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Internal capital networks as a source of MNC competitive advantage: Evidence from foreign subsidiary capital structure decisions

Raj Aggarwal[a,1], NyoNyo A. Kyaw[b,*]

[a] *Sullivan Professor of International Business and Finance, University of Akron, Akron, OH 44325, United States*

[b] *Hagan School of Business, Iona College, 715 North Ave., New Rochelle, NY 10801, United States*

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Abstract

This paper documents multinational company (MNC) strategic advantages arising from its internal financial network. Using data from US multinational company affiliates in 62 countries, we show that MNC affiliates in countries with low credit availability, poor creditor protections, high political risks, and high inflation are found to bear high interest costs and multinational affiliate debt ratios are high in high tax countries. In addition, affiliates in countries with high (low) credit availability, a high (low) corruption index, low (high) political risks and high (low) currency depreciation are found to carry high external (parent) debt ratios. We also find that currency depreciation, credit availability, and location in common law countries are negatively associated with the use of parent (relative to external) debt. Thus, our findings suggest that affiliates substitute external debt with parent debt using internal capital markets to overcome weak external financial markets and institutional environments. This is important evidence of the strategic competitive advantage based on financial networks enjoyed by MNCs.
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* Corresponding author. Tel.: +1 914 633 2269.
E-mail addresses: aggarwa@uakron.edu (R. Aggarwal), nkyaw@iona.edu (N.A. Kyaw).
[1] Tel.: +1 330 972 7442.

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1. Introduction

Foreign operations of multinational companies (MNCs) suffer from the limitations of being foreign – so they must have some unique advantage compared to local competitors. Generally, this advantage is seen to arise from sources such as specialized technology and management know-how, important brand or other intangible asset, or another competency, resource, or advantage (e.g., Buckley, 1998; Buckley and Casson, 1976; Hennart, 1982). Another stream of literature has noted that multinational networks can themselves be sources of social capital and strategic advantage (e.g., Gulati et al., 1989; Holm et al., 1996) and multinational networks can provide operating flexibility and be sources of valuable real options (e.g., Buckley and Tse, 1996; Kogut and Kulatalika, 1994). Many others have contended that much of this strategic option value arises from the financing advantages of MNCs, i.e., the MNCs enjoy advantageous financing access and a lower cost of capital with their ability to tap multiple national capital markets (e.g., Eiteman et al., 2001; Eun and Resnick, 2001).

However, there is little empirical evidence of the advantages based on access to the internal financial network theoretically enjoyed by MNCs. This paper provides important new empirical evidence of the strategic advantage resulting from the multinational financial network available to MNCs by examining the nature and composition of the foreign subsidiary capital structure of US MNCs. We show that MNCs use their access to multinational financial networks to fund their foreign affiliates when local financing is costly or not easily available.

More specifically, using recent data on the financing of US MNC affiliates in 62 countries (all countries where such data is available) this study examines how MNC affiliate's capital structures respond to host country tax, legal, financial, and economic structures. In addition to examining the determinants of overall debt structure of multinational affiliates, we also disaggregate the total subsidiary debt into parent debt and external (non-parent) debt and assess their determinants.

We document important findings regarding the debt-equity composition of the foreign affiliates of US MNCs. First, without considering other country factors as control variables, multinationals seem to adapt to local capital structure norms but, as expected, the importance of local capital structure norms disappears when other aspects of the host country institutional features are included in the estimates – confirming that local capital structure norms are determined by our chosen institutional features of national financial systems. Second, we document the impact of local institutional conditions on debt costs of the foreign affiliates of US MNCs. We find that location in countries with common law, currency depreciation, and higher credit availability is negatively associated with the use of debt in the mix of parent financing of subsidiaries. We find support for the contention that multinationals have high affiliate debt ratios in high tax countries. We also find that MNC affiliates in countries with low credit availability, poor creditor protections, high political risks, and high inflation are found to bear high interest costs, especially interest costs on external debt.

Third, and very interestingly, we also document the ability of MNCs to switch between parent debt and local debt to reflect local conditions. We find that affiliates in countries with high (low) credit availability, high (low) corruption perception index, low (high) political risks and high (low) currency depreciation are found to carry high external (parent) debt ratios. These findings suggest that not only does affiliates' use of external debt depend on country institutional factors and interest rates, but also that affiliates substitute external debt with parent debt in countries with poor institutional features. Thus, these results show the importance of MNC internal capital markets in overcoming weak institutional environments – an important competitive advantage for MNCs that is not usually available to single country firms.

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