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Theory and practice of corporate finance: Evidence and distinctive features in Latin America

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ABSTRACT

We survey 290 LATAM firms on capital budgeting, cost of capital and capital structure issues. We analyze the results and compare them to those of other studies. We interpret differences according to special features characterizing both emerging markets and SME. We observe that LATAM firms make use of standard capital budgeting techniques, but give special weight to liquidity and capital rationing considerations. They rely less on cost of capital formal estimations; rather, they use investors' requests as their primordial input. Finally, surveyed firms are less leveraged, and inclined toward stressing the role of internal financing and minimizing payment commitments.

1. Introduction

It is well known that emerging markets pose not only an attractive but also a challenging business environment for firms expanding overseas. Corporate finance in emerging markets is a complex field for managers and academics. Most of the models used in investments and corporate finance have been developed under the assumption of — at least — moderately efficient markets, but this assumption seems to be questionable when moving to less developed markets. Emerging markets are not efficient markets; they

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are characterized by higher information asymmetries, higher transaction costs, more concentrated ownership, lack of market development, relatively low market liquidity, etc. Additionally, there are relevant differences in terms of suitability for the use of standard corporate finance techniques in the context of small and medium private enterprises. Yet, given that information is often lacking in emerging markets, and particularly, when referred to the subset of small and medium enterprises (SME), a deeper analysis is frequently postponed. In recent years, several scholars have devoted some attention to understand emerging markets special features, but there has not been a comprehensive study of how practitioners really make financial decisions in emerging markets.[1]

In this study we contribute to this field by surveying corporate finance practices in emerging markets. Building on the contribution of Graham and Harvey (2001), whose survey provides a comprehensive description of the current practices of corporate finance in the US public firms' universe, we expand the analysis to emerging markets, covering a quite different sample, mostly characterized by small and medium private Latin American firms. We design a survey in which we replicate Graham and Harvey's questions whenever applicable to the emerging market environment, and add a considerable number of queries that apply to the specific conditions prevalent in these markets. Similar to theirs, our survey copes with three basic topics: capital budgeting, estimation of the cost of capital, and capital structure.

Given the significant differences between developed and emerging economies (in terms of currency stability, capital market development, liquidity, size, information availability, transaction costs, and a vast etcetera), and between large public and small and medium private firms (in terms of access to capital markets or outside equity, ownership structure, information asymmetries, etc.), we hope this survey will be useful to interpret particular corporate financial choices prevalent in settings that differ from those for which most models have been designed.

The Fisher separation property, that sustains that the firm investment decision should be independent of its owners' preferences, and independent of the financing decision, is not likely to hold for many small and medium enterprises, and particularly, for those located in emerging markets. Therefore, the use of standard capital budgeting techniques is likely to be altered in these contexts. Capital constraints, concentrated ownership, and the common coincidence of manager–owner are features likely to favor methods stressing liquidity and uncertainty.

Similarly, standard techniques for estimating the firms' cost of capital — particularly, the Capital Asset Pricing Model, CAPM — rely on assumptions that largely depart from the circumstances of small and medium firms and emerging markets. Once again, one would expect that small versus large businesses, private versus public firms, concentrated versus diluted ownership structures, etc., will cause discount rate estimations to depart from the CAPM figures. A one-factor model is likely to fall short in capturing some of these features.

Finally, differences in tax treatment, rule of law and investor protection,[2]the lack of separation between management and ownership — that characterizes many small businesses, the lack of development of public debt and equity markets in most emerging markets, etc., is likely to influence financing choices.

We avoid surveying previous literature, already summarized in Graham and Harvey's study. Nevertheless, while discussing our results, we do mention some newer contributions as well as studies that make reference to the specific case of emerging markets and/or of small and medium private and public firms.

A typical characteristic of emerging markets is the difficulty in obtaining information. This has influenced our study since we could not rely on a central database to target the survey. To circumvent this problem, the questionnaire was distributed through several leading Latin American Business Schools in different countries, which selected a sample set from their alumni databases. The main advantage of this approach is that we obtained a high absolute number of responses; the major drawback is that, in most cases, we have not been able to estimate a respondent rate.[3]Another consideration is the potential bias in our sample; most of the surveyed managers were part of the alumni network of an important

[1] See for example the books by Beim and Calomiris (2001), Bruner et al. (2003), Hooke (2001), Pereiro (2002) and Sabal (2002), and research papers by Braun and Larrain (2009), Booth et al. (2001), Céspedes et al. (2010), Desai et al. (2008), Espinosa and Maquieira (2010), Garcia-Sanchez et al. (2010), Grandes et al. (2010), Godfrey and Espinosa (1996), Love et al. (2007), Qi (2010), among many others.

[2] See Chong and López-de-Silanes (2007) and La Porta et al. (1997, 1998, 2000).

[3] Moore and Reichert (1983), for example, have 298 responses, and it was, until the publication of Graham Harvey's work, the largest sample in a published survey.