Thomas Lindner and Jakob Müllner and Jonas Puck

Cost of capital in an international context: Institutional distance, quality, and dynamics

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Abstract: Cost of debt is a key cognitive anchor for managerial decisions and an important determinant of firm profitability. We extend international management research by analyzing the effects of institutional distance, institutional quality, and their dynamics on the cost of debt in the context of foreign direct investments (FDI). We test our conceptual model on a sample of companies making 3,764 greenfield foreign direct investments from developed into less developed markets. Using hierarchical linear modelling, we show that the financial consequences of internationalizing into countries with weak institutions depend on both the institutional distance between countries, as well as their institutional quality. Furthermore, we find that recent changes in institutional quality form expectations about future development and ultimately influence post investment financing costs.

1. Introduction

When firms internationalize, a key question for management is the effect of the investment on the firms' cost of capital and specifically the cost of debt (Gallo, 2015). Cost of debt determines the availability of capital for future investments and the profitability of current operations. As investment decisions are based on the expected returns, corrected for the cost of raising capital (Fama and French, 2004), cost of debt is a crucial determinant in strategy formation (Sharpe, 1964). The literatures on underinvestment (Myers and Majluf, 1984) and asset substitution (Jensen and Meckling, 1976) attest to the pivotal importance of the cost of debt in international investment decisions (Mansi and Reeb, 2002; Reeb et al., 2001). In the field of finance, cost of debt is frequently explained using trade-off theory (Kraus and Litzenberger, 1973). From this theoretical perspective, the core determinants of cost of debt are tax benefits of debt on the one hand and "bankruptcy penalties" on the other (Kraus and Litzenberger, 1973 p.912). Tax benefits rather play a role in firms' reaction to the cost of debt (Goldstein et al., 2001). They are mostly associated with a company's domestic tax rate. Foreign tax rates certainly influence the location choice of an investment, but to a lesser extent the ex-post change in cost of debt. Hence, specifically an increasing probability of bankruptcy and the associated cost of financial distress are major drivers of the cost of borrowing for a company.

Finance literature identifies numerous determinants of cost of debt on the firm- as well as on the industry-level based on this model (Fama and French, 2002). Research on the country or cross-country level, however, remains scarce and theoretically under-developed. Empirically, the few existing studies focus either solely on a company's home or host country context (Chen et al., 2011; Hail and Leuz, 2009; Koedijk and Van Dijk, 2004; Qi et al., 2010), or solely on the differences between the two (Gray et al., 2013; Zhu and Cai, 2014). Theoretically, while making an important contribution to the literature, arguments do not relate to an overarching theoretical concept of the environment, but rather focus on

selective influences and remain largely fragmented in their overall contribution. We believe that complementing trade-off theory with the institutional perspective from the field of international business provides a promising alley to develop a more consistent conceptual framework of country-level influences on the cost of debt.

The institutional perspective in international business (Berry et al., 2010; North, 2004; Peng et al., 2009; Scott, 1995) is guided by the assumption that not only firm or industry characteristics, but to equal extent, the institutional context matters for international investment and the risks associated with it. Literature conceptualizes this institutional context along three dimensions: Institutional quality, institutional distance, and institutional dynamics. Institutional quality, i.e. the quality of formal and informal institutions within a country, has been a major research area in the field of IB and strategy for a long time (e.g. Filatotchev et al., 2013; Kostova and Roth, 2002). Scholars have shown that host (Bell et al., 2014; Henisz, 2000; Meyer et al., 2009; Moore et al., 2012) and home country institutional quality (Kogut et al., 2002; Vasudeva et al., 2013) significantly influence risk associated with firms' international activities. To a lesser degree, researchers theorized on the relevance of distance between the home and host countries' institutional contexts (e.g. Zaheer, 1995). Just recently, scholars have started to transfer this approach to the field of international finance and capital markets research (Bell et al., 2012; Bell et al., 2010). Lastly, the dynamics of institutional contexts have received least attention (Peng et al., 2008). This is surprising since investment decisions are driven by expectations about future risk and hence not (solely) by the current institutional setting, but also by the dynamics (development) of the institutional environment over time. Decision makers within and outside the firm base their assessment of risk associated with an international investment also on the trend of institutional development over time (improvement or deterioration) and the expectations they form because of observed changes (Jacowitz and Kahneman, 1995; Tversky and Kahneman, 1974). Research provides substantial empirical evidence of the impact of different dimensions of institutional

context on risk associated with strategic decisions, such as foreign market entry mode, ownership choice, or other strategic foreign investment decisions (Brouthers, 2002; Capron and Guillén, 2009; Delios and Henisz, 2000; Hernández and Nieto, 2015; Hwang, 1989; Rueda-Sabater, 2000; Yiu and Makino, 2002). Given the conceptual relevance and the empirical evidence as a relevant determinant of risk, we integrate the institutional logic along the three lines with the trade-off perspective. Specifically, we reason that institutional contexts, i.e. their quality, distance, and dynamics, will also matter for the risk of bankruptcy in the trade-off perspective on international investments. Firms investing in foreign markets are always facing all three dimensions of institutional context as well as their interdependencies. Omitting one of the dimensions in the assessment of the institutional context may lead to biased conclusions. Consequently, the objectives of this paper are to develop a framework of institutional influences and their relevant interdependencies on the cost of debt associated with an international investment, and to test this framework empirically.

Our study makes the following important interdisciplinary contributions to theory in the fields of finance and international business (Cheng et al., 2009). First, by integrating trade-off theory from the field of finance with the institutional perspective from the field of IB, we extend the institutional perspective from the field of IB to the field of finance, and provide evidence that predictions based on this perspective also hold in the cost of capital logic. While classically rooted in factor markets, we thus expand the applicability of this perspective to a relatively new field, where applications of the institutional perspective so far are limited. Second, by combining both perspectives, we also contribute to trade-off theory from the field of finance. We do so by expanding the set of determinants of the bankruptcy risk, and by offering a conceptualization of institutional context based on the institutional perspective. As financial markets are often argued to be ‘efficient’ across borders, we believe this is an important addition and helps to build a more comprehensive framework that integrates institutional

barriers and frictions. This is specifically relevant as we are among the first to provide a theory-based framework of institutional country-level indicators that matter for FDI financing.

We conduct our study in an environment in which companies from developed countries make greenfield investments in less developed countries, in order to get a clear and undistorted picture of the role of country risk in the cost of capital. This allows us to explicitly analyze the effect of an investment without firm-level confounding effects found in mergers and acquisitions. We use hierarchical linear modelling to account for firm level and country-level effects while controlling for the impact of industries, time, and firm-level variables following Fama and French (2002).

2. Theory and Hypotheses

Corporate strategy, finance and IB literature acknowledge close links between strategic decisions and financial constraints faced by the firm (Filatotchev and Piesse, 2009; Forssbæck and Oxelheim, 2008; Kochhar and Hitt, 1998). Similarly, finance literature provides theories that link financial resources with strategic decisions, investment behavior, and growth (Beck and Demirguc-Kunt, 2006; Beck et al., 2005). Yet, very little research has addressed the financial consequences of strategic decisions and even less the role of investment context therein.

The most prominent theories from the field of finance explaining the cost of capital are pecking order theory (Myers, 1977, 1984; Myers and Majluf, 1984) and trade-off theory (Kraus and Litzenberger, 1973). We base our theoretical reasoning on trade-off theory because it explicitly includes investment risk and the cost of financial distress. Pricing of equity is determined by investors' expected return on investment relative to the risk associated with it. Since creditors do not participate in the upside of an investment, their assessment is predominantly focused on risk. Risk is also the core element in our framework linking trade-off theory and institutional context. Hence, to have a clearer identification of risk effects we focus on cost of debt rather than equity. The main drivers of debt ratios in trade-off

theory are tax benefits of debt on the one hand and "bankruptcy penalties" on the other hand (Kraus and Litzenberger, 1973 p.912). The tax benefit is largely related to marginal tax rates at the global headquarter, not the financing of individual investment projects (Faulkender and Petersen, 2006). Also, the tax benefit mainly affects the way firms adapt the financial structure given the cost of debt (Goldstein et al., 2001). Therefore, we focus on the expected bankruptcy cost. If the probability of bankruptcy and the associated cost of financial distress increase, so will the cost of borrowing for a company. This cost is strongly related to the risk of investments, as the sum and structure of these risks drive the probability of bankruptcy.

Trade-off theory does not explicitly address issues of international context or internationalization. However, scholars argue, "[…] there may be factors unique to multinational firms […] and the traditional capital structure models for domestic corporations may be inadequate" (Burgman, 1996 p.563). In line with this reasoning, the institutional perspective provides three clear links between cost of debt and the institutional context of an international investment. First, diversification logic predicts that internationalizing multinationals (MNCs) can reduce their cost of debt by diversification of investments in institutionally distant country markets (Fatemi, 1984). This is because diversification reduces firm-specific risk (Shapiro, 1978; Stulz, 1999) and in consequence the expected probability of bankruptcy following trade-off theory logic. On the contrary and second, from a trade-off theory perspective additional risk resulting from the presence in markets with imperfect institutional settings (i.e. institutionally founded risk) increases the probability of bankruptcy and the cost of debt. Consequently, the change in cost of debt is contingent upon the institutional context of the home and host market, as well as the distance between them. Third, since cost of debt is directly linked to expected or future probability of bankruptcy, it is also evident that investors consider not only the static institutional parameters in their assessment of cost of debt, but also their future expectations on institutional development.

Overall, the institutional perspective proposes three simultaneous but potentially conflicting effects of the institutional environment on cost of debt changes in the context of international investments. We simultaneously assess the three contextual dimensions within our model: the distance between the two institutional settings, the country specific quality of institutions, and finally, the inter-temporal dimension of how the distance and institutions in the two countries are expected to change.

Trade-off theory assumes that the cost of debt is a function of firm risk and expected probability of bankruptcy. A firm's risk of default is reduced by diversifying into imperfectly correlated markets (Bodnar et al., 1999; Burgman, 1996; French and Poterba, 1991; Geringer et al., 1989; Kwok and Reeb, 2000; Reeb et al., 1998; Reeb et al., 2001; Rugman, 1976). In an international context, we expect the effect of diversification to increase with institutional distance between the home and host country: Institutional differences imply different states of economic development, which in turn are associated with uncorrelated cash flows (Lewellen, 1971; Longin and Solnik, 1995). Thus, by investing in institutionally distant markets, firms can reduce their overall risk of bankruptcy. In consequence, with increasing diversification in institutionally distant markets, firms can raise debt more cheaply. Of course, one particular investment is not the only contributor to firms' cost of debt. Therefore, we refer in all our hypotheses to marginal cost of debt. That is, the change in cost of debt following an international investment. Regarding an investment in such an institutionally distant market and its effect on the cost of debt, we develop H1:

> **Hypothesis 1**: Investments into institutionally distant countries diversify risk and decrease the marginal cost of debt.

However, while distance provides opportunities for diversification, the institutional quality in the home and host countries affect context-specific risk (Hayakawa et al., 2013), which also influences the marginal cost of debt triggered by an investment. If the a-priori institutional quality of the home country

is high, investments in lower quality countries make a strong difference to the overall risk-exposure of the firm and therefore ultimately to marginal cost of debt. When a-priori home country institutional quality is comparatively low (for a developed market), the a-priori base risk of bankruptcy for the focal company is comparatively high. When investing from such a comparatively high-risk environment into a less developed country, the marginal risk from an investment will be comparatively low, as will be the marginal cost of debt. This reasoning is supported by a number of studies that relate cost of capital to home country institutions (Bancel and Mittoo, 2004; Brounen et al., 2006; De Jong et al., 2008; Demirgüç-Kunt and Maksimovic, 1999; Fan et al., 2012; Hall et al., 2004; Rajan and Zingales, 1995; Rajan and Zingales, 1998).We therefore derive the following hypothesis:

> **Hypothesis 2a**: Investments from institutionally weaker home countries add limited risk and lead to lower marginal cost of debt.

While the home country context determines the initial base risk of international operations and the company's ex-ante probability of default, host country institutional quality influences the ex-post addition of marginal risk and hence the marginal cost of debt. Consequently, host country institutional context needs to be included in the modelling of marginal cost of debt.

Some studies account for host country characteristics in financial decisions and cost of capital. For example, Giannetti (2003) finds that host country institutional aspects such as creditor protection, stock market development and legal enforcement heavily influence companies' financing choices. Qi et al. (2010) show that political rights in the host country negatively affect the cost of corporate bonds and Armstrong et al. (2000) show that the development of bankruptcy laws in the markets of MNCs affects the pricing of both equity and debt. Relying on trade-off theory, we reason that investments in low quality institutional environments increase overall corporate risk, the probability of bankruptcy and

ultimately the cost of debt. Straightforwardly, the lower the institutional quality of the host country context in question, the higher will be the marginal cost of debt.

> **Hypothesis 2b**: Investments into institutionally weak host countries add relatively more risk and increase the marginal cost of debt.

In trade-off theory, cost of debt is determined by the creditors' assessment of probability of default of a company in the future. Both the institutional distance and the institutional quality of countries are not static (Berry et al., 2010). Effects of these dynamics have been observed before. Inoue et al. (2013), for example, show decreasing returns on preferential access to government equity as institutions in a country develops. Investor's assessment of the probability of default is also forward-looking. Future expectations of creditors regarding the institutional environments and distance affect their assessment of risk and the marginal cost of debt sustained by an internationalizing company. This forward-looking perspective of cost of capital determination makes it necessary to include future expectations about the institutional environment. Our literature review revealed only two studies that link firms' financial decisions to environmental or institutional dynamics. However, both of them strongly support our claim that inter-temporal changes will have an effect on cost of debt in international context: Simerly and Li (2000) find that environmental dynamics on an industry level affects firms' capital structure. Hail and Leuz (2009) show that future growth prospects affect cost of capital in cross-listings.

When managers and creditors evaluate risks associated with investment projects, expectations of future risk are crucial. Therefore, we argue that the cost at which creditors are prepared to finance an international investment depends not only on the distance and on institutional quality at the time of investment, but also on the expectations of how they will evolve in the future. Hence, we include proxies for institutional dynamics and creditors' expectations for the individual countries involved and the distance between them.

In the absence of reliable estimates for future institutional distance and quality, investors tend to use past changes as cognitive anchors to predict future changes (Jacowitz and Kahneman, 1995; Tversky and Kahneman, 1974). This natural behavior to use past trends for forecasts under uncertainty, even if they have very little predictive capacity, has also been labelled topically oriented trend adjustment in the forecasting literature (Bofinger and Schmidt, 2003; Meub et al., 2015). Consequently, creditors face uncertainty of future developments with regards to future institutional distance. Investors form their expectations based on trends they observe in data and they adjust their estimation of bankruptcy risk accordingly. Investors' assessment of the diversification effect into institutionally distant markets inevitably alters if the institutional gap is likely to change in the near future. Therefore, we argue that negative changes in institutional distance (reflecting an expected reduction of institutional distance and an erosion of the diversification effect) lead to an increase in the marginal cost of debt, and vice versa.

> **Hypothesis 3**: Investments between institutionally converging countries reduce diversification potential and increase marginal cost of debt.

Home and host country institutional quality also have dynamic properties. Following the argumentation leading to H2a and H2b, we argue that a decrease in home country institutional quality decreases the risk added by internationalizing to an institutionally weaker host country. That is because internationalizing into an institutionally weaker country makes less of a difference to the overall probability of bankruptcy. In other words, expected institutional quality reductions at home lead to higher expected base risk, a lower marginal risk increase and a reduction in marginal cost of debt. Applying the same logic, it can be anticipated that an expected deterioration in institutional quality in the host country increases the anticipated probability of bankruptcy and the marginal cost of debt.

> **Hypothesis 4a**: Investments from institutionally weakening home countries add less risk and decrease marginal cost of debt.

Hypothesis 4b: Investments into institutionally weakening host countries add more risk and increase marginal cost of debt.

One of our core propositions is that only an integrative assessment of all three dimensions of institutional context including relevant interactions will help to provide a consistent and robust picture of marginal cost of debt in the context of international investments. As theory proposes that diversification and marginal risks of a specific market entry have opposing effects, but both always occur simultaneously, one needs to consider the interaction of the two. We proposed that internationalization provides a diversification advantage. However, if institutional quality in a host country is very low, the diversifying effect of distance is counterbalanced by the additional risk of bankruptcy resulting from an investment in a weak institutional environment. In a holistic assessment of institutional context, the value stemming from diversification into an institutionally distant country is outweighed by low institutional quality in the host country. This is supported by evidence in the literature, as De Jong et al. (2008), for example, show that country specific effects have both a direct and indirect or interacting effect on firm's capital structure decisions. Therefore, we formulate a moderating effect between institutional distance and host country institutional quality:

Hypothesis 5: The negative effect of institutional distance on marginal cost of debt is moderated by host country institutional quality: The diversification effect of institutional distance is reduced in host countries with low institutional quality.

Addressing the inter-temporal dimension, managers and investors may anticipate future deterioration in host country institutional quality and increase the cost of debt for the internationalizing company accordingly. In line with our reasoning leading to hypothesis 5, we propose a moderating effect between institutional distance and the dynamics of host country institutional quality:

Hypothesis 6: The negative effect of institutional distance on marginal cost of debt is moderated by host country institutional changes: The diversification effect of institutional distance is reduced in host countries with deteriorating institutional quality.

In sum, these hypotheses represent our conceptual model of the institutional contextualizations of marginal cost of debt in the context of international investments. All of them are founded in the overlap between the institutional perspective in IB and trade-off theory. Figure 1 provides an overview of our conceptual model.

3. Sample and Methods

We choose to limit our analysis to firms from developed markets internationalizing into less developed economies, since the cost of debt determination has been shown to be different for companies from markets at different levels of development (Booth et al., 2001). Our definition of developed markets is based on the Morgan Stanley Capital International Index (MSCI). The index is the most widely used equity benchmark index for emerging markets (Asness et al., 2013). We chose the term "less developed" for all other countries intentionally to highlight the down-stream nature of all investment and we exclude all investment in which despite MSCI classification, we do not see a clear treatment of a risk increase (i.e. investment is made into a target country of higher risk than the source country). We focus on a downstream sample for theoretical and empirical reasons to achieve the clearest identification of cost of debt effects as possible. Theoretically, systematic differences in the market's pricing of debt for firms from less-developed markets (increased a-priori liability of foreignness, potential positive signaling effects), differences in financing patterns between companies from developed and less-developed countries, and generally differing investment behavior would require consideration of further cost-of debt effects in a bidirectional sample (Gozzi et al., 2010). Such systematic differences would most likely affect the dependencies in our model, would introduce noise

into our sample and would imply a transferability of results, which we believe, is unwarranted due to the idiosyncrasies of companies internationalizing from less-developed countries. Empirically, modelling the trade-off in a clear and directed manner requires us to have a clear observation of increasing risk (or diversification). Also, there is more variation in host country settings among less developed countries. Finally, focusing on investments in countries with weaker institutional quality allows us to trace the effects of host country institutional quality on cost of debt and we can make sure that the investment projects in question always have countries as hosts that have lower institutional quality than the home countries.

We believe that FDI will have a more pronounced effect on a company's cost of debt than non-equity modes. We obtain a sample of 3,764 greenfield investments between 2005 and 2012 using the fDi Markets database maintained by the Financial Times. This sample represents approximately 20% of the population of foreign direct investments flowing into less developed countries as covered by fDi Markets. The database is the most comprehensive source of cross border greenfield investments covering all countries and sectors. It is used by international institutions such as UNCTAD to compile greenfield FDI data (UNCTAD, 2014 p.8). The sample size is essentially determined by the availability of institutional data in less developed countries receiving FDI. In addition, the investing firms need to disclose financial information to be relevant for our analyses. To avoid bias, we make sure to have investment projects of various sizes (see Table 1) and investments in a broad selection of country pairs (see below for details). We test our hypotheses on a sample of greenfield investments. Excluding M&As we eliminate biases introduced from the target and transaction characteristics (i.e. friendly vs. hostile, related vs. unrelated, upstream vs. downstream in the value chain). It allows us to observe cost of debt changes within the same (or very similar) company context rather than comparing a pre-merger company to a potentially very different post-merger one. In addition, we believe that the functioning

of M&A markets is inherently different from firms' usual area of operation and includes a multitude of other financial, strategic and tax issues, which are beyond the scope of this paper.

Overall, the data include investments from 21 developed countries into 27 less developed countries, which is a broad and quite symmetric distribution. As expected, the most prominent pairs of countries in terms of number of transactions are investments from the USA to China (18%), Japan to China (15%), Germany to China (6%), and the USA to Brazil (5%). The majority of investments (56%) are dispersed over 165 pairs of countries, each contributing less than 5% to the total. Those include investments from Switzerland into Croatia, from Australia into Colombia, and from the United States into Botswana, for example. The sample covers all continents. Regarding industries, the sample consist of firms from 39 different industries. Chemicals take the largest share in the sample (9%), industrial machinery, equipment & tools follows with 8 per cent. The third largest contributor is food and tobacco with 7 per cent. We believe that the sample is well diversified with regards to countries and industries captured.

We conduct hierarchical linear analysis to account for differences in error terms between the firm and country levels. Hierarchical linear modelling is superior to ordinary least square modelling because it explicitly incorporates different levels of error clusters. Hierarchical effects estimation allows efficient modelling and avoids both spuriously significant and inefficient estimators resulting from clustered error terms (Hox, 2002). We test the superiority of random over fixed effects before introducing cross-level interactions into the model. We also control for year and industry effects using dummies.

4. Variables and Measurement

Dependent variable

Our main dependent variable is the cost of debt in the year following the greenfield FDI obtained from Bloomberg. We also run models with the change in cost of debt in the year and the two years following the greenfield investment as robustness checks, which yield consistent results. We use yearly rather than monthly changes in cost of debt to account for the fact that capital structure is rather sticky and changes involve adjustment costs (Byoun, 2008; Fama and French, 2002; Kraus and Litzenberger, 1973; Shyam-Sunder and C. Myers, 1999). The mean cost of debt for our sample companies is 2.572 per cent annually.

Main variables of interest

To test our hypotheses, we include six independent variables. We measure institutional distance (H1) using a compound measure of the normative and regulatory (Scott, 1995) dimensions of cross-national institutional distance as proposed by Berry et al. (2010). These dimensions have been found to specifically affect the cost of debt (Atilgan et al., 2015). We use the administrative, economic, financial, and political distance scores computed from time-varying covariance matrices to capture the dynamics of the measure. These data have been updated in 2014. We compound the four dimensions following Kogut and Singh (1988) by weighting the distance dimensions with the inverse of their variance. Such a compound is the most-used indicator of distance in IB literature (Bae and Salomon, 2010). We conduct robustness checks and find very similar results for individual dimensions of institutional distance compared to the compound we apply.

We measure institutional quality by absolute country risk measures for home and host countries (H2a and H2b). Country risk is a multidimensional construct as risk can stem from varying institutional sources (Miller, 1992). As a consequence, we believe that an isolated consideration of certain types of risk does not capture the full complexity of a country's institutional quality. Therefore, we follow Bevan et al. (2004) and use the country risk score compiled by the Economist Intelligence Unit (EIU)

and provided by Bureau van Dijk Electronic Publishing to operationalize the institutional quality in the home and host country. Of course, higher country risk represents lower institutional quality. Hence, the signs of our coefficients have to be inverted for interpretation. To account for the time lag between investment decision and market entry, we use institutional quality from the year before investment. We calculate the year-on-year changes in institutional distance (H3), as well as in the levels of institutional quality for both home and host country (H4a and H4b) to capture changes in expectations. We do so using changes from three to two years before investment to avoid multicollinearity issues associated with incorporating the value for the year before investment.

As expected, when firms from developed countries invest in less developed markets, host country institutional quality is on average lower than home country institutional quality. Overall, there is considerable variation in both home and host country institutional quality and each market entry in our sample is a downstream investment into a country with weaker than home country institutions.

Company-level controls

We control for size of the foreign direct investment using the reported local FDI capital expenditure in the FDI markets database. Cost of debt in the year preceding the investment is included to make the change in cost of debt following the investment visible. Following Demirgüç-Kunt and Maksimovic (1999) we use long-term debt to total assets as a measure of leverage. In addition, we include the ratio of equity over total assets to account for capital structure characteristics not included in the debt-ratio measure. Fama and French (2002) have shown that the beta of a company influences a company's cost of debt and capital structure. We use the five-year asset beta as reported in the Orbis database of Bureau van Dijk as a direct measure of company specific risk. We also control for other firm-level effects following Fama and French (2002).

As the cost of debt is highly dependent on agency cost, firm governance and shareholder structure play an important role in determining a company's cost of debt. We control for governance structure by including the number of recorded shareholders. Research on internal capital markets has shown that managers can use the complexity of organizational structure in highly diversified firms for empire building and inefficient decision making (Cline et al., 2014). We capture this agency effect by including the number of companies in group, number of subsidiaries and number of affiliates in group as measures of organizational complexity.

Host country-level controls

Several macro variables have shown to have an effect on capital structure and cost of debt (Demirgüç-Kunt and Maksimovic, 1999). We include country level controls for GDP growth, total GDP, inflation (Consumer price index), lending rate, one-year exchange rate volatility and inward FDI. To distinguish different types of emerging markets, we include dummies based on (Hoskisson et al., 2013). In their five-group classification of mid-range economies, they differentiate emerging markets based on improvements in their institutional environment and their factor markets.

5. Results & Discussion

Descriptive statistics and partial correlations of the variables in our models are shown in Tables 1-3. We find no problematic or surprising cross-correlations. The two profitability measures are of course highly correlated. Leaving out either one, however, does not significantly change our results. Following Fama and French (2002) we keep both in our firm-level model.

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insert Tables 1-3 about here

We run an empty model (1) in Table 4 including the fixed effects specification for industries, years, and host countries for the 3,764 observations we collected. The intercept is significant and gives us a conditional mean cost of debt of 2.283 per cent in the year after the FDI for the reference industry and year.

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insert Table 4 about here

We then introduce company level determinants of cost of debt in model (2) and closely follow Fama and French (2002) therein. The intercept remains significant and positive at a somewhat lower level. We control for past cost of debt using the cost of debt in the previous year. Consequently, the other variables can be interpreted as net of the cost of capital in the year minus one (i.e. change in cost of debt). We do not report insignificant controls. Firm-level coefficients support findings by earlier research (Fama and French, 2002). In model 3 we introduce the variables measuring institutional distance and quality. We test them together because our conceptual model is based on the assumption of parallel effects and because, from a statistical perspective, their interplay is contingent on the observed values for the respective other variables (we also find the effects in individual tests, though).

We find strong support for H1 which states that investments in foreign markets should provide a diversification advantage that increases with increasing institutional distance. This expands existing findings from Griffin and Karolyi (1998). On the one hand, our results support their argument that international diversification can reduce the cost of debt. On the other hand, our approach moves beyond their assessment of international diversification, which is purely based on the host country level. By focusing on the cross-country level and by providing a clear concept and measure of distance, our approach provides both an important addition to existing theory as well as guidance for practitioners. We also find strong support for H2a, stating that lower home country institutional quality means less risk added by the investment and hence lower marginal cost of debt. This broadly reflects existing

results from Demirgüç-Kunt and Maksimovic (1999). Qi et al. (2010) and Zhu and Cai (2014) highlight the relevance of the home country institutional context for cost of debt changes stemming from international investments. In the interpretation of host country institutional quality and distance, it is important to look at the value of the respective other in order to interpret the overall effect. Results do not provide direct support for our H2b, as we find that lower host country institutional quality reduces risk as reflected in lower cost of debt. This is not in line with most existing research that points towards a risk and cost increase from low institutional quality in the host country. However, our holistic conceptualization of the institutional context allows us to derive implications beyond effects of the single dimensions: as argued in the development of H5, effects of distance and institutional quality in the host country on marginal cost of debt are related conceptually and empirically. Which effect prevails absolutely may be context specific.

For ease of interpretation of the results on H5, we provide effect plots for the dependencies of cost of debt on host country institutional quality and distance given the respective other in Figure 2. While for low distances the cost of debt decreases with decreasing institutional quality in the host country (bottom left panel of Figure 2), it increases for higher distances (bottom right panel of Figure 2). In the latter case, we therefore find support for H2b even though the direct effect overall does not match our conceptual model. Consequently, our findings strongly suggest that effects of institutional context and distance must be modelled jointly because of strong conceptual and empirical contingencies: In our case, the diversification effect of distance dominates the risk-increasing effect of low institutional quality for high values of institutional quality in the host country (see top panels in Figure 2). For investments in countries with low institutional quality, firms are not able to reap the benefits of diversification and the risk-increasing effect of low institutional quality dominates. This supports H5 also in terms of the direction of the interaction effect.

In model 4 we add the temporal dynamics to our model. We move from a fixed-effects specification to a random-effects specification. The change in model fit is not significant. The findings from model 3 remain robust. We do not find support for H3. This tells us that simultaneous variation in both distance and time might be more complex than the predictions made by static trade-off theory.

Interestingly, we find a significant negative effect of changes in the home country institutional quality while our hypothesis predicts a positive effect (mind the inverse measure). The direct effect of a change in institutional quality in the home country most likely dominates the effect of the international investment. The added risk resulting from low institutional quality in the host country may well be reduced with expectations of a decrease in home country institutional quality. Yet, the change in the home country directly affects the cost of debt as well and the latter effect seems to dominate. We find support for the direct effect we hypothesize in H4b. Yet, as highlighted above, we need to be cautious in interpretation of the direct effects because of the relevance of interactions.

This supports the relevance of our final hypothesis, H6. Again, to facilitate interpretation, we provide effect plots in Figure 3. We observe that the overall effects of expectations about changes to institutional quality and distance are numerically weaker than those of the status quo. Yet, they are highly significant. Expectations seem to play a highly relevant role, but (in economic terms) a smaller one than the status quo. We could interpret this finding in terms of how expectations are formed: mostly, they seem to be based on institutional quality and distance as they are observed today; expected changes strengthen or weaken these expectations. Contrary to the status quo, the diversification effect prevails in institutionally weak countries, while for institutionally well developed countries the effect of institutional quality dominates.

Control variables do not change much in magnitude and significance throughout our models (see Table 4). We conduct robustness checks with an alternative dependent variable as well as different

independent variables. In the dependent variable, we use the change of the cost of debt and obtain very similar results. In the independent variables, we measure institutional distance in several ways (economic distance, political distance, compound measure in the main analyses). We find very similar results. We therefore are confident that our findings are robust.

6. Implications and Limitations

Our empirical examination largely supports the conceptual model we developed based on an integration of trade-off theory with the institutional perspective from the field of IB. We find strong and robust evidence that marginal cost of debt is contingent on the institutional contexts, as represented by institutional quality, distance, and dynamics.

Apart from the empirical contributions we make with the comprehensive dataset of greenfield investments in less developed markets and the method we apply, our results provide important contributions to theory development. By answering the calls of Agmon (2006) and Bowe et al. (2010), we integrate theory from the field of finance with theory and conceptual work central to the field of IB. This has important implications for theory in the field of finance. In this area, theoretical reasoning is largely based on a 'context-free assumption', especially with regard to the country- and cross-country context. Our results provide strong evidence that this assumption needs to be reconsidered. Our conceptual model provides a clear and theory-based framework on potential effects stemming from the institutional environment and our results point strongly towards the significance of country-level institutional factors for cost of capital in an international context. We therefore believe that theory development in the field of finance can benefit from integrating and/or adjusting our conceptual approach to further aspects of investment and financing across borders.

We also make an important contribution to institution-based reasoning in the field of IB. While such reasoning so far largely focusses on factor markets, our model and results provide evidence that this

reasoning also transfers to the field of financial markets. Our results thus provide further evidence for the relevance of institutional reasoning also beyond the areas the approach has already been applied to.

We believe that beyond the two core aspects elaborated above, our approach provides relevant contributions for two additional streams of international business research: the multinationality-performance discussion and transaction cost theory. First, firm performance is a function of expected cash flows and the uncertainty associated with them. Conceptualizing the two elements separately may help to overcome conflicting findings of past research. On the one hand, internationalization confronts firms with additional risks. On the other hand, it provides firms with opportunities to diversify their returns. Hence, only when taking into account both, research can find out which effect dominates under what circumstances. Second, when analyzing entry mode decisions, researchers have repeatedly stressed that a country's institutions and cultural distance are insufficient measures of uncertainty (Zhao et al., 2004). We add institutional dynamics as an additional driver of risk and provide empirical evidence on its relevance. Adding the first order expectations about future changes in uncertainty, as we propose in this paper, may thus help to get a better grasp of different aspects of uncertainty in entry mode studies based on transaction cost theory. Our results highlight the role of institutional expectations and their effect on MNEs. So far, negative effects from institutional dynamics on MNC have been found in the political context (Fisman, 2001; Inoue et al., 2013; Siegel, 2007) when cash-flows of a politically embedded MNE are misappropriated by a changing opposition government. Our result shows that negative effects can occur indirectly from non-local stakeholders such as investors, which adjust their claims to the perceived increase in bankruptcy risk.

Despite the extensive dataset and clear theoretical perspective, our study has several limitations. First, while we can account for changes in cost of capital and institutional quality, as well as the size of the greenfield investment, we cannot control for changes in several other company-level variables such as international diversification or number of recorded shareholders during the time when the greenfield

investment occurs. This could be a limitation as changes in cost of debt may be attributable to variations in these company-level determinants, rather than host country effects. Given the large dataset, however, we hope that the effects of these changes – as they are, by definition, largely unrelated to the greenfield investment in question – average out to zero. Second, as in much literature relating to institutional distance, we have to make a choice of how to measure this construct. We use the dimensions of Berry et al. (2010) that relate to the regulatory and normative domain as identified by Scott (1995). This choice is based upon evidence from Atilgan et al. (2015) who demonstrate that these dimensions are relevant for the valuation of debt. This choice, despite the results being robust to changing the dimensions and prior evidence supporting it, leaves room for further research. The choice of dimensions and their respective weighting remains a topic of intense academic discussion (Dow and Karunaratna, 2006). Third, while using greenfield investments as a research setting provides empirical benefits, it reduces the generalizability of our results since M&A transaction may function very differently. In fact, we believe that they do and we leave it up to future research to address this question. Fourth, a similar limitation is related to the directional or down-stream nature of the investments in our sample. Looking at upstream investments will require different theoretical perspectives that account for the different nature of such investments but could provide valuable insights and important contributions to IB literature. Fifth, future researchers should also consider the source of debt. In our model we do not distinguish whether the debt used to finance the greenfield investment is domestic or foreign. Controlling for the institutional environments in both countries, we implicitly assume that international debt composition of the company remains on average stable before and after the event. While this is a reasonable assumption considering strong home country bias in lending (Carey and Nini, 2007; Centeno and Mello, 1999; Cooper and Kaplanis, 1995; Fidora et al., 2007; Giannetti and Laeven, 2012; Presbitero et al., 2014), foreign debt can help to mitigate exchange rate risk, political risk, and open up favorable financing opportunities. Accordingly, the issue of debt sourcing is one that

needs addressing in future IB research. Finally, reverse causality may be an issue. It is possible that firms anticipate lower cost of debt and decide to enter volatile markets when the price for debt in the future is low. In this respect, we have to make the assumption that managers do not exclusively make decisions based on the availability of financial resources.

Beyond the potential research questions highlighted above, our results indicate further promising avenues for research in different areas. Future studies analyzing the cost of debt or other consequences of risk associated with international investment should go deeper into the institutional characteristics of host countries, combining institutional aspects with corporate governance indicators such as the measures developed by La Porta et al. (1998) and Berkowitz et al. (2003). Such research may help understand two important issues. From the country perspective, legislators can build institutional environments such that they attract firms with desirable governance characteristics. From the firm perspective, investment decisions can be based on the match between the firm's and target countries' governance structures. Disaggregations of institutional quality into different dimensions could be used in order to identify the macro drivers of cost of debt change. While there are some dimensions of institutional distance that may lead to both diversification and risk-increasing effects, there may be others where this is not the case. For some, only risk-increasing effects may be observable, while for others only the diversifying effect plays a role. Finally, trading off diversification and risk-increasing effects and appropriately capturing the two is a challenge and should be further investigated.

Appendix

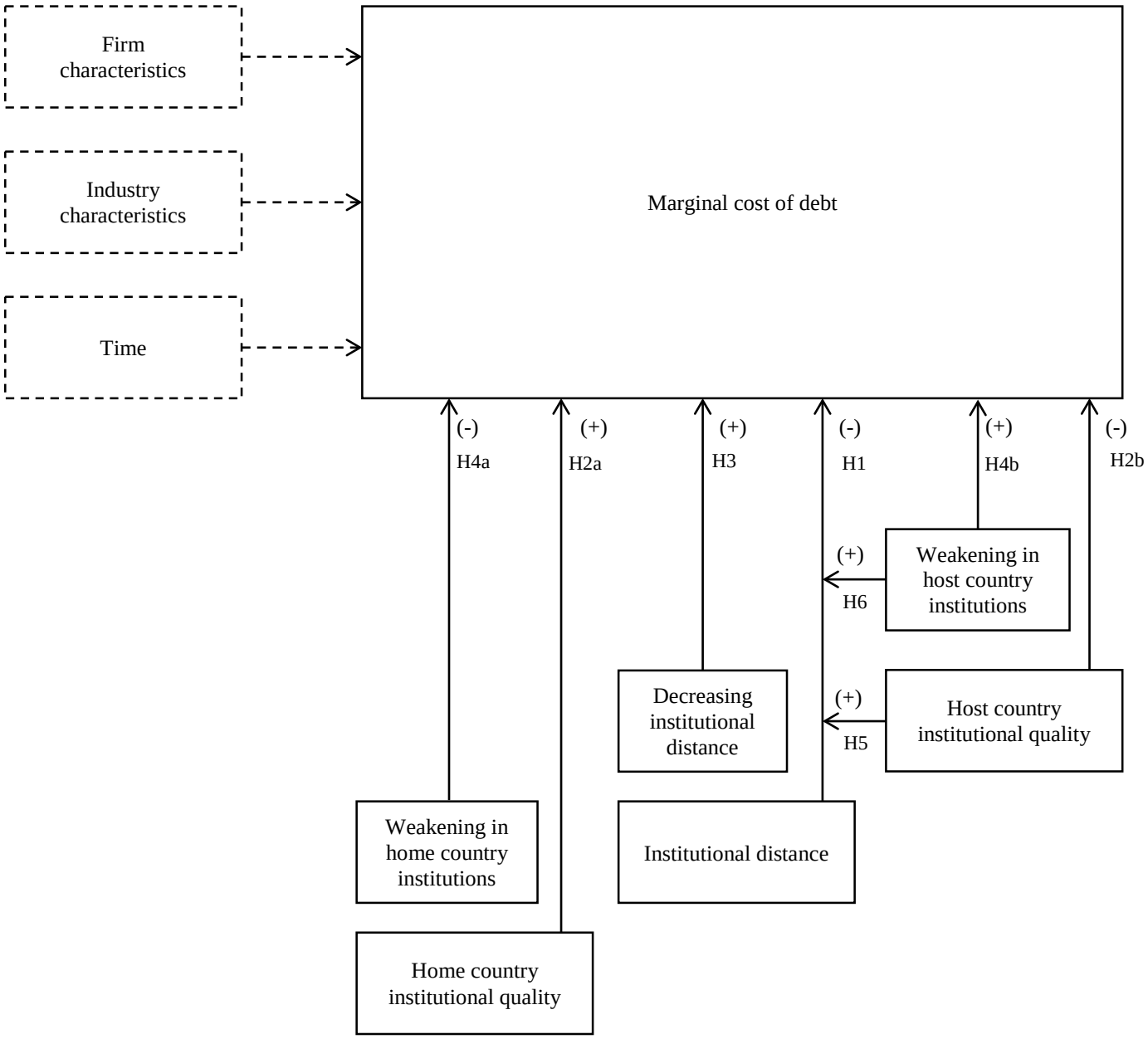

Figure 1: Illustration of hypothesized relationships. Dotted lines indicate control variables.

Statistic	N	Mean	St. Dev.	Min	Max
(1) Cost of debt (t+1)	3,764	2.572	1.608	0.000	9.002
(2) FDI capital expenditure	3,764	105.236	314.129	0.045	7,177.000
(3) Cost of debt (t-1)	3,764	2.793	1.654	0.000	9.002
(4) Long term debt ratio	3,764	27.161	20.967	0.000	96.539
(5) Equity ratio	3,764	39.240	18.851	-88.541	95.840
(6) Industry diversification	3,764	4.190	1.651	2	10
(7) International diversification	3,764	0.003	0.024	0.000	1.368
(8) Company beta	3,764	0.998	0.370	-3.075	5.989
(9) Num. recorded shareholders	3,764	63.812	32.964	0	245
(10) Num. recorded affiliates	3,764	311.912	312.974	0	1,463
(11) Companies in group	3,764	312.679	324.893	0	1,779
(12) Num. recorded subsidiaries	3,764	123.110	592.621	0	6,476
(13) Pre-tax earnings ratio	3,764	0.076	0.093	-1.408	0.532
(14) After-tax earnings ratio	3,764	0.052	0.078	-1.408	0.434
(15) Market-to book value	3,764	1.923	17.435	-513.716	76.873
(16) Total assets	3,764	46,786,616	71,977,069	2,256.728	373,109,737
(17) Number of employees	3,764	119,372.100	252,438.300	7	2,200,000
(18) Fixed asset ratio	3,764	0.249	0.145	-0.029	0.888
(19) Cash ratio	3,764	0.124	0.116	0.001	0.972
(20) R&D ratio	3,764	0.030	0.045	0.000	1.068
(21) R&D dummy	3,764	0.766	0.423	0	1
(22) GDP growth	3,764	7.384	4.412	-14.759	15.007
(23) GDP total	3,764	6,194.529	5,058.774	23.416	14,749.000
(24) Consumer price index	3,764	4.192	2.686	-0.850	26.240
(25) Lending rate	3,764	12.131	12.505	3.543	55.383
(26) Exchange rate volatility	3,764	0.035	0.027	0.000	0.206
(27) Inward FDI	3,764	81.804	74.517	-22.184	231.652
(28) Emerging market type	3,764	4.195	1.060	1	5
(29) Home country institutional quality (inverse measure)	3,764	22.241	5.699	11	42
(30) Change in home country institutional quality (inverse measure)	3,764	1.130	3.200	-6	13
(31) Host country institutional quality (inverse measure)	3,764	42.254	4.963	23	69
(32) Change in host country institutional quality (inverse measure)	3,764	-0.434	3.192	-10	11
(33) Institutional distance	3,764	5.562	1.896	1.191	18.452
(34) Change in institutional distance	3,764	2.290	1.437	-13.470	5.967

Table 1: Descriptive statistics. Cost of debt is in per cent, FDI CAPEX in million USD, Long term debt ratio and equity ratio are in per cent of total assets, Industry diversification is Number of NACE industry codes, International diversification is foreign revenues over total assets, Pre-tax earnings ratio is EBT over total assets, After tax earnings ratio is after-tax earnings over total assets, Total assets is in USD, Fixed assets ratio, Cash ratio, and R&D ratio are fractions of total assets, the R&D dummy indicates whether a firm discloses R&D expenditure, GDP growth is in per cent, GDP in billion USD, Consumer price index and Lending rate are in per cent, Exchange rate volatility is one-year volatility prior to the investment year, Inward FDI is net flow of FDI in billion USD in the year before the investment, Emerging market types are the types identified by (Hoskisson, *et al.*, 2013), Institutional quality is country risk as provided by the EIU field CORS, Institutional distance is a compound of administrative, political, financial, and economic distance (Berry *et al*., 2010).

Pairwise correlations	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
(1) Cost of debt (t+1)	1	0.052	0.734	0.029	-0.193	0.025	-0.0002	0.201	0.226	0.075	0.080	0.021	-0.032	0.0002	-0.031	-0.023	0.013
(2) FDI capital expenditure	0.052	1	0.074	0.080	-0.071	-0.018	-0.009	0.058	0.095	0.080	0.074	0.012	0.026	0.020	-0.053	0.144	0.049
(3) Cost of debt (t-1)	0.734	0.074	1	0.071	-0.235	0.045	-0.002	0.236	0.240	0.068	0.075	0.021	-0.069	-0.032	-0.008	-0.003	0.011
(4) Long term debt ratio	0.029	0.080	0.071	1	-0.645	0.055	-0.013	0.069	-0.185	0.280	0.260	-0.074	-0.428	-0.372	-0.084	0.378	0.114
(5) Equity ratio	-0.193	-0.071	-0.235	-0.645	1	-0.090	0.011	-0.113	0.039	-0.384	-0.364	0.004	0.351	0.319	0.097	-0.351	-0.207
(6) Industry diversification	0.025	-0.018	0.045	0.055	-0.090	1	0.036	0.075	0.107	0.203	0.188	0.121	-0.020	-0.010	0.008	0.190	0.190
(7) International diversification	-0.0002	-0.009	-0.002	-0.013	0.011	0.036	1	0.019	0.047	0.049	0.019	-0.012	0.063	0.055	0.004	-0.019	-0.022
(8) Company beta	0.201	0.058	0.236	0.069	-0.113	0.075	0.019	1	0.340	0.040	0.020	-0.080	-0.109	-0.098	0.004	-0.051	-0.145
(9) Num. recorded shareholders	0.226	0.095	0.240	-0.185	0.039	0.107	0.047	0.340	1	0.082	-0.042	0.082	0.264	0.253	0.0002	0.045	0.003
(10) Num. recorded affiliates	0.075	0.080	0.068	0.280	-0.384	0.203	0.049	0.040	0.082	1	0.864	-0.114	-0.070	-0.057	0.003	0.624	0.287
(11) Companies in group	0.080	0.074	0.075	0.260	-0.364	0.188	0.019	0.020	-0.042	0.864	1	-0.071	-0.081	-0.067	0.0003	0.600	0.294
(12) Num. recorded subsidiaries	0.021	0.012	0.021	-0.074	0.004	0.121	-0.012	-0.080	0.082	-0.114	-0.071	1	0.099	0.073	0.022	0.129	0.693
(13) Pre-tax earnings ratio	-0.032	0.026	-0.069	-0.428	0.351	-0.020	0.063	-0.109	0.264	-0.070	-0.081	0.099	1	0.964	0.058	-0.077	-0.004
(14) After-tax earnings ratio	0.0002	0.020	-0.032	-0.372	0.319	-0.010	0.055	-0.098	0.253	-0.057	-0.067	0.073	0.964	1	0.047	-0.063	-0.003
(15) Market-to book value	-0.031	-0.053	-0.008	-0.084	0.097	0.008	0.004	0.004	0.0002	0.003	0.0003	0.022	0.058	0.047	1	-0.011	0.010
(16) Total assets	-0.023	0.144	-0.003	0.378	-0.351	0.190	-0.019	-0.051	0.045	0.624	0.600	0.129	-0.077	-0.063	-0.011	1	0.519
(17) Number of employees	0.013	0.049	0.011	0.114	-0.207	0.190	-0.022	-0.145	0.003	0.287	0.294	0.693	-0.004	-0.003	0.010	0.519	1
(18) Fixed asset ratio	0.074	0.160	0.068	0.145	-0.030	-0.051	-0.010	0.00004	0.001	-0.126	-0.151	0.264	0.014	0.004	-0.009	-0.083	0.153
(19) Cash ratio	-0.191	-0.070	-0.208	-0.423	0.495	-0.066	0.061	0.024	0.105	-0.244	-0.212	-0.065	0.231	0.195	0.062	-0.178	-0.165
(20) R&D ratio	-0.090	-0.087	-0.114	-0.238	0.234	-0.019	-0.019	0.089	0.055	-0.121	-0.122	-0.098	-0.104	-0.137	0.039	-0.098	-0.115
(21) R&D dummy	-0.064	0.012	-0.080	-0.002	0.090	0.070	-0.016	0.154	0.031	0.033	0.053	-0.237	-0.041	-0.035	-0.031	0.026	-0.243
(22) GDP growth	0.037	-0.037	-0.049	-0.173	0.106	-0.105	-0.011	0.065	0.022	-0.117	-0.130	0.030	0.028	0.012	0.004	-0.154	-0.032
(23) GDP total	-0.193	-0.039	-0.145	-0.043	0.100	0.040	-0.033	0.060	-0.002	-0.176	-0.189	0.026	-0.034	-0.038	-0.014	-0.126	-0.058
(24) Consumer price index	0.138	0.035	0.104	-0.009	-0.060	-0.0002	-0.002	-0.017	-0.035	0.092	0.107	-0.026	0.036	0.044	0.001	0.080	0.028
(25) Lending rate	0.006	0.120	0.018	0.003	-0.016	-0.130	-0.002	-0.001	0.094	-0.003	-0.002	0.020	0.047	0.047	-0.023	0.016	-0.002
(26) Exchange rate volatility	-0.047	0.105	0.011	0.044	-0.016	-0.180	0.0005	-0.085	-0.050	0.018	0.016	-0.042	0.005	0.001	0.013	0.025	-0.025
(27) Inward FDI	-0.185	-0.038	-0.167	-0.068	0.103	0.051	-0.030	0.073	0.028	-0.196	-0.211	0.020	-0.028	-0.025	-0.022	-0.140	-0.071
(28) Emerging market type	-0.097	0.017	-0.066	-0.085	0.108	-0.167	-0.028	0.080	0.071	-0.189	-0.192	0.058	0.028	0.014	-0.007	-0.166	-0.049
(29) HC inst. quality (inverse)	-0.390	0.044	-0.343	0.114	0.021	0.061	0.037	-0.109	-0.021	-0.091	-0.103	-0.051	-0.102	-0.080	-0.050	-0.037	-0.076
(30) ΔHC inst. quality (inverse)	-0.073	0.025	-0.099	-0.023	0.029	0.136	0.009	0.077	0.119	-0.059	-0.061	0.008	-0.009	0.014	-0.057	-0.049	-0.012
(31) HSTC instit. quality (inverse)	0.071	-0.039	0.013	-0.059	0.019	0.007	0.024	-0.025	-0.051	-0.002	-0.007	0.010	0.005	0.006	0.004	-0.033	0.008
(32) Δ HSTC inst quality (inverse)	0.035	-0.033	-0.013	0.004	-0.015	0.069	0.040	0.028	-0.055	0.010	0.014	-0.024	-0.097	-0.078	-0.045	-0.034	-0.019
(33) Institutional distance	-0.026	-0.022	-0.029	-0.179	0.205	-0.066	-0.002	0.186	0.221	-0.323	-0.316	0.109	0.092	0.075	0.001	-0.218	-0.086
(34) Change in institutional distance	-0.149	-0.025	-0.132	-0.112	0.160	-0.052	-0.025	0.158	0.128	-0.275	-0.284	0.105	0.031	0.017	-0.003	-0.159	-0.048

Table 2: Part one of pairwise correlations (abbreviations: HC = home country, HSTC = host country)

Pairwise correlations	**(18)**	**(19)**	**(20)**	**(21)**	**(22)**	**(23)**	**(24)**	**(25)**	**(26)**	**(27)**	**(28)**	**(29)**	**(30)**	**(31)**	**(32)**	**(33)**	**(34**
(1) Cost of debt (t+1)	0.074	-0.191	-0.090	-0.064	0.037	-0.193	0.138	0.006	-0.047	-0.185	-0.097	-0.390	-0.073	0.071	0.035	-0.026	-0.149
(2) FDI capital expenditure	0.160	-0.070	-0.087	0.012	-0.037	-0.039	0.035	0.120	0.105	-0.038	0.017	0.044	0.025	-0.039	-0.033	-0.022	-0.025
(3) Cost of debt (t-1)	0.068	-0.208	-0.114	-0.080	-0.049	-0.145	0.104	0.018	0.011	-0.167	-0.066	-0.343	-0.099	0.013	-0.013	-0.029	-0.132
(4) Long term debt ratio	0.145	-0.423	-0.238	-0.002	-0.173	-0.043	-0.009	0.003	0.044	-0.068	-0.085	0.114	-0.023	-0.059	0.004	-0.179	-0.112
(5) Equity ratio	-0.030	0.495	0.234	0.090	0.106	0.100	-0.060	-0.016	-0.016	0.103	0.108	0.021	0.029	0.019	-0.015	0.205	0.160
(6) Industry diversification	-0.051	-0.066	-0.019	0.070	-0.105	0.040	-0.0002	-0.130	-0.180	0.051	-0.167	0.061	0.136	0.007	0.069	-0.066	-0.052
(7) International diversification	-0.010	0.061	-0.019	-0.016	-0.011	-0.033	-0.002	-0.002	0.0005	-0.030	-0.028	0.037	0.009	0.024	0.040	-0.002	-0.025
(8) Company beta	0.00004	0.024	0.089	0.154	0.065	0.060	-0.017	-0.001	-0.085	0.073	0.080	-0.109	0.077	-0.025	0.028	0.186	0.158
(9) Num. recorded shareholders	0.001	0.105	0.055	0.031	0.022	-0.002	-0.035	0.094	-0.050	0.028	0.071	-0.021	0.119	-0.051	-0.055	0.221	0.128
(10) Num. recorded affiliates	-0.126	-0.244	-0.121	0.033	-0.117	-0.176	0.092	-0.003	0.018	-0.196	-0.189	-0.091	-0.059	-0.002	0.010	-0.323	-0.275
(11) Companies in group	-0.151	-0.212	-0.122	0.053	-0.130	-0.189	0.107	-0.002	0.016	-0.211	-0.192	-0.103	-0.061	-0.007	0.014	-0.316	-0.284
(12) Num. recorded subsidiaries	0.264	-0.065	-0.098	-0.237	0.030	0.026	-0.026	0.020	-0.042	0.020	0.058	-0.051	0.008	0.010	-0.024	0.109	0.105
(13) Pre-tax earnings ratio	0.014	0.231	-0.104	-0.041	0.028	-0.034	0.036	0.047	0.005	-0.028	0.028	-0.102	-0.009	0.005	-0.097	0.092	0.031
(14) After-tax earnings ratio	0.004	0.195	-0.137	-0.035	0.012	-0.038	0.044	0.047	0.001	-0.025	0.014	-0.080	0.014	0.006	-0.078	0.075	0.017
(15) Market-to book value	-0.009	0.062	0.039	-0.031	0.004	-0.014	0.001	-0.023	0.013	-0.022	-0.007	-0.050	-0.057	0.004	-0.045	0.001	-0.003
(16) Total assets	-0.083	-0.178	-0.098	0.026	-0.154	-0.126	0.080	0.016	0.025	-0.140	-0.166	-0.037	-0.049	-0.033	-0.034	-0.218	-0.159
(17) Number of employees	0.153	-0.165	-0.115	-0.243	-0.032	-0.058	0.028	-0.002	-0.025	-0.071	-0.049	-0.076	-0.012	0.008	-0.019	-0.086	-0.048
(18) Fixed asset ratio	1	-0.349	-0.265	-0.034	0.033	0.009	-0.034	-0.014	0.041	0.001	0.044	0.068	-0.032	-0.003	-0.004	0.061	0.038
(19) Cash ratio	-0.349	1	0.427	0.047	0.087	0.054	-0.045	0.020	-0.045	0.081	0.088	-0.002	0.065	0.018	0.007	0.184	0.132
(20) R&D ratio	-0.265	0.427	1	0.368	0.067	0.046	-0.044	-0.007	-0.040	0.047	0.043	-0.083	-0.026	0.001	-0.030	0.119	0.062
(21) R&D dummy	-0.034	0.047	0.368	1	0.005	0.014	-0.006	-0.005	-0.010	0.014	-0.022	-0.008	-0.024	-0.009	-0.003	0.018	0.020
(22) GDP growth	0.033	0.087	0.067	0.005	1	0.642	-0.180	-0.405	-0.182	0.577	0.670	-0.112	-0.028	0.149	0.118	0.211	0.492
(23) GDP total	0.009	0.054	0.046	0.014	0.642	1	-0.259	-0.418	-0.147	0.914	0.786	0.187	0.123	-0.034	-0.018	0.161	0.602
(24) Consumer price index	-0.034	-0.045	-0.044	-0.006	-0.180	-0.259	1	0.307	0.245	-0.121	-0.227	-0.079	0.080	0.324	-0.071	-0.026	-0.190
(25) Lending rate	-0.014	0.020	-0.007	-0.005	-0.405	-0.418	0.307	1	0.457	-0.310	-0.166	0.061	0.064	0.090	-0.109	0.093	-0.284
(26) Exchange rate volatility	0.041	-0.045	-0.040	-0.010	-0.182	-0.147	0.245	0.457	1	-0.152	0.047	-0.026	-0.119	-0.131	-0.263	0.071	-0.015
(27) Inward FDI	0.001	0.081	0.047	0.014	0.577	0.914	-0.121	-0.310	-0.152	1	0.717	0.284	0.273	0.023	0.075	0.141	0.539
(28) Emerging market type	0.044	0.088	0.043	-0.022	0.670	0.786	-0.227	-0.166	0.047	0.717	1	0.063	0.035	-0.159	-0.012	0.248	0.606
(29) HC inst. quality (inverse)	0.068	-0.002	-0.083	-0.008	-0.112	0.187	-0.079	0.061	-0.026	0.284	0.063	1	0.586	-0.047	0.233	-0.165	0.015
(30) ΔHC inst. quality (inverse)	-0.032	0.065	-0.026	-0.024	-0.028	0.123	0.080	0.064	-0.119	0.273	0.035	0.586	1	0.099	0.251	-0.067	-0.005
(31) HSTC instit. quality (inverse)	-0.003	0.018	0.001	-0.009	0.149	-0.034	0.324	0.090	-0.131	0.023	-0.159	-0.047	0.099	1	0.218	-0.013	-0.148
(32) Δ HSTC inst quality (inverse)	-0.004	0.007	-0.030	-0.003	0.118	-0.018	-0.071	-0.109	-0.263	0.075	-0.012	0.233	0.251	0.218	1	-0.104	-0.089
(33) Institutional distance	0.061	0.184	0.119	0.018	0.211	0.161	-0.026	0.093	0.071	0.141	0.248	-0.165	-0.067	-0.013	-0.104	1	0.479
(34) Change in institutional distance	0.038	0.132	0.062	0.020	0.492	0.602	-0.190	-0.284	-0.015	0.539	0.606	0.015	-0.005	-0.148	-0.089	0.479	1

Table 3: Part two of pairwise correlations (abbreviations: HC = home country, HSTC = host country)

DV: marginal cost of debt	*Model (1)*	*Model (2)*	*Model (3)*	*Model (4)*
Intercept	2.283***	1.596**	3.688***	4.946***
	(0.607)	(0.523)	(0.774)	(0.829)
Cost of debt t-1		0.480***	0.475***	0.476***
		(0.014)	(0.014)	(0.014)
Long term debt ratio		0.623***	0.611**	0.588**
		(0.187)	(0.187)	(0.187)
After tax earnings		3.518***	3.526***	3.610***
		(0.809)	(0.807)	(0.802)
Eearnings before tax		-3.572***	-3.570***	-3.648***
		(0.702)	(0.700)	(0.696)
Market value over book value		-2.671**	-2.658**	-2.478**
		(0.915)	(0.913)	(0.908)
Firm Size		-0.063**	-0.066**	-0.063**
		(0.023)	(0.023)	(0.023)
Cash Ratio		-0.832***	-0.872***	-0.902***
		(0.197)	(0.197)	(0.196)
Shareholders		0.003**	0.003***	0.003***
		(0.001)	(0.001)	(0.001)
Institutional distance			-0.239**	-0.386***
			(0.090)	(0.095)
Home country institutional quality (inverted)			-0.024***	-0.032***
			(0.006)	(0.007)
Host country institutional quality (inverted)			-0.032**	-0.050***
			(0.011)	(0.012)
Change in institutional distance				0.028
				(0.026)
Change in home country institutional quality (inverted)				0.034***
				(0.009)
Change in host country institutional quality (inverted)				0.063***
				(0.017)
*Institutional distance * host country institutional quality (inverted)*			0.005**	0.008***
			(0.002)	(0.002)
*Institutional distance * change in host country institutional quality (inverted)*				-0.011***
				(0.003)
Firm Controls	NO	YES	YES	YES
Industry Controls	YES	YES	YES	YES
Year Controls	YES	YES	YES	YES
Observations	3,764	3,764	3,764	3,764
Log Likelihood	-5,995.452	-5,264.778	-5,271.107	-5,269.617

Table 4: Model 1 is an empty base-line model with only industry and year dummies. Model 2 is a firm level model (insignificant controls are not reported). Model 3 adds institutional distance and static institutional quality measures for home and host country. Model 4 is the full dynamic model including institutional dynamic and the interaction of distance and host country institutional quality. Models 2-4 include industry, year and country-pair fixed effects. Model 4 also uses random effects on the country-pairing level. Additional controls include: log of FDI capital expenditure, industry diversification, market-to-book value, log of number of employees, R&D ratio, R&D dummy, international diversification, company beta, fixed assets ratio, size of corporate group, number of subsidiaries, cash ratio, host country GDP growth, log of host country GDP, consumer price index host country, host country lending rate, host country classification acc. Hoskisson et al (2013), host country incoming FDI, and variation in the foreign exchange rate between home and host country.. *, **, and *** indicate significance on the 0.05, 0.01, and 0.001 level respectively.

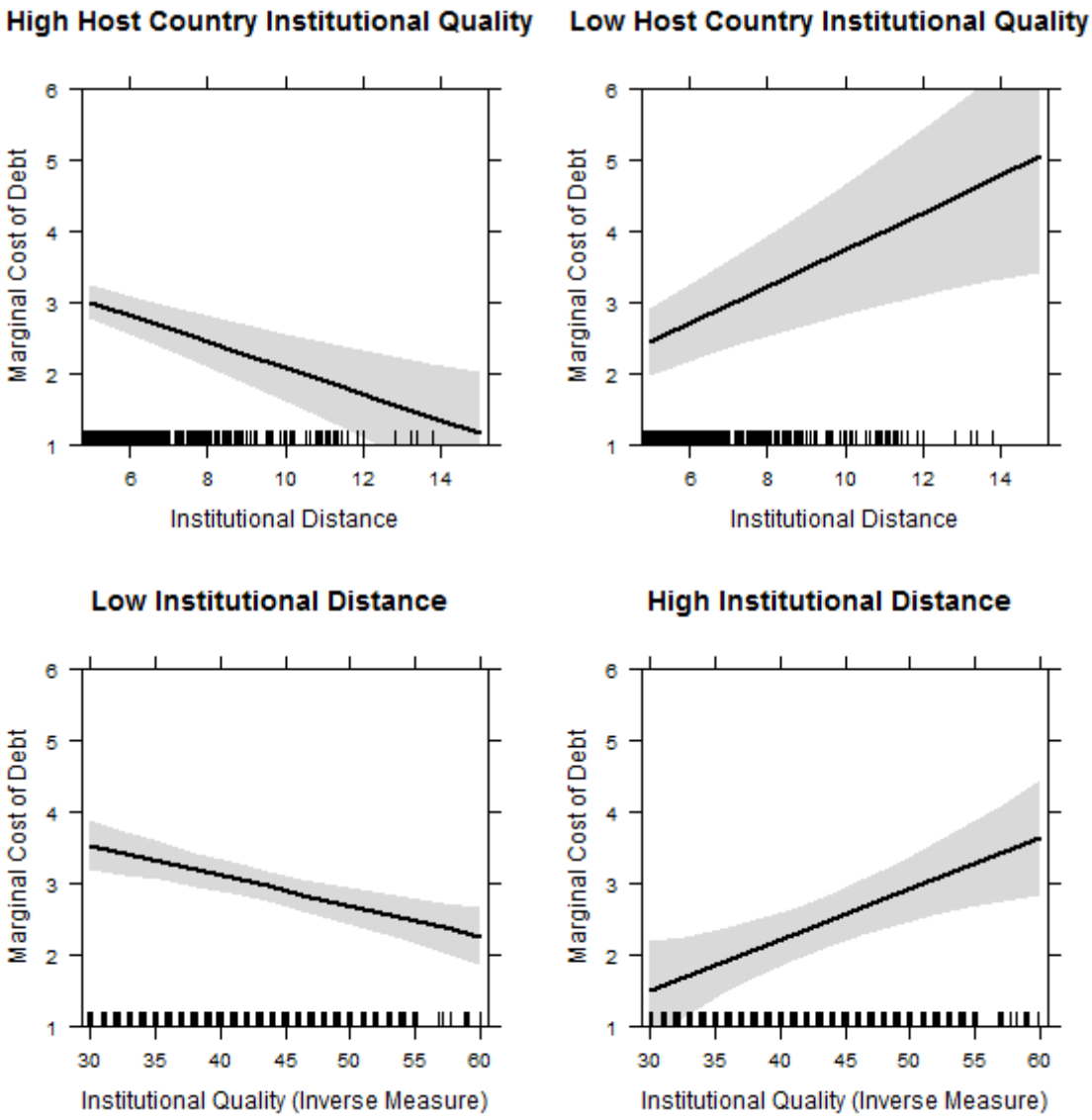

Figure 2: Effect plots of institutional distance and host country institutional distance (CORS inverted) on the marginal cost of debt. Top panels display the effect of distance on the cost of debt given strong (left, CORS=25) and weak (right, CORS=80) institutions. The bottom panels are the impact of institutional quality given distance, low distance (1) on the left and high distance (15) on the right. Dashes in the bottom of the panels show the density of observations. The grey area represents conditional expectation errors of the effect.

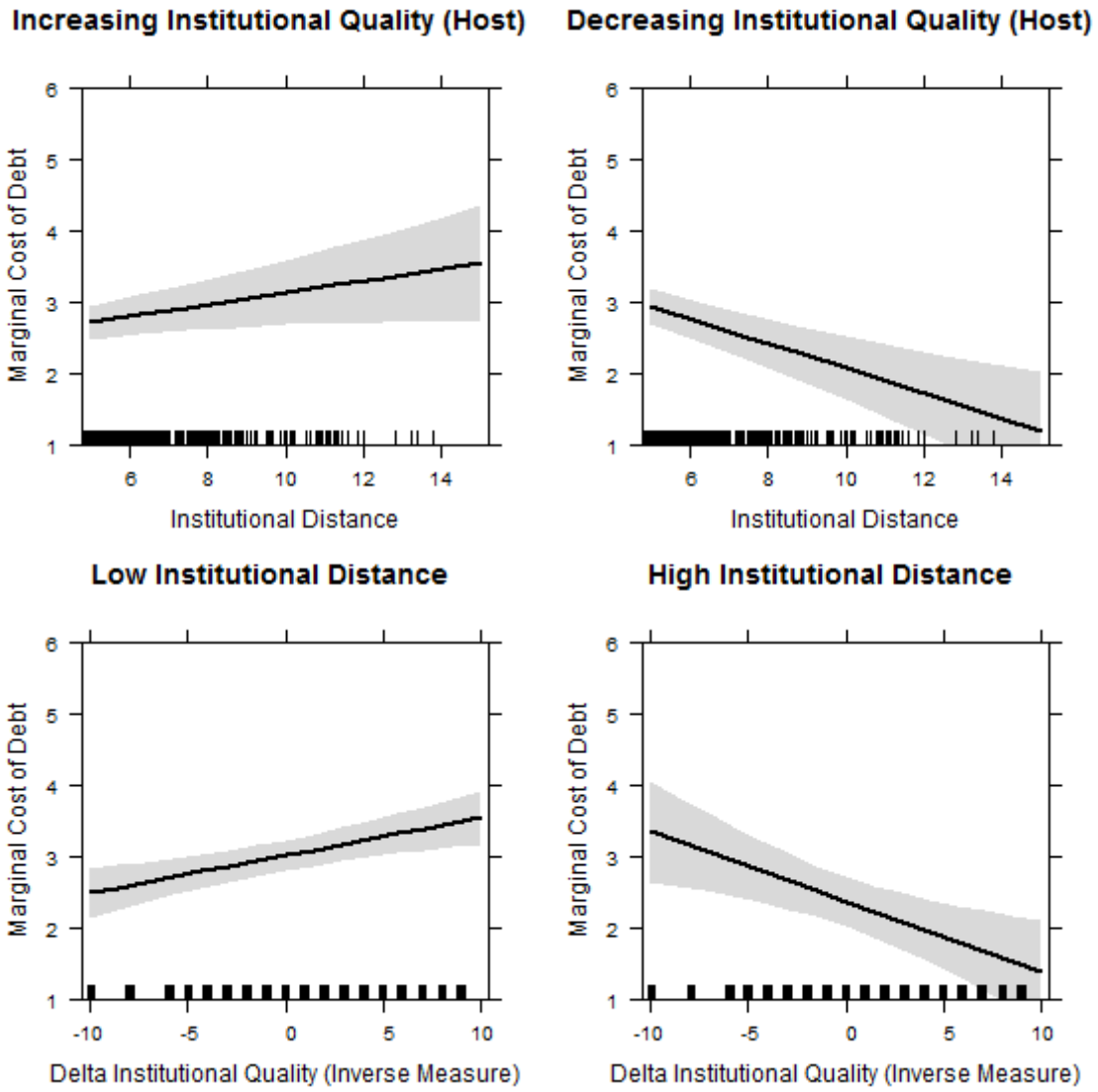

Figure 3: Effect plots of institutional distance and changes to host country institutional quality on the marginal cost of debt. Top panels display the effect of distance on the cost of debt given expectations of improving (left, Change in CORS = -12) and deteriorating (right, CORS =+12) institutional quality. The bottom panels are the impact of expectations of changes to the institutional quality in the host country given low distance (1) on the left and given high distance (15) on the right. Dashes in the bottom of the panels show the density of observations. The grey area represents conditional expectation errors of the effect.

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