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Darden conference issue: Capital raising in emerging economies

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**Guest editorial****Darden Conference Issue:  
Capital Raising in Emerging Economies**

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**Abstract**

The purpose of the 5<sup>th</sup> Annual Darden International Finance Conference, organized jointly with the *Journal of Financial Economics*, was to examine issues related to capital raising in emerging economies. The eight papers in this special issue were selected from the conference program and reflect the substantial breadth and practical importance of research in this area. While the papers often draw attention to issues unique to international financing, they all provide insights and new perspectives on traditional studies and long-standing debates.

## 1. Introduction

The unique characteristics of emerging economies give rise to profitable business opportunities and also raise practical challenges to realizing those opportunities. The ongoing internationalization of these economies regularly brings to light such opportunities and challenges and propels critical reviews of regulatory policy. The impact of this complex and dynamic setting on corporate decision making is clearly evident in the context of capital raising. In contrast to decisions made in efficient and integrated capital markets, capital raising in emerging economies must address issues as fundamental as property rights and as subtle as the differences in information available to domestic and foreign investors.

The papers in this special issue explore topics related to the financing of corporations in emerging economies and have been selected from those included in the program of the 5<sup>th</sup> Annual Darden International Finance Conference.<sup>1</sup> The selected papers can be divided into three topical areas: governance, capital structure, and internationalization. The first two are clearly defined areas of enquiry, while the last spans a broader set of issues related to characteristics uniquely related to global portfolios and direct investment. As with so many topics in international finance, there is substantial overlap between the issues discussed in each paper, and various alternate groupings are readily justifiable. In fact, our goal in this introduction is to highlight the connections

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<sup>1</sup> This annual conference brings together top scholars and practitioners to present and discuss papers addressing a chosen theme. The 5th Annual Darden International Finance Conference was held at the World Bank Headquarters in Washington, DC, and the Darden Graduate School of Business would like to thank its partners (the World Bank and the CFA Institute), conference organizers, program committee members, and conference participants for their engagement and support. Darden would also like to thank the *Journal of Financial Economics* and editor Campbell Harvey for jointly organizing this special issue.

among the papers while providing a context for understanding the relevance and importance of each paper's contributions.

## 2. Governance

At the very least, all shareholders—be they the smallest retail investors or the largest institutional investors—expect that the capital they provide to firms will not be diverted to corporate insiders or expropriated as private benefits of control. In addition, shareholders expect that decisions by managers will not be overly distorted by managers' selfish motives. Three papers in this special issue explore the effect of governance on corporate performance by using variation across emerging markets in either legal protection, sources of monitoring, or the incentives faced by managers. These papers illustrate, in very different contexts, how improvements in governance enhance performance and would, by extension, facilitate capital raising on more favorable terms.

Legal protections of minority shareholders can vary greatly across countries. In "The Law and Economics of Self-Dealing," authors Djankov, La Porta, Lopez-de-Silanes, and Shleifer ask an important question: How difficult is it for minority shareholders to prevent managers from legally enriching themselves at shareholder expense and to recover damages if this occurs? The answer is contained in their new anti-self-dealing index, constructed for 72 countries and composed of numerical measures of the intensity of regulation of self-dealing along a variety of dimensions.

Self-dealing can take the form of executive perquisites, excessive compensation, transfer pricing, appropriation of corporate opportunities, self-serving financial transactions such as directed equity issuances or personal loans to insiders, and outright theft of corporate assets (Shleifer and Vishny, 1997). The new anti-self-dealing index,

more theoretically grounded than previous measures (some of which are updated in the current paper), is an important predictor of a variety of measures of stock market development across countries. This predictive ability should not be surprising. As the authors note, “To the extent that self-dealing is *the* central problem of corporate governance in most countries, the law’s effectiveness in regulating this problem is the fundamental element of shareholder protection.” Not only does the paper deliver interesting empirical results and a wealth of new and updated measures, it also has clear regulatory implications: A laissez faire strategy of no public involvement in corporate governance regulation *does not* lead to developed financial markets. The public sector has a central role to play as the designer of the rules of the game, which, the authors go on to argue, should be enforced by private action.

It turns out that investors should also take a crash course in sociology—and family dynamics in particular. It is well documented that many firms around the world are family-controlled (e.g., La Porta, Lopez-de-Silanes, and Shleifer, 1999). Some research has found that family ownership is beneficial, while other papers have documented that family firms perform worse.<sup>2</sup> In contrast to most of the existing literature, “Mixing Family with Business” by authors Bertrand, Jhanson, Samphantharak, and Schoar exploits the fact that families are not monolithic, but rather are composed of individuals with potentially competing objectives. They argue that sons—especially after the founder has relinquished control and if the sons have equal power—might engage in a “race to the bottom” in which they try to outdo each other in tunneling resources from the firm. Using a sizable sample of private and public Thai firms, the authors show that once

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<sup>2</sup> For example, beneficial effects are documented in Anderson and Reeb (2003), Khanna and Palepu (2000), and Morck, Strangeland, and Yeung (2000), while negative effects are documented in Claessens, Djankov, Fan, and Lang (2002) and Cronqvist and Nilsson (2003).

the founder has passed control, firms with more sons involved exhibit worse performance and greater excess control (the wedge between control and ownership rights).

Whereas family ties might lead to ruin, one might expect the presence of capable monitors to lead to success. In “The Color of Investors’ Money: Which Firms Attract Institutional Investors from Around the World,” authors Ferreira and Matos explore the determinants and effects of institutional investing. They begin by examining the revealed stock preferences of three different institutional investor clienteles—U.S., non-U.S. foreign, and domestic money managers—and investigate which firm- and country-level characteristics attract a particular clientele. Many of the results are well known from the existing literature.<sup>3</sup> More novel are their findings regarding monitoring. Noting that not all money managers act as independent shareholders whose only consideration is shareholder value maximization, Ferreira and Matos classify managers as either “independent institutions” (mutual fund managers and investment advisers) or “grey institutions” (bank trusts, insurance companies, and other institutions). Their identifying assumption is simply the argument that “grey institutions” tend to be loyal to corporate management. They find that firm value is higher when more shares are held by “independent institutions” and, given their identifying assumption, attribute this to monitoring.

### **3. Capital structure**

The quintessential financing choice is the extent of creditor (debt) financing. Most existing theories emphasize either the tradeoffs that dictate an optimal capital structure or the issues associated with the choice of financing at the time of issue (possibly even to an

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<sup>3</sup> See Chan, Covrig, and Ng (2005), Dahlquist and Robertsson (2001), Dahlquist, Pinkowitz, Stulz, and Williamson (2003), and Leuz, Lins, and Warnock (2008), among others.

extent that obviates the concept of an optimal capital structure). In this issue, we have an example of each view. The two papers also provide a nice contrast between the choices made by foreign-based multinational firms with operations in an emerging economy and the choices made by domestic firms in an emerging economy.

In “Capital Structure with Risky Foreign Investment,” authors Desai, Foley, and Hines examine the extent to which exposures to political risk influence the capital structures of American multinational firms. They find that the return volatilities of subsidiaries owned by the same parent company vary systematically with political risk. They also find that parent companies of multinational groups exposed to significant foreign political risk use less leverage than do parent companies without such exposures, to an extent that overall firm leverage falls despite the greater leverage of affiliates in risky countries. Finally, they note that industries primarily serving local markets or the transportation, communication, and public utilities industries are particularly susceptible to local political risks. When the companies in these industries are examined separately, the sensitivity of capital structure to political risk is higher than it is for companies in other industries. These results highlight a cost of operating in politically risky markets and illuminate the degree to which business risk influences financing decisions more generally.

In contrast to the shift in optimal capital structure resulting from exposure to the risks of an emerging economy, the paper “Political Connections and Preferential Access to Finance: The Role of Campaign Contributions” by Claessens, Feijen, and Laeven emphasizes how political connections might affect capital raising. The authors show that around the 1998 and 2002 Brazilian elections, firms that made contributions to winning

politicians had higher stock returns. They argue that this superior performance arises from enhanced access to bank finance, since contributing firms substantially increased bank financing after each election. The effect is of sufficient magnitude to significantly change financial leverage levels. This arrangement, while beneficial to the contributing firms' shareholders, comes at a price—costs associated with the misallocation of capital are estimated to be at least 0.2% of GDP per year.

#### 4. Internationalization

Internationalization means many things. While it might be a goal for a company or country, it is also a set of market conditions and characteristics that can affect decision making. Three papers in this issue explore the nature of internationalization and what it means for both firms and investors. Each of these papers provides a surprising insight that challenges prior perceptions.

The international finance literature attributes at least part of the “home bias” to the presumed information advantage of local investors.<sup>4</sup> It has been established that in the United States, analysts who are geographically closer to the headquarters of a firm have an information advantage (Malloy, 2005). In “Do Local Analysts Know More? A Cross-Country Study of the Performance of Local Analysts and Foreign Analysts,” authors Bae, Stulz, and Tan investigate the performance of local and foreign analysts and find that the information flow emanating from local analysts is indeed more useful. But this advantage is not necessarily a skill advantage, as these same local analysts do not excel at predicting the earnings of foreign firms. Rather, the local advantage is likely linked to information asymmetries. In particular, the local advantage is greater in countries in which earnings

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<sup>4</sup> For reviews of the home bias literature, see Lewis (1999) and Karolyi and Stulz (2003).

are smoothed to a greater degree, firm-level information disclosure is lower, and stock returns are driven more by market-wide than by idiosyncratic information. In short, the more opaque is the environment for information flows to outside investors, the greater is the local advantage.

In “Internationalization and the Evolution of Corporate Valuation,” authors Gozzi, Levine, and Schmukler examine the impact on firm value of internationalization (which they define as either cross-listing, issuing depositary receipts, or raising equity capital in major financial centers) to differentiate between the segmentation and bonding theories of internationalization.<sup>5</sup> They find that firms that internationalize have higher  $q$ 's than firms that never internationalize, but this difference exists years before firms actually access international equity markets, not after. Thus, internationalization is not associated with an enduring change in  $q$  and, in fact,  $q$  peaks in the internationalization year, rising significantly before firms access international equity markets and then falling sharply afterwards. Moreover, internationalization is associated with firm growth, with international firms expanding relative to domestic ones; while  $q$  does not change permanently after internationalization, its components do, with market capitalization rising before internationalization and remaining high thereafter, while corporate assets and debt expand after internationalization. The results are consistent with key predictions from segmentation theories, but challenge the hypothesis that internationalization bonds firms to a better governance system.

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<sup>5</sup> Segmentation theories argue that firms internationalize to circumvent regulations, poor accounting systems, taxes, and illiquid domestic markets that discourage investors from purchasing their shares; see Black (1974), Errunza and Losq (1985), Alexander, Eun, and Janakiramanan (1987), Pagano, Roell, and Zechner (2002), and the review by Stulz (1999). Bonding theories argue that firms internationalize to bond themselves to a better corporate governance framework; see, among others, Stulz (1999), Coffee (2002), and Benos and Weisbach (2004).

In the final paper of the special issue, entitled “Incumbents and Protectionism: The Political Economy of Foreign Entry Liberalization,” authors Chari and Gupta study an aspect of internationalization that many countries must confront. Countries all over the world restrict the inflow of foreign investment to some degree; Chari and Gupta investigate the process by which one country (India) went about reducing its barriers to foreign direct investment. While literatures that evaluate the effects of various economic and financial reforms on firm performance or economic growth typically assume that reforms are implemented uniformly (essentially by liberalizing randomly across sectors), the authors explore the possibility that implementation is affected by incumbent firms’ characteristics. Specifically, the authors take a political economy approach and investigate whether incumbent firms influenced the country’s decision to liberalize foreign direct investment in some industries and not in others. While it is plausible that governments enact welfare-maximizing policy changes to achieve socially efficient outcomes and correct market failures (the ‘public interest view’ of the policymaking process), the authors’ findings are more consistent with a ‘private interest view’ in which special interest groups lobby the government to influence policy decisions in their favor. Their results indicate that firms in concentrated industries are more successful at preventing foreign entry, state-owned firms are more successful at stopping foreign entry than privately-owned firms, and profitable state-owned firms are more successful at stopping foreign entry than unprofitable state-owned firms. The implementation of financial liberalization, therefore, may not occur uniformly or randomly across sectors, but evolve out of the interactions between governments and incumbent firms.

## 5. Conclusion

The papers in this special issue reflect the substantial breadth and practical importance of research in the area of capital raising in emerging economies. From self-dealing in general to tunneling by family members, from degrees of monitoring by money managers to subtleties of the “home bias” among analysts, from the effects of political risk on capital structure to the impact of internationalization on Tobin’s  $q$ , these papers address topics of interest to researchers, regulators, and practitioners alike.

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