Cost of debt for Yankee and Domestic bonds

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ABSTRACT

This paper compares the cost of debt for corporate bonds issued by foreign firms (Yankee bonds) and by U.S. firms (Domestic bonds) in the U.S. market. By using a sample of 2445 Yankee from 68 countries for the 1991–2014 period, I find that better country level governance offset the impact of asymmetric information on the cost of debt. Yankee bonds that domiciled in countries with higher protections and law enforcement, have significantly lower cost of debt than the comparable Domestic bonds. On the other hand, for foreign firms that domiciled in countries with a worse control on the self-dealing, the cost of debt is higher than that of the Domestic bonds because foreign firms have higher asymmetric information than the comparable U.S. firms. Further findings suggest that yield spread is significantly reduced for Yankee bonds that are from countries with better country level governance.

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1. Introduction

Since 1990, the progress of globalization in capital market has accelerated. As documented in Karolyi (2006), in recent years, total cross-border portfolio flows of capital between residents of the U.S. and all other countries represented almost 30% of the Gross Domestic Product (GDP) in U.S. previous literature document different aspects of the cross-listing of foreign firm’s stocks in the U.S. market. For example, Doidge et al. (2004) find foreign firms domiciled in countries with weak investor protection experience greater valuation changes when they cross-list in the U.S. stock market. Lang et al. (2003) document cross-listing of a foreign firm’s stock in the U.S. market increases the foreign firm’s forecast accuracy and analyst coverage. Thus, cross-listed firms are valued higher than their non-cross-listed peers. Lel and Miller (2008) find that firms from weak investor protection regimes increase the corporate governance after cross-listed in the U.S. stock market.

Compare to the cross-listing of the stocks, overseas firms raised a greater amount of capital in the U.S. public bonds market. For example, for the 1991–2014 period, non-U.S. firms raised an average of $1.35 million in the U.S. stock market, while the average amount raised in the U.S. bond market is $531 million. These Yankee bonds provide foreign firms a substantial source of external capital and they play an important role in the international capital markets. However, unlike the cross-listing of stocks, Yankee bond is a yet relatively less examined market.

In this paper, I focus on corporate bonds issued by foreign firms in the U.S. market (Yankee bonds) and examine whether Yankee bonds and bonds issued by U.S. firms (Domestic bonds) have the same cost of the debt at the time of the debt issuance by controlling the issue-, firm- and country-characteristics.

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2 Please see Karolyi (2006) for a review.

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The literature on the cost of debt suggests that investors require a higher yield when information asymmetry between borrowers and lenders is higher. For example, Yu (2005) argues the quality of accounting information could have an impact on the firm’s costs of debt. He finds that firms with more accurate information disclosure (less asymmetric information) have lower short-term credit spreads. Using data in the syndicate loan market, Wittenberg-Moerman (2010) shows that both information asymmetry between syndicate lenders and borrowing firms and information asymmetry among secondary loan market participants are priced in the loan interest rate. Information asymmetry increases the loan interest rate. Using evidence from quasi-random analyst disappearances, Derrien et al. (2016) find that the loss of an analyst causes the cost of debt to increase by 25 basis points. They argue that the loss of the analyst implies an increase in the asymmetric information. The greater information asymmetry means higher risks to the debtholders. As a result, the cost of debt goes up.

Yankee bonds are bonds issued by foreign firms in the U.S. bond market. Previous studies suggest that there is a relatively high level of the asymmetric information between the issuing firm and the investors. For example, Leuz et al. (2003) and Defond et al. (2007) argue that there is more earning management in countries with poor accounting quality and weaker investor protection. Thus, earnings for firms domiciled in these countries are less informative. Miller and Puthenpurackal (2002) and Zhu and Cai (2014) argue that foreign firms have different accounting disclosure requirements and different legal protections from U.S. firms. Thus, it is more difficult for U.S. investors to gather and interpret foreign firms’ information especially when these firms are not cross-listed in the U.S. stock market at the time of the Yankee bond offers. Based on the information asymmetric theory, to ameliorate the higher asymmetric information in the Yankee bond market, investors in the Yankee bond market may demand higher yield spreads.

However, in related studies in the equity market, Bruner et al. (2004, 2006) document that foreign companies that come to the U.S. market for their initial public offer of stocks (IPOs) are larger and better quality firms than domestic U.S. firms. These foreign IPO firms experience lower issue costs than domestic issuers, despite their higher degree of country risk and information asymmetry to the U.S. investors. Following Bruner et al. (2004, 2006), one can argue that Yankee bond issuers may have better quality. As a result, the cost of debt for Yankee bonds is lower.

In summary, although much of the literature in the cost of debt suggests that Yankee bonds should have a higher cost of the debt than the comparable Domestic bonds, there are also reasons to believe that they might have lower costs, leaving the issue an empirical question. In this paper, I compare the cost of the debt of 2445 Yankee bonds with that of Domestic bonds from 1991 to 2014. The Yankee bonds are issued by firms from 68 foreign countries.

First, I test whether the cost of debt is higher for Yankee bonds by running a correlation test. The result suggests that overall Yankee bonds have higher yield spread than Domestic bonds. After controlling the issue- and firm-characteristics in a multi-regression model, the result suggests that Yankee bonds are associated with higher cost of debt than the comparable Domestic bonds, however, the difference is not statistically significant.

Second, La Porta et al. (2000), Miller and Puthenpurackal (2002), Qian and Strahan (2007) and Miller and Reisel (2012) document that for issuers domiciled in countries with stronger investor protection provisions, the cost of the debt is reduced. Miller and Puthenpurackal (2002), Burns et al. (2007) and You et al. (2012) argue that in addition to the investor protection, the enforcement mechanism also affects the cost of the capital. I test how these country characteristics affect the difference in the cost of debts between Yankee- and Domestic-bonds. By running subsample tests, I find that the quality of country governance significantly reduces Yankee bonds’ yield spreads, and the reduction is large enough to completely offset the influence of asymmetric information. For Yankee bonds that are issued by firms domiciled in countries with high creditor rights and good law enforcement, the cost of debt is significantly lower than that of the comparable Domestic bonds. The result is consistent with Bruner et al. (2004, 2006). U.S. investors view foreign companies domiciled in countries with good investor protection and law enforcement as high quality firms. As a result, these foreign issuers experience lower cost of debt than domestic issuers, despite their higher degree of information asymmetry.

On the other hand, investors demand a premium for bonds issued by firms that are located in countries with poor law enforcement. The results are consistent with the asymmetric information hypothesis (Wittenberg-Moerman, 2010; Halov and Heider, 2011). The dissimilarities in U.S. and foreign country increase the cost of information gathering. Foreign firms experience a higher level of asymmetric information. Therefore, U.S. investors consider bond issuers from foreign countries risker and demand a higher yield for bonds issued by these non-U.S. firms than for the comparable Domestic bonds.

Third, to better estimate the effect of governance strength on the cost of debt for Yankee bonds, I match each Yankee bond to a U.S. Domestic bond with very similar offering attributes. In the next set of regression analysis, the dependent variable is the difference in the cost of debt between each Yankee bond and its matched Domestic bond. The regression results suggest that issuing firms in countries with greater law enforcement tend to experience lower cost of debt than the comparable Domestic bonds. In addition, the results suggest that when firms increase the investor protection at the security level through the use of covenants, better law enforcement does not have a significant effect on the difference in yield spread between Yankee bonds and the matched Domestic bonds. However, for Yankee bonds that do not have covenants, better law enforcement decreases the cost of debt relative to the comparable Domestic bonds. The results are consistent with Miller and Reisel (2012) who find that the use of contract covenants can overcome the effects of country-level governance measures. By including worldwide governance indicator (WGI)2 dimension in the regressions, the results

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