and the interests of the shareholders. In such a scenario, a firm would rely more on its available cash flow. This dependence may lead to the rejection of a positive NPV project and an underinvestment problem for firms (Fazzari et al., 1988). Firms facing crowding financing constraints usually tend to exhibit a greater ICFS, as suggested by Fazzari, Hubbard, and Petersen (hereafter Fazzari, Hubbard, & Petersen, 1988, 2000). Subsequently, studies such as Perotti and Gelfer (2001), Kato, Loewenstein, and Tsay (2002), Laeven (2003), and Aggarwal and Zong (2006) have employed the ICFS as a proxy for a firm’s financing constraints. These studies have concluded that firms with more financing constraints appear to exhibit higher ICFS.2

In addition to information asymmetry, another influential factor in corporate investment policy is the agency problem, which results from managers pursuing their own interests regardless of shareholders’ interests. In such a scenario, a firm would also rely more on internal free cash flow and, in turn, would develop an over-investment problem. Overall, the extent to which the sensitivities of investment to cash flow are related to information asymmetry or agency conflict depends on the costs of external financing (Ascioglu, Hegde, & McDermott, 2008; Myers & Majluf, 1984; Stiglitz & Weiss, 1981) or the available cash flow (Jensen, 1986). In short, our paper discusses the influences of internationalization and subsequently discusses the effects of business group affiliation on the relationship between firm internationalization and ICFS.

Our sample includes listed companies in Taiwan from year 2002 to year 2012. We found that the firms with a higher degree of internationalization tend to have lower ICFS. Moreover, our findings also suggest that the relationship between internationalization and ICFS is insignificant difference between group-affiliated firms and unaffiliated firms. In summary, this paper provides solid evidence that the internationalization can effectively lower its ICFS. This finding is our contribution to the current literature of ICFS.

The remainder of this paper is organized as follows. In Section 2, we develop the two hypotheses of this study. Section 3 discusses the data and the major variables used in this study. Section 4 discusses and presents the empirical results. Finally, Section 5 draws conclusions.

2 In contrast, Kaplan and Zingales (1997, 2000) and Cheevar (1999) have found that the firms with the fewest financial constraints exhibit greater ICFS. This finding implies that using ICFS as a proxy for a firm’s financing constraints is not appropriate. Conversely, a number of studies use firm characteristics, such as dividend payout ratio, debt financing, firm size and firm age to proxy a firm’s financing constraints. However, these characteristics are endogenous and change over time (George et al., 2008).

2 Hypothesis development

The prior research has documented that the positive effect of firm diversified funds on capital investment decisions decreases ICFS (Fazzari et al., 1988, 2000). However, the negative effect on capital investment decisions has been observed to create severe information asymmetry and agency problems and, accordingly, to increase ICFS (Ascioglu et al., 2008; Myers & Majluf, 1984; Stiglitz & Weiss, 1981). A firm in an emerging economy usually faces greater challenges or uncertainty due to the immaturity of the economy’s domestic markets and the economy’s structural change (Nachum, 2004). Moreover, emerging domestic markets are restricted by limited resource availability because their financial systems are not as sound as that in the developed countries. Accordingly, a firm in an emerging economy tends to internationalize toward other markets to mitigate the risk and competitive pressure inherent in the emerging economy. Consistent with this logic, internationalization can help firms to develop economies of scale and acquire additional resources from external markets (Svetlicic & Rojec, 2003). For example, one of the advantages of internationalization is fewer external financing constraints, which leads to financing tunnels through more diversified that those for pre-internationalization.

Over the last few decades, with the wave of internationalization, emerging economies have extended their business abroad (Chang, 2007; Chin, Chen, & Hsieh, 2009; Peng, Yang, & Liang, 2011). Due to increasing liberalization and internationalization, more firms in emerging economies have expanded investment into foreign markets and have subsequently established international subsidiaries that have helped them to obtain more funds. When they are considered together, it is clear that higher internationalization leads to lower ICFS. In contrast, however, internationalization leads to more severe information asymmetry, subsequently resulting in higher ICFS, as indicated in Chin et al. (2009): “With increased geographic dispersion of firm assets, corporate international diversification thus increases organizational complexity, and in turn increases information asymmetry between managers and investors” (Duru & Reeb, 2002).

The escalation of internationalization not only increases the degree of information asymmetry between insiders and outsiders and deteriorates firms’ agency problems (Chin et al., 2009; Duru & Reeb, 2002); it also diversifies (expands) the financing tunnels that a firm can use to raise capital (Svetlicic & Rojec, 2003). Therefore, the internationalization on ICFS includes two distinct effects: a positive effect, decreasing ICFS, and a negative effect, increasing ICFS. Accordingly, internationalization can diversify the financing tunnels, we predict the higher the internationalization, the lower the ICFS. We propose the following hypothesis:

H1. Firm internationalization is negatively associated with the degree of ICFS.

In this study, we also consider the effects of business groups since a business group’s internal capital market provides an alternative financing tunnel for group-affiliated firms (Buchuk, Larrain, Muñoz, & Urzúa, 2014; Cho, 1995; Locorotondo, Dewaelheyns, & Van Hulle, 2014; Saed & Sameer, 2015). Business groups can reallocate capital among member firms through internal financial markets, which may maximize the wealth of the entire group. As such, group-affiliated firms are well known for being financially dependent, and their investment projects can be financed through group-internal funds within the groups. Accordingly, group-affiliated firms should have lower ICFS than unaffiliated firms (Hoshi, Kashyap, & Scharfstein, 1991).

Furthermore, we attempt to investigate whether the effect of firms internationalization on its ICFS varies when the firms are
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