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National cultural effects on leverage decisions: Evidence from emerging-market ADRs

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ABSTRACT

We examine leverage decisions in the context of national culture over the 1996–2010 period. Cultural characteristics can explain capital structure decisions from emerging-markets cross-listings. The results show that firms from countries with high Individualism and Indulgence employ more debt. Firms located in countries with high Power Distance, Masculinity, Uncertainty Avoidance, and Long-term Orientation are less leveraged. Additionally, Exchange-traded and capital-raising ADRs are more likely to be from countries with weaker corporate governance. Univariate tests show that capital-raising ADRs employ less debt relative to non-capital-raising ADRs, and notably, in the post-cross-listing period. Interestingly, the home country's cultural characteristics of capital-raising and exchange-traded ADRs exert less influence on their capital structure decisions. Our findings suggest that there is a value discount associated with increased firm leverage. Our insights have practical implications for portfolio managers attempting to enter emerging markets through the use of ADRs. Moreover, investors can evaluate the often neglected effect of cultural values into firm performance.

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1. Introduction

There is a plethora of cross-country studies examining capital structure and firm performances (Aggarwal, 1981, 1990; Bancel and Mittoo, 2004; Booth et al., 2001; Chakraborty, 2010; Chen, 2004; de Jong et al., 2008; Deesomsak et al., 2004; Delcoure, 2007; Desai et al., 2004; Harvey et al., 2004; Leary and Roberts, 2005, 2010; Opler and Titman, 1993; Rajan and Zingales, 1995; Wald, 1999); however, they commonly employ only firm or industry-level characteristics, while ignoring the potential impact of country-level culture factors. We attempt to provide insights on how national culture predicts firms' leverage policy in a sample of emerging-market American Depository Receipts (ADRs).

Previous research identifies a variety of advantages of cross-listing, such as increased visibility and shareholders' base, access to lower cost of capital, increased liquidity, improved shareholder protection, and enhanced brand recognition (Alexander et al., 1988; Doidge et al., 2004, 2009; Foerster and Karolyi, 1999; Merton, 1987; Pagano et al., 2002; Stapleton and Subrahmanyam, 1977). Foreign firms commonly trade on U.S. stock exchanges through ADRs. ADRs are negotiable instruments representing shares of foreign companies and traded in U.S. dollars. Each ADR denotes a specific number of the underlying shares trading in the home market.

Emerging markets started to liberalize their financial markets after 1990 (Bekaert et al., 2001; Esqueda et al., 2011; Henry, 2002). According to *The Economist*,[1] the aggregate output of the emerging world accounts for 38 percent of the world's GDP in 2010, twice its share in 1990. If GDP is measured at purchasing-power parity, then the shares jump to 54 percent. Cross-listings from emerging economies have grown at a faster pace than the cross-listings from developed economies. In 2001, emerging-market issuers account for 73 percent of new ADR issuances (Coffee, 2002). The most extraordinary growth has come from the powerhouse members of BRIC countries (i.e., Brazil, Russia, India, and China) and Mexico. It is important to quantify their financial decisions using different country, industry, or firm-level characteristics to capture possible cross-country variances.

Many studies find that firm-level or industry-level characteristics cannot fully explain the behavior and performance of cross-listed firms without including country-specific factors. For example, Aggarwal (1981) and Collins and Sekely (1983) provide empirical evidence and argue that a country factor is an important determinant of capital structure given various business climates, risks, taxes, and bankruptcy costs. A growing body of financial research also finds that culture matters for capital structure (Gleason et al., 2000). For example, Sekely and Collins (1988) finds that cultural differences play an important role in explaining the variance of capital structure practices in a sample of 23 countries. Chui et al. (2002) finds evidence that national culture affects corporate capital structure, especially in firms located in more conservative countries in Schwartz's cultural dimensions. Given the alleged cultural differences in emerging markets, we endeavor to shed light on the effects of cultural characteristics on the capital structure policy of emerging-market ADRs. Very few studies have tested the theories of corporate financial leverage across countries by accounting for national cultural characteristics.

Our sample consists of 9315 firm-year observations from 621 emerging-market ADRs. We examine the leverage decisions in the context of national cultural indicators over the period of 1996–2010. We find that capital-raising ADRs employ less debt relative to non-capital-raising ADRs, and, notably, in post-cross-listing periods. This is as expected since capital-raising firms have more access to equity capital. We, additionally, find that Hofstede national culture indices provide a high-level of explanatory power about capital structure decisions from emerging-market ADRs. The results show that firms from countries with high *Power Distance*, *Masculinity*, *Uncertainty Avoidance*, *and Long-term Orientation* employ less debt. Firms located in countries with high *Individualism and Indulgence* appear to be more leveraged. Finally, our findings suggest that there is a value discount associated with increased firm leverage.

We provide relevant insights on capital structure and performance of cross-listed firms, emphasizing the importance of the role played by national culture. The rest of the paper is organized as follows:

[1] "Power Shift, Emerging vs. Developed Economies" from *The Economist*, online version, August 4th 2011. Accessible at http://www.economist.com/blogs/dailychart/2011/08/emerging-vs-developed-economies.

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