Capital structure with risky foreign investment

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Abstract

Firms facing significant business risks have incentives to mitigate the costs of these risks by adjusting their capital structures. This paper investigates this link by analyzing the exposures of multinational firms to political risk. The evidence indicates that returns on investment in politically risky countries are more volatile than returns elsewhere. Multinational firms reduce their leverage in response to these political risks: a one standard deviation increase in foreign political risk is associated with 3.5\% reduced leverage. The effect of foreign political risks on leverage is most pronounced for firms in industries whose returns are most susceptible to political influence.

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1. Introduction

While the relation between risk exposures and firm financial decisions is an element of many theories of capital structure, these theories have received only mixed empirical support. Multinational firms operating around the world encounter a wide variety of political regimes, and they face associated risks of sharply reduced profitability. This paper examines the extent to which exposures to political risk influence the capital structures of American multinational firms, thereby illuminating the broader relation between capital structure and risky investments.

Using detailed data on American multinational firms, the analysis begins by considering the extent to which political risk influences the returns of multinational firms. The evidence indicates that the volatilities of the investment returns of subsidiaries owned by the same parent company vary systematically with political risk.
An increase in political risk corresponding to the difference between Canada and Mexico increases the standard deviation of a foreign affiliate’s return on assets by 22%. This increased volatility of returns is also manifest in a greater likelihood of annual losses among foreign affiliates in politically risky countries. Such volatility need not be costly to multinational firms given their ability to diversify risk across countries. An analysis of aggregate foreign risk exposures and foreign returns indicates that diversification benefits are operative but incomplete, as aggregate foreign political risk is associated with significantly more volatile returns.

Previous work suggests that multinational firms respond to political risk by altering financial and operational characteristics of foreign subsidiaries. Desai, Foley, and Hines (2004) show that foreign subsidiaries located in politically risky countries are more highly levered than other foreign subsidiaries of the same multinational parents. Henisz (2000) offers evidence that multinational firms serving politically risky foreign markets are more likely than investors in safe locations to share ownership with local partners. Such behavior presumably entails managing political risk by shifting some of the risk to foreign capital providers who can bear the risk in a less costly manner. This earlier work leaves open the question of how political risk influences, if at all, the capital structures of parent companies located in politically stable countries but whose foreign subsidiaries are exposed to political risk.

The evidence indicates that parent companies of multinational groups exposed to significant foreign political risk use less leverage than do parent companies without such exposures. A one-standard deviation increase in exposure to foreign risk reduces leverage by 3.5% of its mean level. This effect is large enough that overall firm leverage falls, despite the greater leverage of affiliates in risky countries. A notable aspect of this finding is that it runs counter to the incentives identified by Myers (1977), whereby shareholders of heavily leveraged firms prefer greater business risk, some of the cost of which is borne by debt holders.

The effects of political risk on capital structure should be particularly manifest in industries that are clearly exposed to such risk. A review of multinational firm experience with political risk suggests that industries primarily serving local markets and the transportation, communication, and public utilities industries are particularly susceptible to local political risks. Repeating the analysis on these industry groupings indicates that firms in those industries that face the most significant exposure to political risk also feature the greatest effects of political risk on capital structure. Estimated capital structure effects are similar whether political risk is defined as an aggregate measure of country conditions or as an index that focuses more narrowly on political institutions. These results highlight a cost of operating in politically risky markets and illuminate the degree to which business risk exposures influence financing decisions more generally.

The results in this paper are related to earlier studies of the determinants of capital structure decisions and the distinctive nature of finance in emerging markets. As reviewed in Harris and Raviv (1991), empirical efforts to link the volatility of firm or industry returns to capital structure decisions have not produced strong or consistent results. The mixed results on the role of return volatility in determining capital structure is particularly surprising given that the Graham and Harvey (2001) survey of Chief Financial Officers finds that informal criteria such as financial flexibility, credit ratings, and the volatility of earnings and cash flows are the most important factors influencing borrowing levels. The results in this paper employ heterogeneity in exposures to political risk to identify the role of firm risk on capital structure, finding significant effects in the multinational setting.

As noted in Bekaert (1995), Harvey (1995), and Bekaert and Harvey (1997, 2000), stock markets in emerging markets feature distinctive return distributions; aspects of local institutional environments, including political risk, contribute to higher return volatilities. The evidence indicates that these patterns carry over for multinational firms operating in risky environments, providing some support for the various capital budgeting practices, described in Sabal (2004), used to address such risk. Corporate finance practices in emerging...
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