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Corporate financial determinants of foreign direct investment

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ABSTRACT

Financial market incompleteness and (partial) segmentation of financial markets internationally may endow some firms with a financial advantage which can be exploited through foreign direct investment. We argue that this advantage appears as a distinct cost-of-capital effect on FDI, and identify possible channels for such an effect. Using a sample of European firms' cross-border acquisitions, and controlling for traditional firm-level determinants of FDI, we find strong support for a cost-of-equity effect, whereas the effect of debt costs is indeterminate. Moreover, financial FDI determinants are more important for firms with high knowledge intensity and for firms resident in relatively less financially developed countries.

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1. Introduction

Different theories and research traditions compete about providing the logic behind and the determinants of non-financial firms' decisions to undertake foreign direct investment (see, e.g., Buckley and Casson, 1976; Dunning, 1977; Rugman, 1981; Markusen, 1984). However, a common denominator of these approaches is the focus on 'real' determinants of FDI. The potential role of a firm's cost and availability of financing for its propensity to undertake international investment, on the other hand, has received less attention within the mainstream FDI literature. A possible reason is that the efficient markets hypothesis (financial market completeness and international financial integration) essentially reduces a firm's financial position to a by-product of traditional FDI determinants, such as its marginal productivity or investment opportunities.

A small body of recent literature challenges this view, and suggests a link between finance and FDI by explicitly or implicitly imposing financial market inefficiencies (see, e.g., Baker, Foley, & Wurgler, 2009; Oxelheim, Randøy, & Stonehill, 2001). Building on theories motivating a link between financing and investment domestically (Blanchard, Rhee, & Summers, 1993; Jovanovic and Rousseau, 2002; Shleifer and Vishny, 2003) and on theories underpinning an exchange rate effect on FDI (Froot and Stein, 1991), the present paper adds to this literature by showing that the combined assumptions of financial market inefficiencies and (partial) capital market segmentation between countries open up several possible mechanisms which may give rise to a distinct firm-level financing effect on cross-border direct investment. We further argue that financial advantages are more important determinants of FDI for firms in more knowledge-intensive industries, and for firms resident in countries with relatively illiquid and segmented domestic capital markets.

We also add to the existing literature by adopting a broad approach to testing these predictions empirically, using firm-level data and controlling both for traditional FDI determinants and for a general investment-opportunity effect. The tests are conducted in the form of a series of binary response (probit) models

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testing the effect of financial characteristics on the probability of undertaking FDI, using a sample of approximately 1400 European non-financial firms' cross-border acquisitions in a total of 44 target markets. The results reveal a consistently significant explanatory power of equity-related financial variables over a number of different specifications, and regardless of the proxy used for equity market valuation. The effect of debt costs, on the other hand, is indeterminate. The hypothesis that financial motivations for FDI are stronger for more knowledge-intensive firms receives strong support from the data, whereas a more general systematic variation in FDI-finance sensitivity by industry could not be detected. As hypothesized, financial determinants also prove to be more important for firms originating in countries that are relatively less financially developed. Finally, the importance of financial explanations of cross-border direct investment is confirmed in a number of robustness tests.

The article is organized in the following way. Section 2 outlines a number of mechanisms whereby financial factors can be identified as independent drivers of FDI. Section 3 presents the empirical methodology. In Section 4 we present the variables and the dataset. Results are presented and discussed in Section 5, and Section 6 concludes.

2. Financial determinants of FDI

2.1. Background

Existing theories of FDI and of multinationals' cross-border operations have developed along parallel paths within the economics and management literatures, but essentially coincide in terms of the basic explanations of why firms invest across borders (see Buckley and Casson, 1976; Caves, 1971; Dunning, 1977, 1988; Horstmann and Markusen, 1989; Hymer, 1976; Markusen, 1984; Rugman, 1981). While these mainstream FDI theories largely build on assumptions of market imperfections, the efficient market hypothesis was long maintained as regards financial markets. As a consequence, firms' cost and availability of funding were until recently only rarely considered as potential individual determinants of FDI.¹

Starting with the work of Froot and Stein (1991), which motivated an exchange rate effect on FDI flows by imposing financial market inefficiency, a small body of recent work addresses the possible effects on cross-border direct investment of financial market inefficiencies. Beyond the exchange rate effect, however, existing empirical work is limited to specific aspects of the finance-FDI link (e.g., Aguiar and Gopniath, 2005; Klein, Peek, & Rosengren, 2002), or is performed at the country level (Baker et al., 2009; Di Giovanni, 2005). In order to motivate our own subsequent empirical tests, which focus on firm-level cost of capital effects on FDI, the next sub-section addresses a number of possible mechanisms whereby firms' financial position may matter for their propensity to undertake FDI. Common to these mechanisms is that a financing effect on FDI requires the assumption of some degree of international financial market segmentation. This might in itself require some motivation, but ample evidence support our view of international

capital markets as characterized by what may be termed 'partial segmentation'.²

2.2. Mechanisms for a financing effect on FDI

Allowing for (partial) segmentation, one can distinguish between two main groups of mechanisms whereby a firm's financing may have an effect on its propensity for undertaking FDI: *reactive* and *proactive* firm behavior (Oxelheim et al., 2001). The first group refers to opportunistic firm behavior in response to financial market imperfections. The second group contains measures undertaken to improve the availability of capital and/or to lower the cost of capital.

Assuming permanent capital market segmentation implies that risk-adjusted capital costs differ across countries. Such differences, in turn, imply a financing effect on FDI in simple discount-factor terms: some countries' firms will find foreign investment projects profitable that are forgone by local firms because in net-present-value terms, local and foreign firms value the project differently.

However, we do not have to assume permanent segmentation to find financing effects. The combination of temporary mispricing of company fundamentals by the market and opportunistic managers has been suggested as explanation for 'excessive' stock market effects on investment (both capital expenditure and acquisitions) *domestically* (see, e.g., Baker, Stein, & Wurgler, 2003; Gilchrist, Himmelberg, & Huberman, 2005; Jovanovic and Rousseau, 2002; Morck, Shleifer, & Vishny, 1990; Shleifer and Vishny, 2003), and may be extended to the international case under relatively general assumptions. The basic argument is that if the market places a higher value on the firm's fundamentals than the managers, then managers should capitalize on the mispricing, issue stock, and invest in positive-NPV projects given the 'mispriced' cost of capital, rather than basing investment policy on their own perception of fundamentals (for a concise exposition of the arguments and counterarguments, see Blanchard et al., 1993). The international analogy would be to issue stock (or debt) locally and invest internationally. As noted by Shleifer and Vishny (2003), mispricing may be idiosyncratic or attributable to some specific industry, group of firms, or geographic area. It follows from an assumption of international financial market segmentation that local risk factors matter more for the pricing of stocks. This suggests that the mispricing component in those prices may be correlated within countries, in which case cost of capital may drive not only investment domestically, but may represent a *particular* (temporary) advantage – or disadvantage, in the case of undervaluation – for undertaking *foreign* investment projects.

Discount-factor-type motivations for a financing effect on FDI are similar to traditional motivations for FDI in that they assume that some firms have an advantage which makes them value foreign

¹ Under the assumption of efficient and internationally integrated financial markets, any firm can source its funding anywhere, regardless of country of residence, and so no firm will have a financial advantage over any other. Nor will exchange rates have any effect on FDI, because any effect of exchange rates on the price of a foreign investment will have a reverse effect when the investing firm exchanges the returns on the investment back to its home currency. For an early alternative view, see Aliber (1970).

² For example, Bodnar, Dumas, and Marston (2004) conclude that "[f]or all countries, it is clear that [...] local-country risk premium dominates the pricing. This is a striking empirical fact [...]" (p. 24). Similar conclusions may be found in surveys of the empirical literature, such as Karolyi and Stulz (2003). Even the most recent empirical studies fail to find support for a far-gone international integration in capital markets. For instance, Lombardo and Pagano (2006) construct a model of international equity markets, which produces clear implications for parameter estimates depending on whether the markets are integrated or not; when put to the data, the hypothesis of international equity integration can be clearly rejected regardless of time period, geographical coverage, and proxy variables used. Brealey, Cooper, and Kaplanis (2010) study changes in betas from cross-border mergers, and find that the observed changes are only consistent with the assumption of equity market segmentation. The inevitable conclusion, we believe, is that firms must use local pricing models also to discount foreign investment projects, because their cost of equity is determined in the (segmented) market where it is raised, i.e., the home market.

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