

# National Variation in Financing Growth: Empirical Evidence on Unlisted Firms

by:

Thomas W. Hall

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# Presentation Overview

1. The Spectrum of Finance
  - Firm-level and country-level
2. Patterns of Financing Unlisted Firms
  - U.S., OECD, non-OECD
3. Making Investment and Lending Decisions
  - Internal finance
  - Demand and supply of external finance
4. Policy Implications
5. Conclusion/Summary

# 1. The Spectrum of Finance

# Spectrum of Finance: Firm Level

- Finance = right-hand side of the balance sheet
- Generally listed in order of liquidity:
  - Short-term liabilities
    - Trade finance/Accounts payable/Short-term loans
  - Long-term liabilities
    - Bank loans/Corporate bond markets
  - Equity
    - Accumulated retained earnings
    - Existing owners—increasing investment
    - External equity finance: angel/venture capital/corporate vc
- These categories comprise the “spectrum” of financial options that firms confront

# Spectrum of Finance: Country Level

- Internal Finance/Few Owners (Blocks)
  - Large, family-owned enterprises existed since ancient times
  - Growth and expansion from accumulated retained earnings
- External Finance
  - Bank loans/trade credit/accounts payable
    - Backed by reputation of borrower; since middle ages
- “Advanced” External Finance
  - External equity finance (dispersed owners)
    - Curb trading markets; listed?
  - Foreign and disintermediated lending
    - Corporate debt markets; FDI; venture capital; commercial paper

# NLC External Finance = NLC Capital Structure

- The issue of external finance is essentially identical to the issue of leverage
  - Abstracting away from private equity investment and public equity listing
  - Focusing on leverage as long-term debt
- We can use the literature on leverage, therefore, to identify important issues for external financing of NLCs

## 2. Patterns of NLC Financing

- Internal and external finance
  - USA
  - Non-US OECD
  - Non-OECD
- Legal system and institutions

# U.S. NLCs: Patterns and Listing

- Patterns of Financing:
  - Empirical evidence
    - Nonlisted firms tend to use debt
    - Among listed firms (pecking order vs. trade-off)
      - Smaller ones with high market-to-book ratios use external equity (SEOs)
      - Larger ones tend to use more debt and retained earnings
        - » Depends on definition of “equity” (Fama and French, in press)
        - » Not only SEOs, but M&A, private placement, convertible debt, warrants, direct purchase plans, rights issues, employee options, grants, and benefit plans
  - Quantity of NLC equity and debt, 1971-2002
    - Frank and Goyal, 2005
  - Figure 1: Equity disinvestment; debt investment
- Listing vs. Delisting (Block, 2004)
  - Benefits of listing
    - Greater liquidity (assuming enough analysts follow the firm)
  - Cost of listing since Sarbanes-Oxley
    - Annual costs of being public raised from \$900,000 to \$1,954,000
  - Number of U.S. firms that delisted between Jan 2001 and July 2003: 236
    - Of 110 such firms that took part in survey, estimated daily volume in the 12 months prior to delisting was 9,753 shares, with average share price of \$4.01 per share
    - Difficult for such firms to use status as a listed firm to raise any new equity

# U.S. NLCs: Internal Equity Returns

- What is the risk-return relationship of NLC ownership?
  - Moskowitz and Vissing-Jørgensen, 2002
- Returns *should* reflect undiversifiable (unsystematic) risk
  - Family businesses = Poor diversification
    - Most families are “overweight” in one firm: their own
    - 75% of all private equity is owned by households for whom it constitutes at least half of their total net worth
      - So, should have lower returns
  - Study controls for labor component of returns (salary), tax evasion motives, entry and exit of firm equity over time
  - FINDING: on average, private returns  $\approx$  stock market returns
- Implication: Must be other benefits, such as:
  - Risk tolerance (higher for entrepreneurs)
  - Non-salary perks (should compare asset returns *after* personal taxes)
  - Nonpecuniary benefits (independence; flexibility)
  - Preference for skewness (shooting the moon; hoping for a miracle)
  - Overoptimism and misperceived risk (behavioral finance explanation)

# OECD NLCs (non-US)

- Long-Term debt
  - Predominates in bank-based financial systems
    - Gerschenkron, 1962
  - Bank-based vs. Market-based doesn't seem to matter for growth
    - Demirguc-Kunt and Maksimovic, various
- Private Equity
  - Buy-out (M&A)
    - Useful in “going private” (Block, 2004)
  - Venture capital and early-stage private equity investment
    - Armour, 2003; Armour and Cumming, 2003; Cumming and Fleming; Cumming and MacIntosh, forthcoming
      - Insolvency law, venture capital, exits, cross-country comparisons
    - Hall, 2005
      - Cost of capital premium for firms in countries with relatively worse institutional environments (Common vs. Civil; EVCA ratings)

# Non-OECD NLCs

- Evidence is fairly sparse
- Long-term debt
  - Domestic: Harder for NLCs vis-à-vis large, listed firms
    - Beck, et al, various
    - Demirguc-Kunt and Maksimovic, various
  - Legal system (*de jure*) + enforcement (*de facto*) matter
    - Hall and Joergensen, 2005
- International equity/FDI
  - Portfolio investment is not channeled through domestic banks
    - Knill, 2004
  - Property rights protection is related to *type* of FDI
    - Hall, 2004
- Equity
  - Little chance for public listing; equity markets are relatively illiquid
    - Reduces difference between listed and nonlisted companies
  - Private equity in emerging market setting
    - Lerner and Schoar, 2004

# Legal System and Institutions

- Legal system matters (*de jure*)
  - Common law vs. Civil law and investor protection
    - La Porta, Lopez di Silanes, Shleifer, Vishny, various
  - Land transferability and secured transactions law
    - Hall and Jörgensen, 2005
    - Legal rules (creditor protection) and institutions (rule of law) are substitutes in their effect on firm-level leverage
- Institutions matter (*de facto*)
  - Acemoglu, Johnson, Robinson, 2001
  - Pistor, 2001
  - Berglöf and Claessens, 2004

# 3. Investment and Lending Decisions

# Investment and Lending Decisions

- Internal Finance
  - Firms decide to invest using accumulated retained earnings (REs)
  - Opportunity cost of REs is dividends
    - Affected by different tax rates: personal vs. corporate income taxes vs. dividend taxes vs. capital gains tax (for listed firms)
  - Unlisted firms likely to be less sophisticated in their allocation of investment
    - Fixed cost of a sophisticated CFO easier to bear for larger, listed firms
- External Finance
  - Demand
    - Firms obtain external debt and equity
    - Compete against government, households
  - Supply
    - Households, other firms, foreign sources, etc.

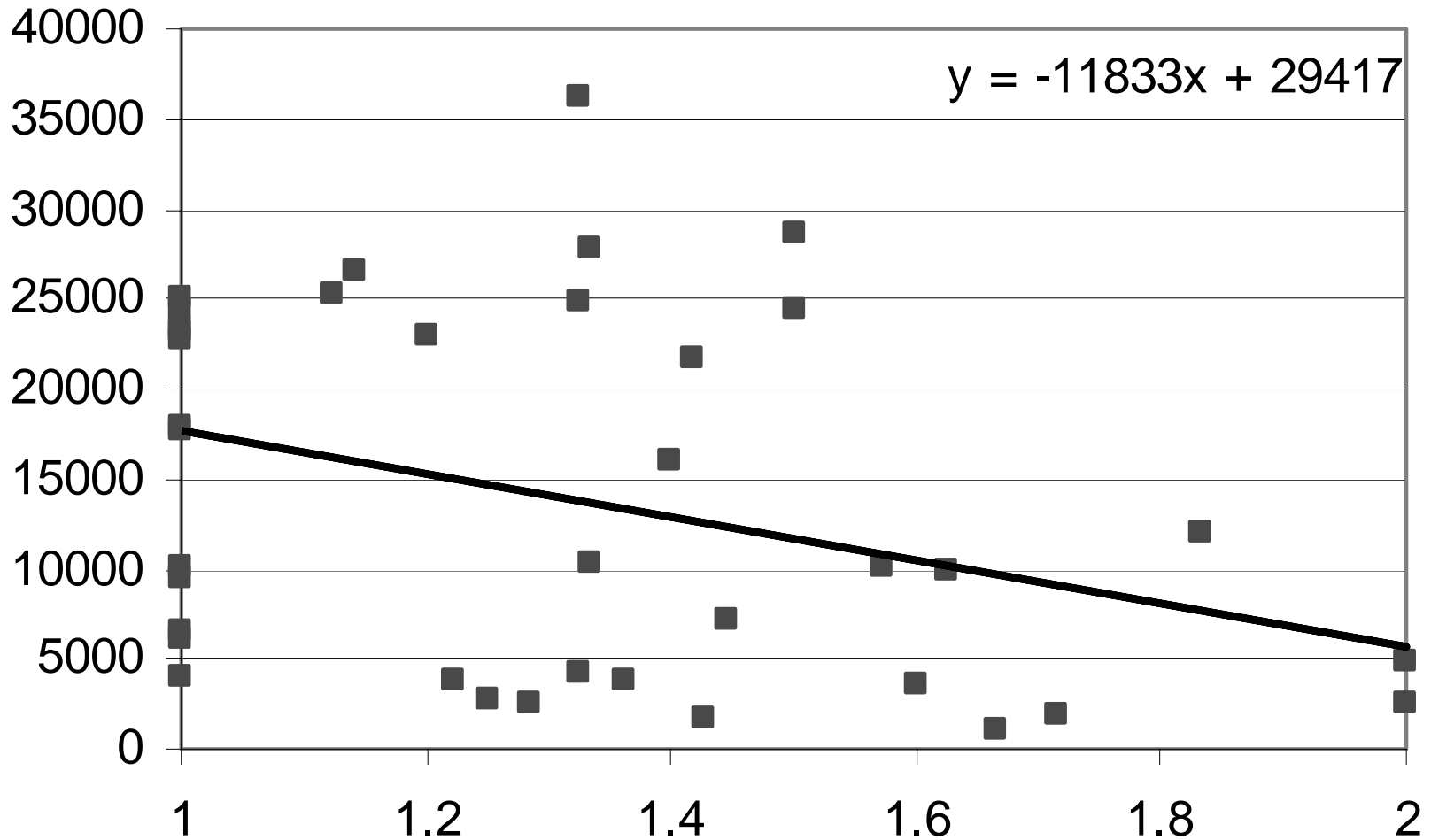
# Decisions: Internal Finance

- In general, firms should say “yes” and invest in projects IFF:
  - Benefits > Costs
    - Meaning, IRR is greater than market rate of return for projects of similar risk, OR meaning  $NPV > 0$
- Why wouldn't they make the right decision?
  - Capital market failure (imperfections)
    - Information asymmetry—Lemons problem
    - Financial repression or other government allocation of credit
  - Corporate governance failure (misaligned interests)
    - Overinvestment in white elephants; “diversion”
      - Perks and shirking

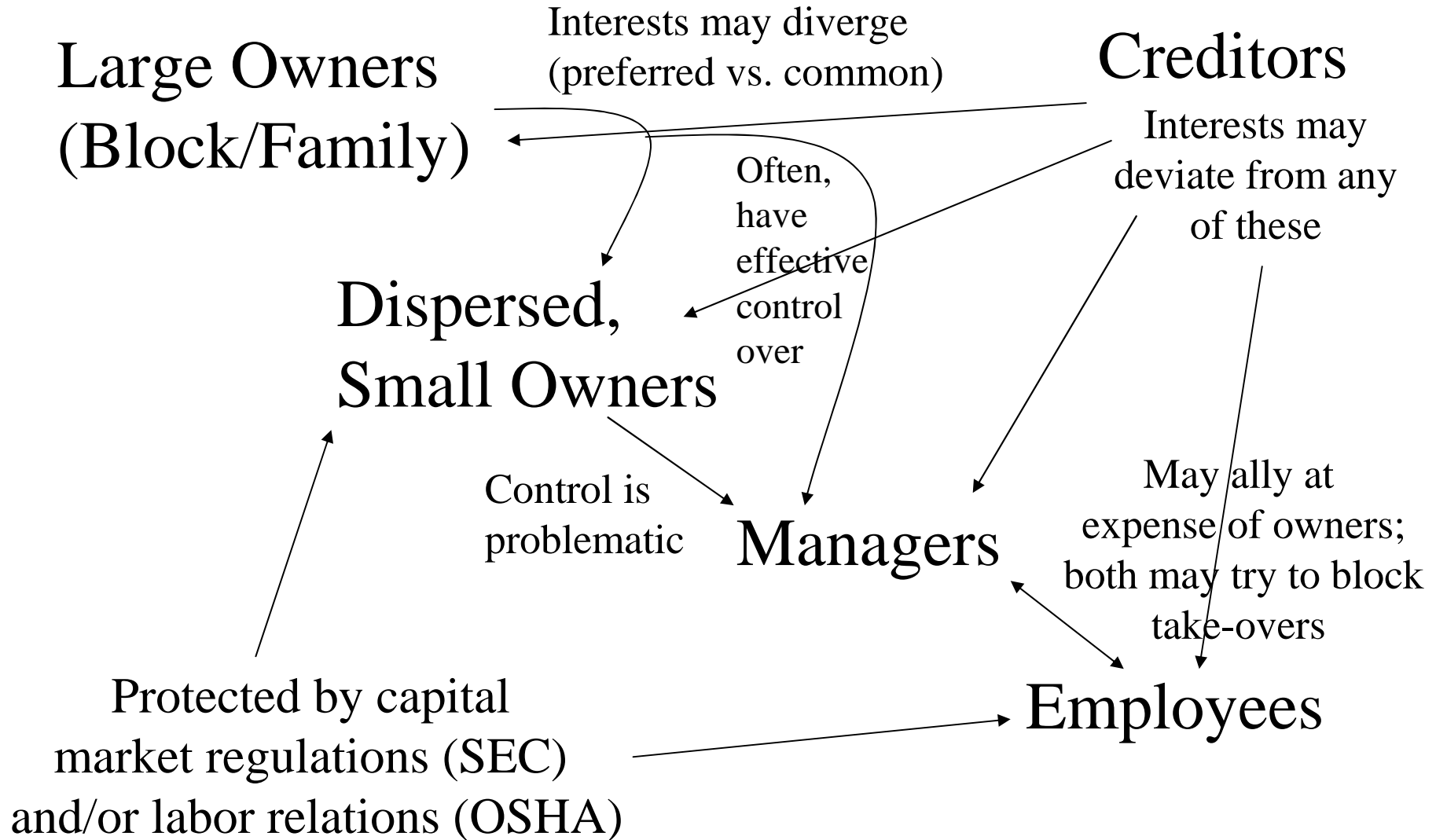
# Decisions: External Finance

- Conceptual Scheme
  - Each type of financing has advantages and disadvantages (Figure 1)
- When to raise external debt?
- When to raise external equity?
- Legal and institutional setting (next slide)
  - One-point increase in collateral laws and institutions is equivalent to an increase of PPP-adjusted per capita GDP of over \$10,000
  - Univariate correlation (causality issue)

Collateral Score vs. Per Capita GDP (PPP, 2000)



# Figure 5: Listed Firms Corp. Gov.



# Figure 6: NLC Corporate Governance

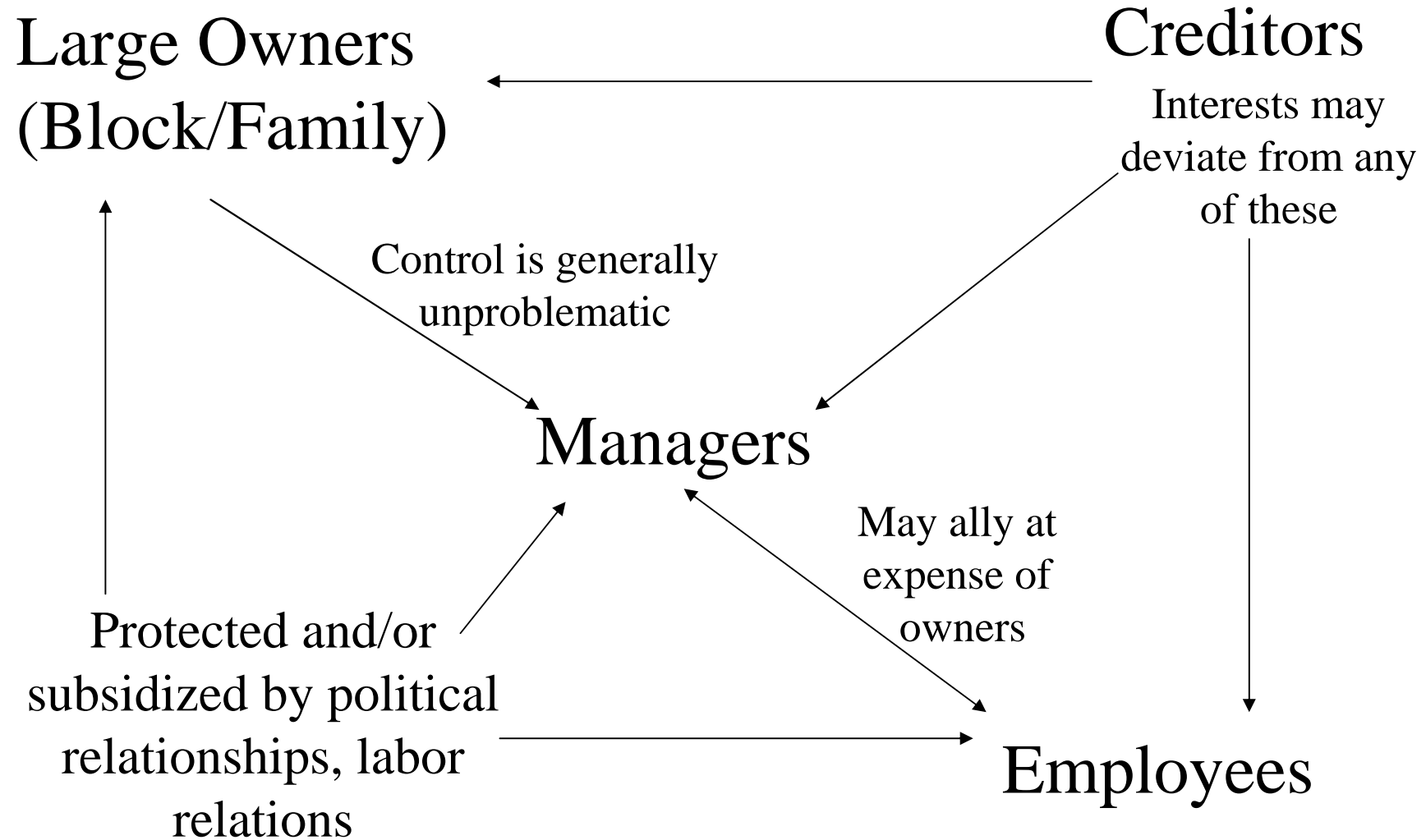


Figure 7: Schematic Research Agenda: NLCs in non-OECD Countries

	<b>Owners (Block)</b>	<b>Owners (Minority)</b>	<b>Managers</b>	<b>Employees</b>	<b>Creditors</b>
<b>Owners (Block)</b>	“Family conflicts”	--	--	--	--
<b>Owners (Minority)</b>	Private benefits of control	Proxy issues	--	--	--
<b>Managers</b>	Entrenchment	“Typical” (listed) corp. gov. problems	Differing degrees of incentive alignment	--	--
<b>Employees</b>	Labor relations	Little contact or relations; intermediated by managers	Differing degrees of incentive alignment	Differing degrees of incentive alignment	--
<b>Creditors</b>	Upside vs. downside risk	Upside vs. downside risk	Discipline-inducing role of debt (assumes enforcement)	Little contact or relations; intermediated by managers	Creditor classes (secured, junior, etc.)

# 5. Policy Implications

# Policy Implications: NLCs

- Internal finance/REs
  - Dividend policy and differential taxation
- Long-term debt
  - Domestic long-term bank debt
  - International long-term lending
- Equity
  - Domestic equity investment
  - Foreign equity investment

# Summary/Conclusion

- Clearly, policies matter
- Corporate governance for NLCs avoids the classic problem of LCs, but other problems exist
- Enforceability of creditor rights and efficient credit allocation will stimulate long-term debt finance
- Costs and benefits of external equity finance will depend on:
  - For NLCs, tax rates and institutions promoting equity investor protection (e.g., EVCA ratings)
  - For decision as to whether to list or remain unlisted, disclosure costs vs. liquidity benefits of listing