Cost of Loans and Group Affiliation

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ABSTRACT

The paper examines the impact of business group affiliation on cost of loans in an emerging market setting. Bank loans are dominant source of corporate funding, specifically in emerging markets, in which business groups exist as leading economic entities. The impact of belonging to a group on the firm's cost of capital is important to understand. Overall, findings suggest that cost of borrowing advantages/disadvantages exist for business groups and their affiliated firms.† Business groups may create borrowing cost advantages by their implemented policies and the selection of their loan applicant firms at the time of their borrowing.

INTRODUCTION

Is there an advantage/disadvantage in business group affiliation when seeking capital? Does affiliation level of the borrowers affect the assessment of the lenders? How about group strategies, structure or implemented policies? Altogether, what is the impact of business group affiliation on cost of borrowing? This study aims to provide more insight to address these economically important questions for business group affiliated firms.

Business groups are important economic actors in many markets around the world (La Porta et al., 1999). These entities are associations of legally independent firms, which are bound together with formal or informal ties, and act in coordination (Khanna and Rivkin, 2001). The economic, social, and regulatory characteristics of countries play a role in the formation of these entities in each market setting; nevertheless, these groups play a significant role in their respective economies and control a substantial part of their country's productive assets (Weinstein and Yafeh, 1995; Khanna and Yafeh, 2007). They essentially serve as an important powerful form of an economic organization, specifically in emerging market economies (e.g., South Korean *chaebols*, Indian *business houses* and Turkish *holdings).* These groups are one of the major drivers behind the increased role of emerging economies within the global economy.

Bank loans are the most important source of corporate financing as shown in existing research on loan financing, financial contract terms, and cost of debt (e.g. Chava et al., 2009; Graham et al., 2008). Especially in emerging markets, banks are the foremost credit suppliers and outside monitors (Demirguc-Kunt and Levine, 2001; Love et al., 2007), leveraging decisions of group-affiliated firms are significantly different from those of non-affiliated firms such as these groups enjoy exceptional access to government and foreign

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† For further details of the results and tables, see Küllü et al. (2014a).

loans (Manos et al., 2007), and single countries are considered the best settings to understand financial contracting terms regarding hard-to-compare small and private firms (Qian and Strahan, 2007).

Building on the extant literature on group affiliation, this paper examines the impact of group affiliation on the respective members' cost of debt. It specifically brings organizational structure (group affiliation extent, foreign and government ownership, being a financial firm, foreign group affiliation), operational strategy (having a group bank, being diversified or focused), and internationalization (cross-listing) policies into the picture to provide a more thorough perspective to analyze the group affiliation impact on cost of debt. It uses bank loans as the metric and Turkish groups (holdings) and the market as the setting. It concentrates on firms' cost of loans as captured by the spread given that default risk is the foremost determinant of loan pricing (Guner, 2006), and is significantly impacted by corporate governance practices (Freixas and Rochet, 1997). Effective corporate governance is expected to decrease the risks that are associated with information asymmetries. Easley and O'Hara (2004) argue that disclosure of information lowers the informational risk, and therefore decreases the cost of capital. Strahan (1999) shows that the cost of loans is related to the riskiness of the borrowers, and non-price loan terms are related to pricing. For non-price loan terms, I examine maturity and deal amount, and for price term, I examine spread.

In examining the impact of group affiliation on the firm's cost of bank loans I seek answers to the following questions: (a) What is the impact of business group affiliation on affiliated firm's cost of loans, and does the extent of group affiliation matter? (b) What is the impact of having a group bank, or being a financial firm on the cost of loans? (c) What is the impact of being focused or diversified on the cost of loans? (d) Does foreign or government ownership, foreign group affiliation, or cross-listing matter?

LITERATURE REVIEW

A majority of business groups are highly diversified entities with pyramidal or complex ownership structures. Corporate finance theory suggests that corporations need to focus in order to minimize possible agency problems and utilize management expertise (Jensen, 1986; Denis et al., 1997). Lang & Stulz (1994) and Berger & Ofek (1995) find that membership in diversified conglomerates destroys value. Many other diversification studies have also found that focus leads to better performance compared to diversifying (Meyer et al., 1992; De Long, 2001; Laeven and Levine, 2007). On the other hand, Khanna and Palepu (2000b) show that diversification may not destroy value in emerging market settings. Since, these groups are highly diversified, but controlled by dominant/founder shareholders, major lines of these studies focus on corporate control motivations of dominant/founder shareholders and some potential governance concerns around agency problems. Unlike widely-held US conglomerates, emerging market business groups tend to have concentrated corporate control (La Porta et al., 1998). They can be private family firms, or public but governed with a very limited number of major shareholders.

Dominant/founder shareholders create corporate control via differentiating cash-flow/control rights (La Porta et al., 1999), cross-holdings (Claessenset al., 2000) and pyramid ownership structures (Bebchuk et al., 1999; Almeida and Wolfenzon, 2006). With established control rights, the dominant shareholders of these groups create a joint standing against minority shareholders, creditors, regulatory agencies and any other third parties.

Corporate finance theory suggests that diversified corporations underperform, -possibly due to potential agency problems and inefficiencies in management (Jensen, 1986; Berger and Ofek, 1995; Denis et al. 1997)-, group affiliation enables some positive perceptions such as co-insurance/risk sharing effect (Ferris et al., 2003; Khanna and Yafeh, 2007; Francis et al., 2014), use of funds to provide support to distressed group firms - propping (Bae et al., 2002), monitoring ability of large controlling shareholders (Shleifer and Vishny, 1986; McConnell & Servaes, 1990; Weinstein & Yafeh, 1995), existence of internal markets and group financial support (Hoshi et al., 1991; Lincoln et al., 1996; Bianco and Nicodano, 2006; Gopalan et al., 2007; Masulis et al., 2011), importance of group reputation/track record as a substitute for underdeveloped investor protection regulations (Khanna and Palepu, 2000a; Gomes, 2000), debt renegotiation power of large controlling shareholders against creditors (Davydenko and Strebulaev, 2007), increased competitiveness and ease in investment implementation and technology transfers (Guillen, 2000).

On the other hand, the possibility of controlling shareholders' expropriation of resources - tunneling (Bae et al., 2002; Bertrand et al., 2002), increased controlling rights against the interest of minority shareholders (Claessens et al., 2002; La Porta et al., 2002), hard to monitor internal group activities by outsiders (Lin et al., 2011), inefficiency in allocation of resources through internal capital markets (Rajan et al., 2000; Scharfstein and Stein, 2000), and inefficiencies and value loss from diversification discount perspective (Berger and Ofek, 1995; Lang & Stulz, 1994) are considered as major potential problems that are associated with business groups.

At large, positive and negative sides of business group's corporate control have been at the center of the studies from structural and performance perspectives. Performance impact of group affiliation (Khanna and Rivkin, 2001), the groups' role of circumventing market inefficiencies (Chang and Hong, 2002; Fisman and Khanna, 1998; Fisman, 2001, Amsden and Hikino, 1994) and comparisons of affiliated and unaffiliated firms (Khanna and Palepu, 2000a; Manos et al., 2007) has been some related subjects of study.

Business groups have been studied in various emerging market settings such as Chili (Khanna and Palepu, 2000b), Thailand (Bertrand et al., 2008), Korea (Chang and Choi, 1988; Bae and Jeong, 2007; Bae et al., 2002), India (Khanna and Palepu, 2000a; Bertrand et al., 2002; Gopalan et al., 2007), Russia (Chernykh, 2008; Shumilov, 2008), and cross-country studies (Guillen, 2000; Khanna and Rivkin, 2001; Khanna and Yafeh, 2005; Claessens et al., 2000) among others. However, despite the importance of these

groups in the economic development of significant number of countries, one area of importance that has not been examined in detail is the impact of group affiliation on its members' cost of loans.

Information asymmetry between borrowers and lenders is highly important in the lending process (Sufi, 2007). Banks have access to proprietary information, and they are more effective monitors than equity and bond holders (Diamond, 1984; Fama, 1985). Since, some business groups have group banks within their group structure, and group firms tend to act in coordination, financing capabilities of affiliated firms may differ from unaffiliated firms at the time of their borrowing. It would be interesting to examine if having a group bank has an impact on group firms' cost of debt. Existing theoretical literature shows that corporate governance and debt policies are highly related (Williamson, 1988; Diamond, 2004). Empirical studies show that both firm-level governance characteristics (Sufi, 2007; Francis et al., 2008; Chava et al., 2009), and country-level regulatory environment and business firm characteristics are highly important factors regarding bank loans and loan contract terms (Qian and Strahan, 2007; Bae and Goyal, 2009). Firm-level corporate governance has been found to have an impact on bank loan contracting (Francis et al., 2009). The ability of controlling shareholders to expropriate from minority shareholders and creditors is a major concern (Claessens et al., 2000), and a main source of corporate credit risk is strategic actions of self-interested dominant shareholders (Aslan and Kumar, 2012). Hence, this study focuses on the loan market and single emerging economy to better understand the relationship among firms' cost of debt, group affiliation, firm structure, corporate strategies, and policies.

TURKISH BUSINESS GROUPS

The importance of emerging markets within the global economy has increased steadily over the past two decades. Emerging markets differ from developed markets in many respects. Though there are many other relevant characteristics, important differences are their rapid growth rates, abundant resources, increasing population, and dynamic internal demand. Similar to other emerging markets' business groups, Turkish holdings play a dominant role within the economy and around the neighboring regions. Turkey presents an appropriate setting to examine business groups. It is highly integrated with European and Asian markets with a rapid growth in the last decade (fastest-growing European economy). The Turkish economy is the fifteenth largest in the world, and the sixth largest in Europe based on World Bank gross domestic product (GDP) rankings. Its economy has been steadily growing despite several crises it has faced in the last decade. It experienced an average growth rate of 6.8% from 2002 to 2007. After the 2008 global crisis, growth reached 9.2 % in 2010, and 8.5 % in 2011. Ownership data and group affiliation information is available and tightly monitored by regulatory agencies. Beyond Turkey, Turkish holdings are specifically active in neighboring regions: Eastern Europe, Central Asia, the Middle East, and Northern Africa. These groups are highly diversified, and group firms are tightly controlled. Both family and non-family business groups exist. Turkey is not a transition economy, liberalization policies has been implemented since 1950s

with an escalated trend after 1980s. Additionally, Turkish business groups have been studied at a lesser level compared to other emerging economy business groups.

MAIN RESULTS

Using bank loan data from Dealscan and firm-specific data from Worldscope and the Istanbul Stock Exchange over the 1991–2011 time-period, I find that group affiliation extent increases cost of loans (lower maturity, higher spread), government ownership increases cost of loans (lower maturity, higher spread, lower deal amount). Moreover, having a group bank is advantageous in terms of cost of loans (higher maturity, lower spread), and foreign ownership is beneficial in terms of pricing (lower spread), however being affiliated with a foreign group is not beneficial (lower maturity). Additionally, diversification strategy is not beneficial in terms of cost of loans (lower maturity and deal amount). Several studies show that emerging market firms that are diversified, have foreign ownership, or are cross-listed have a lower cost of bank loans. The results have important implications for understanding the relationship among an affiliated firm's strategy, structure, and its cost of debt and also for the development and growth of emerging markets. Overall, these findings suggest that there is a cost of borrowing advantage in having a group bank, having foreign ownership and being focused in terms of their decreasing impact on borrower firms' cost of loans.

CONCLUSION

The empirical evidence considered in this study shows that the extent of group affiliation matters. I find that group affiliation extent increases cost of loans (lower maturity, higher spread), government ownership increases cost of loans (lower maturity, higher spread, lower deal amount). Moreover, having a group bank is advantageous in terms of cost of loans (higher maturity, lower spread), and foreign ownership is beneficial in terms of pricing (lower spread), however being affiliated with a foreign group is not beneficial (lower maturity). Additionally, diversification strategy is not beneficial in terms of cost of loans (lower maturity and deal amount).

Overall, these findings suggest that there is a cost of borrowing advantage in having a group bank, having foreign ownership and being focused in terms of their decreasing impact on borrower firms' cost of loans. On the other hand, the extent of group ownership in a borrower group firm is perceived to be highly important from the point of lenders, and the choice of borrower group firm have an impact on the cost of debt. This analysis may have important implications for both business groups and lending institutions in terms of loan contracts.

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