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Asset specificity and a firm's borrowing ability: an empirical analysis of manufacturing firms

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Abstract

This paper investigates the importance of asset specificity in explaining differences in firms' ability to borrow money. With empirical research, we investigated whether there is a relationship between asset specificity and the debt ratio of a Slovene manufacturing firm. The basic idea of the research was to link the sources of finance that define property rights and the attributes of the assets that are the objects of finance. A firm's capital structure can be viewed as a description of the allocation of risk and control among investors. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Recent developments in transaction cost economics suggest that a firm's debt ratio may have more to do with strategic and control factors than with purely financial factors (Williamson, 1988; Balakrishnan and Fox, 1993).[1] A firm often invests in firm-specific assets in order to enhance its uniqueness and competitive advantage. The specific asset has greater value when used by that firm than when used for any other purpose. Such assets, however, adversely affect the firm's ability to borrow because firm-specific assets often cannot be redeployed as collateral for borrowing. Many firm-specific assets are intangible (for example, R&D and advertising) and difficult to measure and evaluate (Balakrishnan and Fox, 1993). Transactions involving such assets will be affected by informational asymmetry between the firm's insiders and outsiders. For the firm, specialized assets create both

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[1] Debt ratio is defined as the ratio of debts to assets as proposed by Brigham and Gapenski (1997).

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a problem and an opportunity (Williamson, 1975, 1985). The firm may have problems financing such assets that are encumbered by debts because of the nature of the assets — their ability to be redeployed (Williamson). Williamson suggested incorporating uncertainty explicitly into the analysis (Choate, 1997). Nevertheless, the firm has an opportunity to create governance structures [2] in a way that mitigates this problem.

Effective relationships with lenders could become a key source of competitive advantage, which means that every firm theoretically can influence its debt ratio (Balakrishnan and Fox, 1993). The choices of an appropriate source of finance are just as important as are the decisions of production. Investments in the assets that contribute to competitive advantages raise the value of the firm, which in turn favorably impacts on financing such assets (Balakrishnan and Fox, 1993). A distinction among the different sources of funds, the costs and risks associated with the terms of financing, and the relationship between the extent of financing remain significant issues requiring research attention.

Some empirical studies have already been carried out, in which the authors tried to identify the determinants of a firm's capital structure using different samples, variables, and methods. Motivated by the differences in results from these studies, we decided to do a similar empirical study with the aim of detecting if there is a relationship between asset specificity and the debt ratio of Slovene firms.

The paper is organized as follows: Section 2 provides a brief overview of financing from the transaction cost economics perspective. Section 3 presents the results of two earlier major empirical studies that have great relevance for our empirical study. Section 4 discusses the propositions underlying our research. Section 5 introduces our methodology, sample and model. Our results are revealed in Section 6 and our conclusions are presented in the final section.

2. Financing from a transaction cost economics perspective

In the following sections, we will discuss several key issues of the theory of transaction costs related to the issues of choosing appropriate sources of finance. Williamson has argued that debt and equity ought to be viewed as different forms of governance structure. In this paper, we examine corporate finance through the lens of transaction cost economics. The basic theoretical issue herein underlies the relationship between organizational management, firm uniqueness and capital structure. It focuses on capital market imperfections [3] and their impact on the firm's capital structure.

2.1. Governance structures and their incompleteness

The selection of institutional form determines different coordinating and control mechanisms and different abilities to adapt to disturbances (Williamson, 1991). Governance structures should be chosen that forestall or attenuate potential conflicts in the future and

[2] One can also use the term "constitutive coordination mechanisms and allocations of organizational rights", which is proposed by Grandori (1997, p. 33).

[3] Unlike the modern finance literature that assume perfect capital markets.