Financing the Outward Foreign Direct Investment - Conceptual Framework

***Dr. Vanita Tripathi**

**** Ms. Sonal Thukral**

Abstract

In the wake of increasing Outward Foreign Direct Investment (OFDI) from India their financing in the form of intra-company loans and equity is an interesting area of research. Outward foreign direct investment by a member firm (called as parent firm) to another member firm in a host country in a multinational system (called as foreign affiliate) can take the form of debt (parent debt) and equity (parent equity). Myers' pecking order theory talks about the external debt and external equity but there might be some preference hierarchy for internally generated funds - parent debt or parent equity. The literature focusing on nature of these flows (debt or equity) is scant owing to opacity of flows within a multinational system. The opacity of flows within a multinational makes the analysis empirically challenging and hence one may focus on the outward foreign direct investment by a parent firm into their foreign affiliates to capture the financial flows.

The paper discusses the two types of capital market from where a multinational could tap funds, laying emphasis on internal capital market, a multinational specific advantage, besides various issues specific to internal capital market. The paper presents three perspectives to view such an analysis that have implications for efficiently utilising the internal capital market of the multinational system, supply-side determinants of capital structure of foreign affiliates, and the outward foreign direct investment. The paper thus attempts to provide areas where the contribution can be made especially with regards to the determinants of OFDI, a value addition to both the international finance and international business literature.

Keywords: Capital structure, Capital market, Internal capital market, Internal finance, Outward foreign direct investment, Parent debt, Parent equity

* Associate Professor, Department of Commerce, Delhi School of Economics, University of Delhi. E-mail: vanitatripathi1@yahoo.co.in

** Assistant Professor, Department of Commerce, Shri Ram College of Commerce, University of Delhi, E-mail: sthukral1@gmail.com (Corresponding Author)

1. Introduction

As multinational corporations expand their operations abroad, their need for overseas financing has increased accordingly. One of the reasons why FDI is not undertaken is the inability to finance FDI activities by firms. The difficulties of small firms in financing the development of international activities have long been stressed as a significant constraint on their outward push and on the foreign operation modes they are able to employ (Welch, Benito, & Petersen, 2008).

A firm operating overseas has a wide array of choice of financing available to choose from. They invest abroad by using a mix of internal and external sources of finance. A foreign affiliate can borrow from:

- External sources (outside the multinational system) i.e., the host country or third countries, thus taking advantage of **external capital market.**
- Internal sources (within the multinational enterprise) i.e., either from its parent or its sister subsidiaries, thus taking advantage from the **internal capital market.**

The fact that a multinational (directly or through its affiliates) can receive loan externally or internally vastly expands the number of possible alternatives for financing. Where n is the number of affiliate companies, a typical MNC would have $3n^2$ potential financing channels to consider, thus aggravating the problems of financial coordination (Ness, Jr., 1972).

The capital flows in the system are used to finance these ventures abroad in a manner that maintains low global cost of funds. When foreign direct investment is made out of a country it is called as outward foreign direct investment from that country. In a multinational setting, the firm undertaking OFDI is called as the parent firm and the firm in which it invests is called the foreign affiliate. The investment in the **foreign affiliate** manifest in the form of debt or equity and when they are provided by the parent firm, we call them as **parent debt or parent equity.**

Financing of FDI has not gathered much attention in literature due to the difficulty in availability of data and the opacity of flows of funds in a multinational system. The present paper sheds light on the implications of financing of OFDI on the finance literature and international business literature.

In light of scant literature on financing the OFDI, the primary objective of the study is to understand the financing pattern of OFDI by multinational enterprises. The objectives can be enlisted as under:

1. To understand and appraise the different types of capital market (external and internal capital market) from where the funds may be raised by firms of a multinational system to finance their Outward Foreign Direct Investment (OFDI).

2. To understand different sources of raising finance from internal capital market.
3. To analyse various issues in raising finance from internal capital market.
4. To understand different perspectives of OFDI.
5. To understand the implications of OFDI financing for theories of FDI.

The structure of the paper is organized as follows: Section 2 presents the suitability of internal capital market over external capital market. Section 3 discusses constituents of internal capital market. Section 4 highlights the issues related to internal capital market while Section 5 discusses the three perspectives of financing the OFDI. Section 6 discusses the role of financing dimension of OFDI in various theories of international business. Finally, the concluding Section presents areas of future research that may impact financing of OFDI.

2. Financing the OFDI - Suitability of Internal Capital Market over External Capital Market

The implications of financing from external capital market and internal capital market, and why the latter has an edge over the former are explained as follows.

2.1 External Capital Market

Financial markets are affected by adverse selection, moral hazard, principal-agent problems, and herding behaviour. Cross-border finance is likely to accentuate these problems due to a variety of financial environments faced by MNEs. A multinational is characterized by financial flows between its related entities. The opaque nature of flows subjects them to greater manipulation by the multinational. As a result, the external lenders view these multinationals with scepticism and therefore impound a higher premium on funds extended to their affiliates abroad. So, to raise external finance, it becomes imperative on part of the multinational to reduce information asymmetries which gets aggravated in a multinational system. Self-financing, thus, comes to the rescue of such firms that are hesitant to share information with external lenders.

Enforcement of financial contracts covered by different jurisdictions is also challenging for multinationals to deal with. Also, if financial markets in host country are underdeveloped, firms may find it difficult to access external capital market, steering them to rely on internal capital market. Obtaining funds from internal capital market eliminates the transaction cost of raising finance in external capital markets. Thus, there lies an implication of internalising financing strategy of the multinational and thereby reducing the transaction cost (Williamson, 1988).

2.2 Internal Capital Market

2.2.1 Internal Capital Market as Multinational Specific Advantage

Corporate finance literature suggests that small and medium sized firms rely more on internal finance than large firms due to constraints in financing externally (Butters & Lintner, 1945). Fluctuation in internal finance makes this source uncertain for them. However, in a multinational setting, internally available funds offer them a unique advantage. Internal capital market helps the multinational to manage the funds globally and transfer funds from cash-rich entities to cash-deficient ones. The volatility in internal funds in a multinational system operating worldwide is far less than small domestic firms because they can smoothen out liquidity fluctuations across its various entities. This offers a multinational an edge over its rivals in international markets by having access to internal capital market which is a cheaper source of finance.

Affiliates of parent firm residing in under-developed capital markets or the ones that are illiquid may not be able to raise external debt at competitive prices. By resorting to internal funds available such firms can overcome market imperfections in external capital markets to a great extent. Availability of internal funds is especially important for small and medium sized firms that often lack characteristics that may attract external investors to fund them. Availability of internal funds puts a limit to increasing marginal cost of capital that they experience. Internal capital market, thus, is a multinational specific advantage that helps MNEs to maintain low global cost and availability of capital.

2.2.2 Bright and Dark Side of Internal Capital Market

When firms are constrained in their ability to raise funds from international markets, internally available funds become an important determinant of financing strategy of parent firm to provide funds to their foreign affiliates. Internal capital financing has its own costs and advantages. A copious literature, dating back to Fazzari, Hubbard, and Petersen (1988), has emphasised that availability of internally generated funds mitigate their financial constraints, giving them an edge over their cash-poor rival counterparts. This advantage is even more when financial markets are under-developed. Loans are the dominant observable channel through which Indian business groups transfer cash across member firms (Khanna & Palepu, 2000). There are various motives with which the entities in multinational system tap internal capital market. Khanna and Yafeh (2005) show that Indian business groups use intragroup loans to smooth liquidity across firms. It helps to share risk across group firms (Khanna and Yafeh, 2005). Internal capital market also plays an important role to foster the affiliated firm's access to external finance (Khanna & Palepu, 2000; Shin &

Park, 1999. Financial flows between group firms can be utilised to finance profitable ventures abroad, supporting weak member firms (Bertrand, Mehta & Mulliniathan, 2002; Friedman, Johnson, and Mitton, 2003; Gopalan et al., 2007). Khanna and Yafeh (2005) argue that internal capital market in business groups promotes efficient risk-sharing; while Gopalan, Nanda, and Seru (2007) show that the reputational risk of firms in a business group makes them support each other in times of distress via intra-group loans. This points to the bright side of internal capital market.

On the other hand, business groups whose firms are operating worldwide are also seen to exacerbate agency conflicts between insiders and minority shareholders (Claessens, Djankov, & Lang, 2000). The conglomerates experience distortment in investments due to agency conflicts between insiders and outside shareholders (Ozbas & Scharfstein, 2010; Rajan, Servaes, & Zingales, 2000; Scharfstein & Stein, 2000; Seru, 2014). Tunneling of funds from minority shareholders to the group insiders have been observed (Bertrand, Mehta, and Mullainathan, 2002; Johnson, La Porta, Lopez-de-silanes, & Shleifer, 2000). The group insiders may even prop member firms in distress to tunnel their resources (Friedman, Johnson, & Mitton, 2003). These reasons increase monitoring cost by external lenders and may refrain them to extend credit to the affiliates. Such situations steer affiliates to their parent firms for funds and may keep external lenders away from financing the foreign affiliates.

3. Implications of Constituents of Internal Capital Market

A firm in the multinational system can obtain capital from both internal and external sources (refer Figure 3.1). These are discussed as follows:

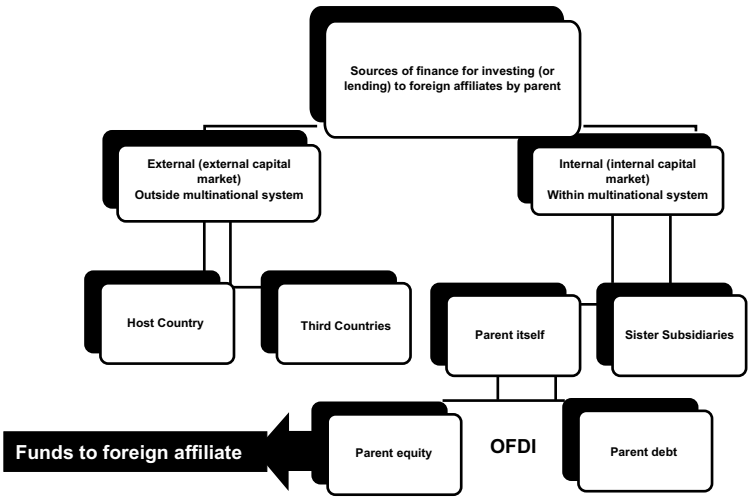

Figure 1: Sources of Funds to Finance OFDI

3.1 Internal Capital Market

In terms of the multinational system, capital is obtained internally when funds are obtained from parent firm, funds from operations, from retained earnings, and inter-subsidiary capital transfers. These are explained as follows:

3.1.1 Funds from Parent Firm

The three major types of funds supplied by the parent to its affiliates are parent equity, parent debt, and parent-company guarantees.

(1) Parent Equity

Equity contributions by the parent firm into its foreign affiliate signal both authorities in the host country and external creditors about its solvency. Provisions of capital by the parent firm enables foreign subsidiary to procure additional loans from external lenders, increasing their capital base (Kim, 2011). Besides cash, the parent may acquire a percentage of equity of its foreign business in exchange for machinery, equipment, tools, and intangibles. The parent firm has residual claim on earnings and assets in the event of liquidation. Equity investment by parent is most acceptable to the host country and external creditors while they grant loans to foreign affiliates. Also, the dividends from the equity investment are heavily taxed as they are subject to local income taxes and withholding taxes (Kim, 2011). Thus, MNEs refrain themselves from making equity investments in their foreign businesses.

(2) Parent Debt

MNEs may provide investment funds to their foreign businesses in the form of intercompany loans (called parent debt). Characteristically, parent debt usually contains a specified repayment period for the principal amount and earns interest income which is taxed relatively lightly as compared to parent equity. Parent loans are popular than equity contributions as a form of investment in foreign businesses for a number of reasons. First, parent loans give parent firm greater flexibility in repatriating funds from its foreign affiliate as it attracts less restrictions by host government. Second, tax considerations are another reason for favouring parent loans over equity contributions. Interest payments on internal loans are tax deductible in the host country while dividends are not (Kim, 2011). Moreover, principal payments, unlike dividend payments do not generally constitute taxable income. Thus, it is possible that both parent and subsidiaries will save taxes by using loans instead of equity contributions. MNEs can provide loans to their subsidiaries by delaying the collection of accounts receivables also. This involves no formal documents and hence is easier to use. However, the host governments limit the length of the credit terms.

(3) Parent Guarantees

When foreign subsidiaries have difficulty in borrowing money, a parent may guarantee the debt of their foreign subsidiaries. The type of loans with parent guarantees and the availability of such loans depend largely upon the parent's reputation and credit worthiness.

3.1.2 Funds provided by Operations

Once an affiliate gets well established in the foreign land, its own fund flows - retained earnings and depreciation become major sources of its funds. Foreign affiliates generally face restriction from host country to remit their earnings in hard currency that may hit their balance of payments. This frequently forces foreign affiliates to reinvest their internally generated funds in the host country.

3.1.3 Loans from Sister Subsidiaries

A subsidiary may take loan from its sister subsidiary that does not require funds immediately. However, many countries impose exchange restrictions on capital movements to limit the possibilities of inter-subsidiary loans. Moreover, extensive use of inter-subsidiary financial links makes it extremely difficult for a parent firm to control its subsidiaries effectively. On the contrary, when there are only a few subsidiaries within a firm's multinational system, it is easier to arrange inter-subsidiary loans. The parent firm may prefer to have its central staff to handle all excess funds or to establish a central pool of these funds on a worldwide basis.

4. Issues Relating to Internal Capital Market

4.1 Under-developed External Capital Market, and Internal Capital Market

Shallow and under-developed capital market of host country significantly reduces the accessibility of funds by foreign affiliates due to unavailability of funds or the availability of debt at a high premium (Aggarwal & Kyaw, 2008; Desai, Foley, & Hines Jr., 2004). This steers the foreign affiliates to internal funds.

4.2 Asymmetric Information and Internal Finance

Information costs play a distinctive role in investment decision of a firm as pointed by Gordon and Bovenberg (1996). They provide a model to explain the Feldstein and Horioka (1980) puzzle that relies on the existence of asymmetric information between investors in different countries. The asymmetric information between external lenders and the firm is higher in case of the multinational system, making external finance expensive. Reliance on internal funds before resorting to external funds has been emphasised in Myers' pecking order theory. The internal managers and

shareholders are better informed about the true value of the firm than external lenders hence making external finance expensive. The information asymmetries may be reduced by parent if internal funds are provided to affiliates. Nature of funds may also help to reduce such asymmetries. Parent equity provided to affiliates may pass reputation of parent to affiliates, thereby reducing the asymmetries between affiliates and external lenders. The firms that invest more in reputational or brand assets may not be willing to raise funds from external market due to fear of divulgence of information about the firm to external lenders, making them to rely on internal funds. So, internalisation of finance function adds an important dimension to the financing of OFDI.

4.3 Agency Costs of Internal Capital Market

Internal market may accentuate agency cost problems not only between outsiders and inside shareholders but also amidst managers at parent firm and affiliates. There is a tussle between empire building tendencies of managers and the fear of squandering off money provided by managers at parent firm to managers at affiliates. Provision of parent debt may limit such tendencies (Jensen's free cash flow hypothesis). Manager at the parent firm has control and monitoring rights that ensures carrying out value-enhancing activities at the affiliate. Providing funds to the affiliate may act as a whip on these affiliates preventing them from squandering off funds. On the other hand, this may prompt manager at affiliate to refrain from risky ventures, though profitable. This gives rise to agency conflict between managers at the two entities.

4.4 Coinsurance Effect and Internal Capital Market

Diversification of a firm may lead to the reduction of total risk, reducing its probability of default and thereby paving way for increased debt. This is what is called as 'coinsurance effect' in the finance literature (Kim and McConnell, 1977). Extending the same concept to a multinational setting, the chances of default of a foreign affiliate, whose risks and rewards are shared by its parent firm, reduces as parent firm may bail out its affiliate from bankruptcy that may arise. Gopalan et al. (2007) also shows that one of the motives of Indian firms extending loans abroad is to prevent bankruptcy of distressed affiliates. This coinsurance effect may help to overcome hesitation of external lenders in lending to foreign affiliates.

5. Three Perspectives of Financing Pattern of OFDI

Studying financing of foreign affiliates by parent firm can be viewed from three perspectives:

5.1 Financing the Outward Foreign Direct Investment from India

Most of the studies have focused on the determinants and motives of OFDI (Buckley et al., 2010; Elango & Pattnaik, 2007; Pradhan, 2004; Kumar, 2007). However, the financing aspect of OFDI (or even FDI) has not been gathered much attention. An attempt has been made by Chowdhry and Coval (1998) that consider parent debt or parent equity to finance foreign affiliates of MNEs. Study by Gopalan, Nanda, and Seru (2007) analyses loan outflows from India but could not adequately explain the choice between nature of internal financing - debt or equity to finance foreign affiliates.

Funds provided by parent firm to affiliate abroad is the outward foreign direct investment from the home country. Macroeconomic factors of the host country are one set of factors that impact the financing of OFDI (Tripathi & Thukral, 2013). A recent study by Tripathi & Thukral (2016) notes the importance of financial market development to affect the OFDI financing by Indian MNEs. However, there is a dearth of studies that empirically examines various country level (host and home country), industry level and parent firm characteristics that have a bearing on financing the OFDI by parent firm.

5.2 Financing from the Internal Capital Market

Small firms or firms that are not part of business groups may be credit constrained due to non-availability of adequate internal funds and capital market imperfections. In case of a multinational, internal capital market acts as a multinational specific advantage by infusing capital in cash-deficient member firms from cash-rich member firms. Internal capital market helps business groups to overcome constraints in raising external capital (Hoshi, Kashyap, and Scharfstein, 1991). When external markets are underdeveloped, internal capital market helps the member firms (Baker, 1992; Ramirez, 1995). One of the reasons for formation of business groups is availability of internal financing (Almeida, Park, Subrahmanyam, & Wolfenzon, 2011; Gopalan, Nanda, & Seru, 2007). On the dark side, controlling shareholders may siphon off cash flows and thereby engage in 'tunnelling' activities (Johnson, La Porta, López de Silanes, & Shleifer, 2000) and negative tunneling, called 'propping' wherein the capital is reallocated within the multinational system to bail out the troubled group affiliate.

5.3 The Supply-side Determinants of Capital Structure of Affiliates

The determinants of capital structure can be shaped by demand side factors or the supply side factors. When foreign affiliates receive funds from parent

firms, the funds shapes its capital structure. The literature has focused mainly on the demand-side factors (from the perspective of foreign affiliates) of capital structure. The supply-side factors i.e. the financing strategies of parent firm also shape the capital structure of the foreign affiliates. So, when we study the financing of OFDI, we take into account the perspective of parent firm which is nothing but the supply side factors that shape the capital structure of foreign affiliates. The three perspectives discussed above are shown in Figure 2.

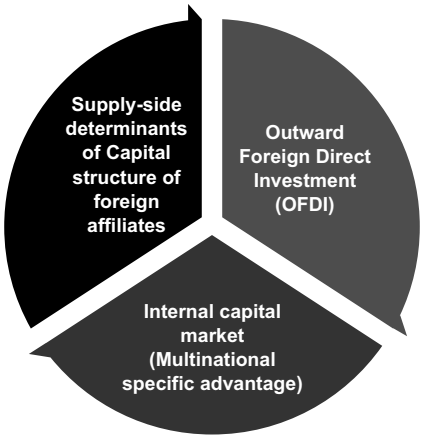

Figure 2: Three perspectives to finance foreign affiliates

6. Theories of FDI and Implications for OFDI Financing

This section reviews implications of OFDI financing for various theories of FDI.

6.1 The Classic Theory of International Capital Flow

One of the earliest theories of FDI developed by MacDougall (1960) and subsequently elaborated by Kemp (1964) propounded that the capital flows from capital-abundant economy to a capital-scarce economy till the marginal productivity of capital is equal in both the countries. Earlier theories have focused on FDI being motivated by cross border capital flows in search of higher return on capital. As long as there is no risk and barrier to capital flows, the capital flows from countries with low interest rates to countries with high interest rates. Movement of capital was criticized by Hymer (1976) who propounded that FDI occurs due to market imperfections. Earlier theories assumed perfect markets. This naïve assumption erodes veracity of the theory and capital can flow in any direction (Hosseini, 2005).

6.2 Monopolistic Advantage Theory

The monopolistic advantage theory suggests that the MNE possesses monopolistic advantages that enable it to operate its subsidiaries abroad more profitably than its rival counterparts. Monopolistic advantage is the benefit accrued to a firm that gives it a monopolistic power in the market. These advantages are firm-specific or ownership-specific advantages. To be competitive abroad, firms select those markets and industries where they can capitalise on their strengths. According to this theory, monopolistic advantages emanate from two sources: superior knowledge and economies of scale. The term knowledge includes production technologies, managerial skills, industrial organization, and knowledge of product. Economies of scale occur through horizontal or vertical FDI. Such advantages are specific to the investing firm rather than to the location of its production.

OFDI Financing Dimension: We argue that finance available to multinational is a multinational-specific advantage that offers it a monopolistic advantage. This gives the multinational an added advantage of having access to not only external funds but also large internal funds of the multinational system, which is at a low cost. By transferring funds from 'cash cows' to 'stars' and 'dogs' (BCG matrix), the multinational growth is accelerated. Thus, access to internal capital market helps the multinational to reap benefits of economies of scale.

6.3 Oligopoly Theory

The theory, given by Frederic Knickerbocker (1973), argued that firms in industries characterized by oligopoly would tend to follow each other's location decisions. An action by a firm in an industry accentuates counter reactions by rival firms. Knickerbocker argued that firm in an industry might undertake FDI because of mimetic reasons.

OFDI Financing Dimension: We believe that guided by follow-the-leader behaviour of firms in an industry, the financing strategy of one firm may be followed by other firms in that industry. So, firms may follow other firms in an industry and resort to internal financing simply due to mimetic reasons.

6.4 Internalisation Theory

Internalisation theory suggests that external market does not provide an efficient environment to multinationals to use its technology resources in production (Buckley & Casson, 1976). The imperfections in the market pose certain challenges to the operations of the firm that may increase its transaction cost. The firm then resorts to its internal market to internalize its activities and thereby reduce cost of these market imperfections or benefitting from functions that are internally integrated in the intra-organizational network. Internalisation offer advantages to the firm by

avoiding search and negotiating costs, costs of moral hazard , costs of violated contracts and ensuing litigation, government intervention, besides capturing economies of interdependent activities, and controlling supplies and conditions of sale of inputs and market outlets.

OFDI Financing Dimension: We argue that internalising the finance function by a multinational offers it an advantage by avoiding above mentioned costs, thereby reducing transaction cost of obtaining funds in external market. Thus, access to internal capital market provides an added advantage to the multinational firms. Access to internal capital market provides global competitive advantage to a multinational by integrating the financing function of various units of the multinational system. The flow of funds across the system helps in tapping the location-specific advantages and competitive advantages of the firm more efficiently.

6.5 The Eclectic Paradigm

Dunning's (1977) Eclectic paradigm is a multifaceted theory of FDI that takes into account a broader picture of various factors that propels the firm to undertake FDI. This paradigm includes three dimensions that a firm must consider:

- Ownership advantages (O): the company's competitive advantages, such as proprietor knowledge, management skills, natural endowments, manpower, capital, goodwill, and economies of scale
- Location advantages (L): the relevant cost and risks posed by economic, political, cultural, and regulatory environment of the host country
- Internalisation advantages (I): the benefits derived by firm if it undertakes the managing of operations in host country all by itself rather than relying on local suppliers, distributors etc.

This paradigm is also referred to as OLI framework. It weaves the macroeconomic aspects (L) as well as microeconomic aspects (O and I) in a theory of FDI that prevents the firm to be trapped in a narrow focus while deciding to undertake FDI, providing a comprehensive view to explain FDI vis-à-vis other theories of industrial organization and location-based theory.

OFDI Financing Dimension: Access to internal funds of a multinational system offers an ownership-specific advantage to the parent firm. These funds are available to the affiliate at low cost and may be transferred to 'growing' affiliates from 'matured' affiliates. This gives an added advantage to the firm vis-à-vis local firms. So, by internalising the finance function, the high cost of funds in external market owing to information asymmetries or under developed financial markets is greatly reduced. Reduction in

transaction cost by accessing internal funds acts as a competitive advantage to the multinational undertaking FDI.

Dunning also adds a variable of strategic change to his theory and asserts that international production is sum of these strategic responses of the firm to OLI that shapes the direction and pattern of FDI (Dunning, 1980, 1993). Since we focus on the financing of OFDI, financing strategy of the firm (choice between parent debt and parent equity) may be added to the OLI framework.

6.6 Currency based Theories

The currency based theories are based on imperfect foreign exchange and capital market. One such theory has been developed by Aliber (1971). He postulates that firms move from a strong-currency country to a weak-currency country. FDI in US, Canada and United Kingdom have stood up to empirical testing of this hypothesis. They also suggest that exchange risk theory of FDI explains the geographic and industrial patterns of FDI. Another theory based on strength of currency has been given by Froot and Stein (1991). They postulated that it is cheaper for foreign firms to acquire foreign assets in a country where the currency has devalued because the depreciation lowers the wealth of domestic residents as compared to foreign residents. Theory by Caves (1988) also supports the view that exchange rate influences FDI and finds a negative relationship between exchange rate depreciation and FDI. Makin (1974) explained FDI in terms of changes in level of exchange rates, associating overvaluation of a currency with outflow of FDI and undervaluation with inflow.

OFDI Financing Dimension: These theories have implications for internal funds transferred by parent firm to affiliates abroad. The internal funds are expected to be issued to the affiliates if the host country experiences depreciation otherwise the financing of FDI may take place from external sources.

6.7 Political Risk Theories

These theories concentrate on political risk. Political stability in host countries attracts FDI in host country (Kamal & Safizadeh, 1989) and political instability in host country encourages FDI outflow from host country (Tallman, 1988).

OFDI Financing Dimension: The political clout in host countries may impose restrictions with regard to currency convertibility and repatriation of dividends to parent firm. This has implication to choose between nature of finance in financing the OFDI.

6.8 Portfolio Theory of FDI

The desire to engage in portfolio diversification offers another explanation of FDI. This theory suggests that if the rates of return on various investment projects across countries have a less than perfect correlation, a firm can reduce its overall risk exposure by diversifying its investment internationally. The theory of portfolio selection under uncertainty given by Tobin (1958) and Markowitz (1959) was first applied to portfolio of international assets by Grubel (1968). He demonstrated that individual asset holders can reduce risk by holding an efficiently diversified portfolio of international assets. Agmon and Lessard (1977) also used portfolio theory to explain the use of FDI by multinationals to diversify and stabilise their earnings. They observed that at corporate level, FDI rather than portfolio capital movements provided multinational an opportunity to diversify. The theory, thus, captures the risk factor.

OFDI Financing Dimension: OFDI by parent firm to its foreign affiliates can also help it to diversify its overall risk and stabilise earning as foreign affiliates operate in different markets (countries) and possibly in different lines of businesses.

6.9 Kojima Theory

One of the earliest theories on FDI from Asian developed countries was put forward by Kojima (1973, and 1975) mainly with regard to FDI outflow from Japan. He argued that the reason why firms invested abroad was because of their inability to compete in domestic market. The efficient firms in domestic market were driving the less competent firms out of the domestic market, especially to the developing countries. The theory was criticized because it failed to explain international expansion of domestically competent firms.

OFDI Financing Dimension: In relation to this theory, we argue that in specific, the financial stability of the parent firm (that makes them competent or non- competent at home country) may impact their decision to provide funds to their affiliates abroad by tapping their internal capital market.

6.10 Network Theory

Firm's internationalisation is a natural development from network relationships with foreign individuals and firms (Johanson & Mattsson, 1988). Every entity of a multinational system is a member in an international network comprising of home and host country's network of suppliers and customers, a network based on its industry, and of organizational network under the control of the parent firm. Thus, explaining internationalisation process cannot be understood just by

viewing the internationalizing firm as a unit of analysis but rather by viewing an MNE as part of a big global business network. Interaction with various market actors has an impact on the internationalisation process.

OFDI Financing Dimension: Although, the overall strategic direction of the affiliate is the legal responsibility of parent firm, foreign affiliates play an important role in shaping the financing strategy of the parent firm. The foreign affiliates compete with each other and also the parent firm for expanded resources. The kind of network these foreign affiliates have with their external suppliers may also shape their decision whether to raise finance from internal capital market or external capital market. Thus, the behavioural strategy of FDI shapes the financing strategy of the parent firm.

7. Conclusion

The extant literature on FDI focuses mainly on the motives of FDI, modes of FDI, impact on host and home country and determinants of FDI. The financing aspect of FDI has not gained much attention in literature may be because of the difficulty in availability of data and the opacity of flows within a multinational system.

The present paper explains that the internal capital market is a multinational specific advantage that helps MNEs to maintain low global cost and availability of capital, and the volatility in internal funds is far less than small domestic firms because they can smoothen out liquidity fluctuations across its various entities. Internal capital market helps to circumvent problems posed by external capital market. However, internal capital market has a dark side too. It may accentuate propping and tunnelling activities in a multinational system. This has been elucidated in Section two. Section three, discusses the implications of parent debt vs. parent equity in detail. Although parent equity helps to procure additional loans from external lenders, it is a risky-capital. Parent debt is resorted to by multinationals because it is flexible than parent equity in terms of repatriation of funds and tax benefits. Section four highlights various issues in internal capital market. Section five concludes that the financing of OFDI has implications for internal capital market, and supply-side factors that shape the capital structure of the foreign affiliates. Thus, the present paper attempts to explain the implications of financing the OFDI and sets to roll financing of OFDI as an area in the finance literature.

By appraising above sections, we find that such a study, if undertaken, would contribute to various facets as follows.

- The study would contribute to almost non-existent literature on outward FDI that takes into account financing aspect of outward FDI.

- Capital structure theories discuss about factors or issues relating to raising debt and equity, focusing on borrower's side (demand side factors) but ignores supply side factors.
- Discussion about financial flows between business groups and specifically between parent and subsidiary (Aulakh & Mudambi, 2005) literature is in nascent stage that discusses about flows from subsidiary to headquarter. An extensive literature documents that financial flows between parent and subsidiary are influenced by a number of subsidiary specific factors and do not directly take into account parent's characteristics. (e.g. Aulakh and Mudambi takes into account relative difference of variables between HQ and subsidiary).
- Our discussion of nature of financing of affiliates by parent firm is indirectly related to the vast and growing literature on conglomerates and internal capital markets; for a recent discussion of this literature, see Campa and Kedia (2002), Khanna and Yafeh (2005).
- The study would help to analyze finance-specific factors in investment decision as pointed by Oxelheim, Randoy and Stonehill (2001)
- As per "pecking order" theory (Myers, 1984): firms' financing preferences follow this sequence - internally-generated funds, debt (external) financing and equity (external) financing. Such a study would answer the question: Is there any preference between internally generated funds - between internal equity (parent equity) and internal debt (parent debt)?
- In the international business literature, the theories of FDI lack in providing a comprehensive picture because they do not include financial factors comprehensively. The financing strategy of the firm in particular has implications for theories of FDI that may impact its decision to undertake OFDI as presented in Section six. There is a scope to examine the influence of financing decision of the parent firm (or multinational) on OLI framework. The paper calls for research to add finance dimension to the theories of FDI. With regards to the 'O' there exists parent-firm characteristics that impels it to decide the financing for OFDI. For the 'L' factor, location-specific characteristics of host country and home country seem to impact the financing decision of OFDI, and 'I' - the availability of internal funds helps it to internalize the finance function. This OLI framework, we believe would help us to provide insights into the financing decision of OFDI. We question - Does OLI framework just helps us to know what propels firms to undertake FDI or is it also capable to explain the decision of financing the OFDI?
- As also pointed by Buckley and Casson (1976), we expect the OFDI financing decision to be affected by country, industry, and parent firm-

level factors. A disaggregated analysis using firm-level data would add to the richness of such analysis. Hymer (1976) recognized that FDI is a firm-level strategy rather than a capital-market financial decision, therefore parent firm-level data to analyse the financing of outward foreign direct investment could add to the literature on outward foreign direct investment. Accordingly, we believe that parent and affiliates' firm-specific factors, strategic factors (e.g. foreign promoter holding), location specific factors, parent's and affiliates' industry factors may impact OFDI financing decision by parent firm.

The study believes that the 'Multinational' structure of the firm accentuates benefits of internal capital market i.e., 'Strategy may follow structure'. There is lack of research on above mentioned issues and a research on financing pattern of outward foreign direct investment would fill the void. Thus, the study attempts to set a framework for future research in this area.

References

Aggarwal, R., & Kyaw, N. A. (2008). Internal capital networks as a source of MNC competitive advantage: Evidence from foreign subsidiary capital structure decisions. *Research in International Business and Finance, 22*(3), 409-439.

Agmon, T., & Lessard, D. R. (1977). Investor recognition of corporate international diversification. *The Journal of Finance, 32*(4), 1049-1055.

Aliber, R. Z. (1971). The multinational enterprise in a multiple currency world. In J. H. Dunning (Ed.), *The multinational enterprise* (pp. 49-56). London, United Kingdom: Allen and Unwin.

Almeida, H., Park, S. Y., Subrahmanyam, M. G., & Wolfenzon, D. (2011). The structure and formation of business groups: Evidence from Korean chaebols. *Journal of Financial Economics, 99*(2), 447-475.

Aulakh, P. S., & Mudambi, R. (2005). Financial resource flows in multinational enterprises: The role of external capital markets. *Management International Review, 45*(3), 307-325.

Baker, G. (1992). Beatrice: A study in the creation and destruction of value. *The Journal of Finance, 47*(3), 1081-1119.

Bertrand, M., Mehta, P., Mullainathan, S., 2002. *Ferreting out tunneling: an application to Indian business groups. Quarterly Journal of Economics 117*(1), 121-148.

Buckley, P. J., & Casson, M. C. (1976). *The future of the multinational enterprise*. London, United Kingdom: Macmillan.

Buckley, P. J., Clegg, L. J., Cross, A. R., Liu, X., Voss, H., & Zheng, P. (2007). The determinants of Chinese outward foreign direct investment. *Journal of International Business Studies, 38*(4), 499-518.

Butters, J. K., & Lintner, J. (1945). *Effect of federal taxes on growing enterprises*. Cambridge, MA: Harvard University Press.

Campa, J. M., & Kedia, S. (2002). Explaining the diversification discount. *The Journal of Finance*, 57(4), 1731-1762.

Caves, R. E. (1988). *Exchange rate movements and foreign direct investment in the United States.* Harvard Institute of Economic Research Discussion Paper No. 1383.

Chowdhry, B., & Coval, J. D. (1998). Internal financing of multinational subsidiaries: Debt vs. equity. *Journal of Corporate Finance,* 4(1), 87-106.

Claessens, S., Djankov, S., & Lang, L. H. (2000). The separation of ownership and control in East Asian corporations. *Journal of Financial Economics, 58*(1), 81-112.

Coase, R. H. (1937). The nature of the firm. *Economica, 4*(16), 386-405.

Desai, M. A., Foley, C. F., & Hines Jr., J. R. (2004). The costs of shared ownership: Evidence from international joint ventures. Journal of Financial Economics, 73(2), 323-374.

Dunning, J. H. (1977). Trade, location of economic activity and the MNE: A search for an eclectic approach. In B. Ohlin, P.-O. Hesselborn, & P. M. Wijkman (Eds.), *The International Allocation of Economic Activity* (pp. 395-418). London, United Kingdom: Palgrave Macmillan.

Dunning, J. H. (1980). Toward an Eclectic Theory of International Production: Some empirical tests. *Journal of International Business Studies,* 9-31.

Dunning, J. H. (1993). Internationalizing Porter's diamond. *Management International Review, 33*(2), 7-15.

Elango, B., & Pattnaik, C. (2007). Building capabilities for international operations through networks: a study of Indian firms. *Journal of International Business Studies, 38*(4), 541-555.

Fazzari, S., Hubbard, R. G., & Petersen, B. (1988). Investment, financing decisions, and tax policy. *The American Economic Review, 78*(2), 200-205.

Feldstein, M., & Horioka, C. (1980). Domestic saving and international capital flows. *The Economic Journal, 90*(358), 314-329.

Friedman, E., Johnson, S., & Mitton, T. (2003). Propping and tunneling. *Journal of Comparative Economics, 31*(4), 732-750.

Froot, K. A., & Stein, J. C. (1991). Exchange rates and foreign direct investment: An imperfect capital markets approach. *Quarterly Journal of Economics, 106*(4), 1191-1217.

Gopalan, R., Nanda, V., & Seru, A. (2007). Affiliated firms and financial support: Evidence from Indian business groups. *Journal of Financial Economics, 86*(3), 759-795.

Gordon, R. H., & Bovenberg, A. L. (1996). Why is capital so immobile internationally? Possible explanations and implications for capital income taxation. *The American Economic Review, 86*(5), 1057-1075.

Grubel, H. G. (1968). Internationally diversified portfolios: Welfare gains and capital flows. *The American Economic Review, 58*(5), 1299-1314.

Hennart, J.-F. (1982). *A Theory of multinational enterprise.* Ann Arbor, MI: University of Michigan Press.

Hoshi, T., Kashyap, A., & Scharfstein, D. (1991). Corporate structure, liquidity, and investment: Evidence from Japanese industrial groups. *The Quarterly Journal of Economics, 106*(1), 33-60.

Hosseini, H. (2005). *An economic theory of FDI: A behavioral economics and historical approach. The Journal of Socio-Economics, 34*(4), 528-541.

Hymer, S. H. (1976). *The international operations of national firms: A study of direct foreign investment.* Cambridge, MA: MIT Press.

Johanson, J., & Mattsson, L.-G. (1988). Internationalisation in industrial systems-A network approach. In N. Hood, & J.-E. Vahlne (Eds.), *Strategies in Global Competition* (pp. 287-314). New York, NY: Routledge.

Johnson, S., La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2000). Tunneling. *American Economic Review Papers and Proceedings, 90*(2), 22-27.

Kamal, F.-S., & Safizadeh, M. H. (1989). The association between political instability and flow of foreign direct investment. *Management International Review, 29*(4), 4-13.

Kemp, M. C. (1964). *The pure theory of international trade.* Englewood Cliffs, NJ: Prentice-Hall.

Khanna, T., & Palepu, K. (2000). Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups. *The Journal of Finance, 55*(2), 867-891.

Khanna, T., & Yafeh, Y. (2005). Business groups and risk sharing around the world. *Journal of Business, 78*(1), 301-340.

Kim, E. H., & McConnell, J. J. (1977). Corporate mergers and the co?insurance of corporate debt. *The Journal of Finance,* 32(2), 349-365.

Kim, K. A. (2011). *Global Corporate Finance - A Focussed Approach. Singapore: World Scientific Publishing*

Knickerbocker, F. T. (1973). *Oligopolistic reaction and multinational enterprise.* Boston, MA: Harvard Business School Press.

Kojima, K. (1973). A macroeconomic approach to foreign direct investment. *Hitotsubashi Journal of Economics, 14*(1), 1-21.

Kojima, K. (1975). International trade and foreign investment: Substitutes or complements. *Hitotsubashi Journal of Economics, 16*(1), 1-12.

Kumar, N. (2007). Emerging TNCs: Trends, patterns and determinants of outward FDI by Indian enterprises. *Transnational Corporations, 16*(1), 1-26

MacDougall, G. D. (1960). The benefits and costs of private investment from abroad: A theoretical approach. *Economic Record, 36*(73), 13-35.

Makin, J. H. (1974). Capital flows and exchange rate flexibility in the post-Bretton woods era. *Essays in International Finance, 103*, pp. 1-29.

Markowitz, H. (1959). *Portfolio selection: Efficient diversification of investments.* New York, NY: Wiley.

Myers, S. C., & Majluf, N. S. (1984). Corporate financing and investment decisions when firms have information that investors do not have. *Journal of Financial Economics, 13*(2), 187-221.

Ness, Jr., W. L. (1972). A linear programming approach to financing the multinational corporation. *Financial Management, 1*(3), 88-100.

Oxelheim, L., Randoy, T., & Stonehill, A. (2001). On the treatment of finance-specific factors within the OLI paradigm. *International Business Review, 10*(4), 381-398.

Ozbas, O., & Scharfstein, D. S. (2010). Evidence on the dark side of internal capital markets. *Review of Financial Studies, 23*(2), 581-599.

Pradhan, J. P. (2004). The determinants of outward foreign direct investment: A firm-level analysis of Indian manufacturing. *Oxford Development Studies, 32*(4), 619-639.

Rajan, R., Servaes, H., & Zingales, L. (2000). *The cost of diversity: The diversification discount and inefficient investment. The Journal of Finance, 55*(1), 35-80.

Scharfstein, D. S., & Stein, J. C. (2000). The dark side of internal capital markets: Divisional rent?seeking and inefficient investment. *The Journal of Finance, 55*(6), 2537-2564.

Seru, A. (2014). Firm boundaries matter: Evidence from conglomerates and R&D activity. *Journal of Financial Economics, 111*(2), 381-405.

Shin, H.-H., & Park, Y. S. (1999). Financing constraints and internal capital markets: Evidence from Korean 'chaebols'. *Journal of Corporate Finance, 5*(2), 169-191.

Tallman, S. B. (1988). Home country political risk and foreign direct investment in the United States. *Journal of International Business Studies, 19*(2), 219-234.

Tobin, J. (1958). Liquidity preference as behavior towards risk. *The Review of Economic Studies, 25*(2), 65-86.

Tripathi, V., & Thukral, S. (2013). The research gap in MNE financing decision - Financing of outward foreign direct investment (OFDI). *Journal of Business & Finance, 6*(2), 1-18.

Tripathi, V., & Thukral, S. (2016). Financing the internationalisation of Indian MNEs. Transnational Corporations Review. 8(3), 215-229.

Welch, L. S., Benito, G. R., & Petersen, B. (2007). Foreign operation methods: *Theory, analysis, strategy.* Cheltenham, Northampton: Edward Elgar.

Williamson, O. (1988). Corporate finance and corporate governance. *The Journal of Finance, 43*(3), 567-591.