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Corporate governance and investment-cash flow sensitivity: Evidence from emerging markets

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ABSTRACT

Controlling for country-level governance, we investigate how firms' corporate governance influences financing constraints. Using firm-level corporate governance rankings across 14 emerging markets, we find that better corporate governance lowers the dependence of emerging market firms on internally generated cash flows, and reduces financing constraints that would otherwise distort efficient allocation of investment and destroy firm value. Additionally and more importantly, firm-level corporate governance matters more significantly in countries with weaker country-level governance. This suggests substitutability between firm-specific and country-level governance in determining a firm's investment sensitivity to internal cash flows.

1. Introduction

How firms make investment decisions in the face of financing constraints is one of the most fundamental questions in contemporary finance research (Almeida and Campello, 2007). This is the case because financing constraints can distort the efficient allocation of investment and destroy firm value (Agca and Mozumdar, 2008; Stein, 2003). Indeed, an extensive amount of theoretical and empirical research finds a strong relationship between external financing constraints and poor investment decisions, especially for badly

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governed companies (see, e.g., Almeida and Campello, 2007; Brown and Petersen, 2009; Hovakimian, 2009). These studies contend that in the presence of agency problems associated with managerial control, investors require higher returns on their capital as compensation for monitoring costs (Jensen, 1986; Stulz, 1990). This restricts managers' access to external financing, forces them to rely more heavily on low-cost limited internal funds, and limits their ability to accept positive net present value projects.

Although the extant literature provides ample evidence of the impact of country-level governance—such as the efficiency of the legal system, the rule of law, the risk of expropriation, corruption, and legal origin—on firms' investment–cash flow sensitivity (see, e.g., Love, 2003; Lins et al., 2005), there is little if any evidence on the relationship between investment–cash flow sensitivity and firm-level corporate governance, especially in emerging market firms.[3] More importantly, it is still an open question whether firm- and country-specific governance mechanisms substitute or complement each other when firms make investment decisions, conditional on internally generated funds.

In a quest for a better understanding of these issues, this study investigates the influence of firm-level corporate governance on investment–cash flow sensitivity, after controlling for country-level governance. Employing firm-level corporate governance rankings for 14 emerging countries, we test whether the relationship between firms' corporate governance and investment–cash flow sensitivity varies among countries with different country-level governance.

Specifically, this study first attempts to examine how governance standards affect firms' investment–cash flow sensitivity, with baseline investment equations following those of Fazzari et al. (1988). However, unlike earlier studies, we also include the interaction term between cash flow and firm- and country-level governance measures that capture the effect of overall corporate governance on the investment–cash flow sensitivity relationship.

Consistent with the earlier literature (e.g., Cho, 1998; Degryse and de Jong, 2006; Goergen and Renneboog, 2001; Hadlock, 1998; Kathuria and Mueller, 1995; Schaller, 1993; Vogt, 1994), our results confirm that the sensitivity of investment to free cash flows increases in response to poor firm-level corporate governance. This is consistent with the idea that badly governed firms have limited access to external financing and thus have to rely more heavily on internally generated funds. However, we also find that the effect of firm-specific corporate governance on the availability of external funds becomes especially pronounced when the home country has a weaker investor protection. This suggests that firm level corporate governance is especially important in emerging markets with a weaker investor protection, where the availability of external funds is limited to begin with. Our findings also suggest a substitution effect between firm and country level governance mechanisms that is particularly important in determining the level of corporate financial constraints.

The results are robust to various specifications of investment cash flow sensitivity measures, sample selection criteria, and endogeneity. For example, while we acknowledge that data availability on the firm-level governance measure in emerging markets restricts us from using multiple years of data, a two-stage regression procedure confirms that reverse causality does not drive our results.[4] In addition, to further deal with a potential omitted variables concern, we include several variables that could relate to firms' growth opportunities and investment behaviors such as Tobin's Q, firm size, cash flow volatility, leverage, sales, cash, foreign direct investment, GDP per capita, GDP growth, American Depositary Receipts dummy, a dummy for firms in Latin America, and industry dummies, and we obtain qualitatively similar results. Finally, measuring cash flow sensitivity following Almeida et al. (2004) provides qualitatively similar results. In an additional robustness check, we also find that firm-level corporate governance positively affects a firm's access to external capital, as measured by the growth rate in leverage. Overall, our findings suggest that superior firm-level governance reduces financial constraints, and that firm-specific corporate governance and country level governance are substitutes in determining a firm's access to external financing.

This paper contributes to the existing literature in several important ways. First, as far as we know, it provides the first empirical evidence of a link between firm-level governance standards and corporate

[3] There is some limited evidence on the impact of firm-level corporate governance on corporate investment expenditures in the U.S. and other developed countries (e.g., Almeida and Campello, 2007; Brown and Petersen, 2009; Cho, 1998; Degryse and de Jong, 2006; Goergen and Renneboog, 2001; Hadlock, 1998; Hovakimian, 2009; Kathuria and Mueller, 1995; queryAgca and Mozumdar, 2008; Schaller, 1993; Shin and Park, 1999; Vogt, 1994).

[4] We acknowledge that we cannot fully address endogeneity problems because we only have one year firm-level corporate governance data. We leave this task to future research.