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**BEYOND PRODUCT MARKETS: NEW INSIGHTS ON LIABILITY OF  
FOREIGNNESS FROM CAPITAL MARKETS**

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## **BEYOND PRODUCT MARKETS: NEW INSIGHTS ON LIABILITY OF FOREIGNNESS FROM CAPITAL MARKETS**

### **Abstract**

We expand the Liability of Foreignness (LOF) construct beyond the product market domain to include liabilities faced by firms attempting to secure resources in host capital markets. Drawing from institutional theory and research in finance, we identify institutional distance, information asymmetry, unfamiliarity, and cultural differences as the main sources of capital market LOF (CMLOF). We then propose that the impact of these antecedent factors can be moderated through bonding, signaling, organizational isomorphism, and reputational endorsements.

## **BEYOND PRODUCT MARKETS: NEW INSIGHTS ON LIABILITY OF FOREIGNNESS FROM CAPITAL MARKETS**

The accelerating pace of global capital market integration in the last two decades has had a profound impact on the strategies of firms accessing capital resources. Today, with the lowering of institutional barriers, cross-border capital flows occur in a variety of ways such as foreign portfolio investment, foreign direct investment, cross-border acquisitions, cross-listings, and initial public offerings in foreign stock exchanges. However, despite the initial euphoria about increased access to global capital markets, foreign firms tend to be at a disadvantage compared to domestic firms as they are likely to experience higher cost of capital, lower liquidity, and less analyst coverage (Blass & Yafeh, 2001; Ding, Nowak & Zhang, 2010). Further, a number of foreign firms have been found to withdraw shortly after entering host capital markets (see Karolyi, 2009, for a review). Extant literature provides only limited theoretical understanding about the underlying factors that cause foreign firms to experience higher costs in host capital markets. This, in turn, has resulted in an inability to identify potential remedies foreign firms can deploy to mitigate these costs.

To date a significant body of theoretical and empirical research has accumulated evaluating the sources of liabilities of foreignness (LOF) that foreign firms face in host countries, compared to domestic firms (Caves, 1971; Hymer, 1976). LOF is considered as the “fundamental assumption driving theories of the multinational enterprise” (Zaheer, 1995: 341) and is often treated as a “taken-for-granted assumption” (Zaheer, 2002) in the international management literature. Researchers evaluating LOF have tried to answer two fundamental questions. First, what are the sources of these additional costs that a foreign firm would incur that a local firm would not incur? Second, what can firms do to overcome the costs associated

with LOF? However, much of the growing body of research on LOF that has focused on answering these fundamental questions is almost exclusively related to firms expanding their products, services, and operations to other countries as part of their global expansion. Consequently, our collective understanding of LOF are usually associated with the local lack of knowledge of the foreign firm's products and brand, cultural differences in management practices, etc. that ultimately lead to foreign firms competing at a disadvantage and underperforming against local competitors in host markets. This conceptualization may have been adequate in an era when 'internationalization' was understood almost exclusively as globalization of product markets. However, the increasing integration of capital markets adds a new dimension to internationalization where a firm, in addition to selling its product and services to foreign customers, may attempt to sell its securities to foreign investors. Further, there is increasing recognition among international business scholars that investors in both developed and developing markets strongly prefer to invest in domestic firms rather than foreign firms in capital markets (Ke, Ng, & Wang, 2010). Hence, the objective of this paper is to expand the domain of the liabilities of foreignness construct to include liabilities faced by firms accessing host country capital markets<sup>1</sup>. Throughout the rest of this paper, we refer to these liabilities as capital market liabilities of foreignness, or CMLOF. Further, we also identify the strategies managers can employ to overcome CMLOF.

Navigating the dynamic international capital market environment and attracting capital market participants located in dissimilar cultural and institutional environments is a difficult challenge facing the international manager. Just as managers must contend with liabilities of foreignness in product markets, they must also be aware of the sources CMLOF and be prepared

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<sup>1</sup> The majority of our discussion is restricted to equity markets since a rapid integration of equity markets was the most pronounced globalization phenomenon over the past decade.

to strategically mitigate the resulting costs. If liabilities of foreignness are prevalent in the capital markets, it has implications for a firm's cost of capital and firm value (Stulz, 1999). In addition to addressing CMLOF costs and strategies to mitigate their effects, investigating the internationalization of firms through capital markets can help to answer why firms engage in foreign expansion despite the prevalence of these costs that put them at a competitive disadvantage relative to local firms. The need for studying the internationalization of capital markets was eloquently made recently by Birkinshaw et al. (2006: 697)

".....it is interesting to speculate on the idea that MNCs can internationalize with regard to the capital markets, to parallel the classic line of thinking about internationalization vis-à-vis the product markets (Johanson & Vahlne, 1977). MNCs have a range of ways in which they can increase their visibility and relationships with major shareholders and financial institutions, from depositary receipts through a full overseas listing to a relocation of the corporate HQ to a global financial center. While different in many ways, these approaches can be viewed as a series of steps, each involving a higher investment and a greater level of commitment to the global capital markets, but offering important rewards in terms of the costs of borrowing, the liquidity of the stock, and the effectiveness of the MNC's corporate governance."

In order to extend the domain of the LOF construct to capital markets, we start by reviewing the extant literature on the different sources of such liabilities in product markets and assess the cumulative empirical evidence on strategies pursued by firms to overcome LOF. We then develop a model that includes the costs facing firms in host country capital markets and the willingness of host market investors to devote resources in outside firms. We explain how CMLOF costs may be driven by institutional differences between home and host markets. Similarly, information flows are an important determinant of cross-border equity transactions (Portes & Rey, 2005). Additionally, it is quite plausible that cultural differences between countries will influence a wide range of capital market transactions (Guiso, Sapienza, &

Zingales, 2006, 2008, 2009) and ultimately impact the performance of foreign firms in host markets relative to local competitors. We then suggest a variety of strategies that firms can pursue to moderate CMLOF and gain legitimacy in host country capital markets. These include bonding and signaling activities, organizational isomorphism, and endorsements by third parties. Finally, we offer a research agenda for the future investigation of CMLOF and conclude by discussing the implications for further research and theory development.

### **LIABILITY OF FOREIGNNESS: SOURCES AND MITIGATION STRATEGIES**

The origins of the concept of LOF can be traced back to the works of Hymer (1976) and Kindleberger (1969) who laid out the theoretical reasons why foreign firms are likely to incur additional costs that local firms would not incur and face competitive disadvantages. Hymer (1976) argued that foreign subsidiaries experience a competitive disadvantage due to fact that local firms have better information about the local competitive environment, including the economy, language, social needs and preferences, law, and politics. It has been argued that firms with an “operation in a foreign country will usually entail higher costs, everything else being equal, than operation at home” (Hennart, 1982: 2). The study of the systematic liabilities encountered by populations of firms due to factors that are by and large out of their control has parallels in population ecology research where considerable attention has been paid to the twin concepts of liabilities of newness (Stinchcombe, 1965) and liabilities of smallness (Hannan & Freeman, 1977). Given the conceptual similarities between LOF and these other types of liabilities, Zaheer and Mosakowski (1997: 440) suggest that “liability of foreignness might need to stand alongside the other liabilities of age and size.”

The most widely used definition of LOF in the literature is provided by Zaheer (1995: 343) who considers LOF as “all additional costs a firm operating in a market overseas incurs

that a local firm would not incur.” The focus of LOF is on the subtle structural/relational and institutional costs, or the “social costs of access and acceptance” (Zaheer, 2002: 352).

Structural/relational costs arise from a foreign firm’s network position in the host country and its linkages to important local actors. Most likely, a local firm would incur less of these costs because it has better developed local networks. Institutional costs arise from institutional distance between the home and host countries, and higher the institutional distance the lower the legitimacy of the foreign firm. Eden and Miller (2004) explain that these social costs arise from *unfamiliarity, relational, and discriminatory hazards* with institutional distance as the key driver behind each of these costs. Unfamiliarity costs result from a firm’s lack of knowledge of or experience in the host country. Discrimination hazards arise from discriminatory treatment by the host government in a variety of ways ranging from discriminatory taxation to discriminatory procurement. It can also arise from discriminatory treatment by customers in the host country who may prefer a local product out of nationalistic reasons or dislike products from a foreign country for historical reasons (ex. Japanese cars in Korea). To a great extent, the discrimination hazards arise from the “legitimacy deficit” (Schmidt & Sofka, 2009) faced by a firm in a foreign country. Relational hazards relate to the higher costs that a foreign firm would incur both with respect to internal organization and external market transactions.

In Table 1 we provide a summary of empirical research on LOF. While LOF has been the underlying theoretical motivation for a wide range of studies, we limit our review to those studies that make a direct comparison between foreign and local competitors. For instance, Zaheer (1995) found that there are systematic differences in the profitability of foreign trading rooms compared to local trading rooms in the same location, and attributed the lower profitability of foreign trading rooms to LOF. Zaheer and Mosakowski (1997) found that foreign



trading rooms have a lower chance of survival compared to local trading rooms providing additional empirical demonstration of the existence of LOF. Similarly, it has been found that foreign-owned banks in the United States were less efficient than U.S. owned banks (DeYoung & Nolle, 1996). Likewise, Japanese-owned banks in the U.S. market have been shown to be less profitable than their U.S. counterparts (Hasan & Hunter, 1996).

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Insert Table 1 about here  
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The empirical results in Table 1 imply that, at least among firms competing in the product market domain, foreign-owned firms are expected to have lower profitability and a lower survival rate than domestic firms, *ceteris paribus* (see, e.g., Lord & Ranft, 2000; Zaheer, 1995; Zaheer & Mosakowski, 1997). The cumulative evidence suggests that LOF is prevalent across a wide range of industries such as banking, automobiles, and currency trading (DeYoung & Nolle, 1996; Mezas, 2002; Miller & Parkhe, 2002; Miller & Richards, 2002; Sofka & Zimmermann, 2008) and that it has a negative impact on firm performance (DeYoung & Nolle, 1996; Hasan & Hunter, 1996; Miller & Parkhe, 2002; Sofka & Zimmermann, 2005; Zaheer, 1995; Zaheer & Mosakowski, 1997).

### **Sources of Liabilities of Foreignness**

Based on a review of prior literature, Zaheer (1995) identified at least four sources of costs that put a foreign firm at a competitive disadvantage with local firms. First, these are spatial costs, which relate to costs arising from transportation and coordination. Even in a world where technology has shrunk distance and time, these costs are non-trivial (Ghemawat, 2001). Second, there are costs that arise because of a firm's unfamiliarity with the local environment.

As Caves (1971: 5) points out, “the foreign firm must pay dearly for what the native has acquired at no cost to the firm.....or can acquire more cheaply” as a result of its knowledge of the host country. Third, there are costs resulting from the host country environment due to the lack of legitimacy of the foreign firm as well as the prevalence of economic nationalism in many countries. The boycott of French products in the US in the aftermath of the Iraq war or the Japanese government making only Japanese cars eligible for its equivalent of the “cash for clunkers” program are recent examples of economic nationalism impacting consumer behavior. In addition, local consumers may be not familiar with the foreign firm’s brand and products, and they would lean towards buying more familiar local brands even when their quality and prices do not match foreign entrants. Finally, there are costs arising out of the home country environment as well. These may take the form of restrictions on high technology exports, embargos on trade and investment against specific countries etc.

### **Strategies to overcome Liabilities of Foreignness**

Considerable recent empirical research has concentrated on the question of what firms can do to overcome LOF. Zaheer (1995) suggested local isomorphism as a possible response. This approach requires the firm to mimic the administrative practices of local firms. In a similar vein, Mezias (2002) found that foreign firms who used American top officers or whose parent firms had more U.S. operations faced fewer labor lawsuit judgments. Eden and Miller (2004), Haiyang, Griffith, and Ru (2006) and Chen (2006) suggest that the negative effects of LOF can be reduced by appropriate entry mode choice. Luo, Shenkar and Nyaw (2002) report that foreign firms entering China reduced their LOF by a combination of offensive (networking, legitimacy improvement) and defensive (contracts, output standardization) strategies. Both Eden and Molot (2002) and Nachum (2003) suggest that the key to overcoming LOF is to use firm specific

resources to outperform local rivals based on studies of auto and financial service industries respectively. Elango (2009) found that foreign insurance companies in the US coped with LOF by greater boundary spanning and adoption of differing strategic postures. Zaheer (2002) argues that LOF is an inherently dynamic concept. That is, LOF can change with the passage of time. Over time, as a firm becomes an insider in a country, LOF might decline or disappear. Hindustan Lever (the Indian subsidiary of Unilever) and ITC (the Indian subsidiary of Imperial Tobacco Company) may be two examples of foreign firms that as a result of their long history and specific strategies have attained insider status in their home country. Kostova and Zaheer (1999) and Insch and Miller (2005) even suggest that there may be situations in which foreignness can be an advantage rather than a liability.

Thus, there is considerable evidence that the theoretical arguments and empirical analyses have been mostly confined to the discussion of LOF associated with a product market entry by a foreign firm. In the following sections we will extend these arguments to situations when a foreign firm offers its securities to investors located overseas either through an IPO or secondary offerings.

### **LIABILITIES OF FOREIGNNESS IN CAPITAL MARKETS AND THEIR ANTECEDENTS**

Because strategic decisions relate to issues of domain selection and domain navigation (Bourgeois, 1980) it is not surprising that much of the research in the international business, strategic management, and entrepreneurship areas surrounds the product market strategies pursued by firms and the liabilities they face when operating abroad. Certainly, the strategies firms pursue in the product market domain are one of the most important decisions that a firm will make. However, firms often need external financial resources in order to capitalize on growth opportunities provided by their chosen product markets. The equity capital raised on the

stock market is usually cheaper than private money and publicly traded shares are a useful currency in making acquisitions and helping a company to grow. Given the rapid globalization of capital markets, it is important to explore whether LOF applies to capital markets. And if it does, it is equally important to identify the sources of LOF in capital markets as well as the specific strategies that firms can pursue to reduce such liabilities.

There are a variety of reasons why firms choose to seek equity financing outside of the home markets. In addition to the financial benefits, marketing and public relations benefits, political benefits, and employee relations benefits have been pointed out (Biddle & Saudagaran, 1991; Howe & Kelm, 1987; Mittoo, 1992; Saudagaran, 1988). Using data on the capital raising activities of foreign firms in the U.S., it has been demonstrated that a successful listing can enhance operations or sales in the U.S., enhance analyst coverage, and provide firms with larger amounts of capital in order to pursue growth and acquisition strategies (Ritter & Welch, 2002). By listing in a foreign market, firms can obtain access to more liquid markets, more easily attract debt capital at lower costs and better terms, and tap into a wider investor base (Claessens, & Schmukler, 2007). In addition, there are a number of regulatory and institutional changes that have helped foster international capital raising activities. A number of countries have eased restrictions on foreign ownership in recent years. One of the biggest developments that have facilitated the entry of small and medium sized firms into global capital markets is the establishment of stock exchanges in several major financial centers requiring lower levels of transparency of listed firms. Although there are considerable advantages to seeking equity from host country capital markets, firms also face many liabilities due to their foreign origin.

Identifying and measuring CMLOF presents challenges that are specific to capital markets. Yet, understanding what forms these liabilities can take and identifying their sources

are vital to developing strategies for overcoming them. Liability of foreignness is inherently a relative construct in that its degree can only be assessed relative to host country competitors (Mezias, 2002). Therefore, while there is no equivalent of profitability in capital markets, whether debt or equity markets, these liabilities may manifest in the form of *higher costs* of raising capital, *lower liquidity* of its securities, and *tighter regulation* of foreign firm's securities compared to their domestic counterparts. Alternatively, firms raising equity in a host country capital market may have to “underprice” its shares (e.g., offer its equity at a price that may be lower than equilibrium trading price), pay higher underwriting fees, pay higher professional fees (ex. costs to secure the services of legal advisors, auditors and independent directors), or higher initial listing fees, than domestic firms. Similarly, differences in analyst coverage may result in lower trading volume, and therefore, reduced liquidity. There is growing evidence that foreign firms do indeed experience higher costs in host capital markets compared to domestic firms (Ding et al., 2010; Oxera, 2008). Foreign firms may also be subject to more restrictive regulation than domestic firms. For example, the Russian firm Severstal was not allowed to issue shares to retail investors during an IPO in Hong Kong although it listed its shares in the local stock exchange.

Despite the integration of capital markets, and the lowering of formal institutional barriers that have historically limited foreign ownership of firms around the world, finance researchers have consistently found that investors do not take advantage of the diversification benefits of foreign stocks (Ahearne et al., 2004; Cooper & Kaplanis, 1994; French & Poterba, 1991; Tesar & Werner, 1995). For example, studies have shown that U.S. investors hold about 91 percent of their stock investments in domestic stocks—despite the fact that U.S. stocks represent only 49 percent of the world market portfolio (Dahlquist, Pinkowitz, Stulz, &

Williamson, 2003; French & Poterba 1991). Although economic theory suggests that international diversification would reduce portfolio risk, it been repeatedly documented in the finance literature that both professional and individual investors hold too small portions of their wealth in foreign assets because of their preference for domestic over foreign assets has (Cooper & Kaplanis, 1994; French & Poterba, 1991; Lessard, 1973, 1976; Levy & Sarnat, 1970; Solnik, 1974; Tesar & Werner,1995). Recent evidence by Chan et al. (2005) shows that the phenomenon is pervasive across 48 developed and developing countries worldwide. This is particularly intriguing because unlike the trade in goods, transactions in financial markets do not incur spatial costs as there are virtually no transportation costs. The preference shown by investors to overweight their portfolios with domestic securities and underweight foreign securities is generally referred to as “home bias” (French & Poterba, 1991). This prevalence of home bias in capital markets clearly has implications for firms seeking equity in foreign markets. Even if a Chinese or Mexican firm lists its securities in the US or UK capital markets, investors in these countries still see these as foreign securities because they are issued by foreign firms and may still continue to underweight them in their portfolios. This, in turn, can lead to lower trading volumes, lower security prices, and hence higher cost of capital.

Why would investors, who are assumed to be rational, forego the obvious benefits of portfolio diversification and continue to invest most of their funds in home markets? More importantly, how does the pervasive ‘home bias’ phenomenon impact the costs firms incur in their international capital raising activities? A number of explanations have been offered for the puzzling persistence of such suboptimal behavior by investors and these explanations provide valuable insights regarding the liabilities faced by firms in capital markets.

Drawing from the many insights gained from research on home bias in capital markets, we identify at least four major sources of CMLOF costs. These are institutional distance, information asymmetry, unfamiliarity, and cultural differences (Ahearne et al., 2004; Cai & Warnock, 2004; Chan et al., 2005; Daude & Fratzscher, 2007; Tesar & Werner, 1995). Each of these is discussed next. We summarize these costs on the left side of our model in Figure 1.

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Insert Figure 1 about here  
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### **Institutional Distance**

Scott (1995: 33) defines institutions as “cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior.” Institutional distance is defined as the degree of separation or extent to which institutions differ between countries (Xu & Shenkar, 2002). Substantial institutional differences create difficulties for foreign firms attempting to achieve legitimacy in a host country (Kostova & Zaheer, 1999; Xu et al., 2004). Of the three dimensions of institutional environment mentioned above, the regulatory dimension is particularly salient in explaining LOF in capital markets. The regulatory dimension consists of the rules and laws that provide support for product and capital market participants and facilitate firms’ efforts to acquire resources. Eden and Miller (2004) describe the regulatory pillar as the “may” and “may not” behaviors firms must adhere to. A country’s regulatory dimension can provide support for firms, including governmental regulations that structure competition within industries (Barnett & Carroll, 1995) and rules and policies that structure transactions within capital markets. Regulative distance describes the differences in the general legal environments between home and host countries (Xu et al., 2004) and higher regulative distance between two

countries can discourage investors from one country to invest in another. For example, recent research on Chinese governance points to the widespread practice of earnings management through related party transactions. Such practices are the norm in the Chinese institutional context (Chen & Yuan, 2004), but would be frowned upon elsewhere.

It is generally understood that when investors perceive that the risks and costs of acquiring and holding equities issued by foreign firms are sufficiently higher than they are for domestic securities, they will choose to keep their focus on domestic firms. These risks and costs arise primarily due to institutional differences between home and host country capital markets. For example, protections afforded to minority investors may be less in a foreign country compared to the investor's home country. As a result, investors would demand compensation in terms of higher costs of capital, offer discounts etc. when a foreign company comes from a less investor-friendly country. In addition, when a firm comes from an institutionally distant country, host country investors may lack understanding of informal institutional settings in the home country, such as the level of corruption, the importance of informal networks, etc. Again, these factors increase risks and uncertainty associated with a foreign firm's equity, and, consequently, its CMLOF. Taxation on foreign income by either country may present additional problems. There may be costs resulting from institutional barriers to trade assets. Each of these problems reduce the expected returns on foreign firms' assets relative to domestic assets, and hence, increase CMLOF for foreign issuers.

Certainly, institutional differences, transaction costs, taxes, and other legal restrictions serve as a barrier to international investment, yet to date there is considerable disagreement over the extent to which formal institutional barriers account for the home equity bias (Tesar & Werner, 1995). If institutional differences and the resulting transaction costs are indeed the



reason for home bias, it logically follows that the deregulation and liberalization of asset markets would conceivably diminish such bias. However, recent studies demonstrate that the lowering of formal institutional barriers does not eliminate home bias (Ahearne et al., 2004). Indeed, despite the reduction in ‘direct’ costs or barriers to international investment activity, studies by French and Poterba (1991), Tesar and Werner (1995), Cooper and Kaplanis (1994), Lewis (1999), Coen (2001), and Glassman and Riddick (2001) demonstrate that empirical support for a cost-based explanation for home bias is generally poor. However, regardless of the disagreements over the extent to which formal institutions present transaction costs sufficient to dissuade foreign investments, researchers agree that differences in legal frameworks concerning, for example, accounting systems, corporate governance, restrictive investment regulations, or investor protection persist and can likely explain at least part of the home bias (Chan, et al., 2005; Dahlquist et al., 2003; Oehler, Rumber, & Wendt, 2008; Rowland, 1999).

Similar logic applies when local investors provide capital to overseas companies. Although in theory there is no difference between the characteristics of securities (debt or equity) issued by a foreign company in the local capital market and those issued by domestic companies, investors’ sentiments towards these financial instruments may be driven by regulatory differences and costs associated with the firm’s country of origin. In particular, differences in the investor protection regimes may be translated into substantial CMLOF costs for companies coming from less “investor-friendly” countries. Hence, we suggest:

*Proposition 1: There is a positive relationship between the institutional distance between a home and host country and the extent of CMLOF faced by a foreign firm.*

## **Information Costs**

Finance researchers have recently turned their attention to information asymmetry to explain the puzzle of home bias in particular and patterns of transnational portfolio investments in general (Aviat & Coeurdacier, 2007; Daude & Fratzscher, 2007; Portes & Rey, 2005; Portes, Rey & Oh, 2001). Information asymmetry is present whenever one party in a transaction has more or better information than the other. In the case of capital market investments, it is not uncommon to have information asymmetries between insiders and outsiders. Asymmetries exist because insiders (managers) are able to continually observe changes in investment productivity on an individual asset basis while outsiders are only able to obtain highly aggregate information at discrete points of time (Aboody & Lev, 2000). In international financial markets, there is greater potential for an unequal distribution of information between national and foreign investors. An important source of such asymmetry is uncertainties regarding the codified rules regulating the behavior and activities of company insiders in foreign markets. In addition, information such as business practices and conventions, national cultures, and corporate cultures are required for investors to meaningfully evaluate foreign financial assets, but such information is often difficult to obtain and even more difficult to interpret.

In sum, local investors have better knowledge than their foreign counterparts about domestic firms. Foreign investors often face high barriers to access information when attempting to evaluate their ownership levels in foreign assets. A significant body of empirical studies has accumulated in recent years which clearly suggest that information costs do indeed affect the composition of investors' portfolios. For example, it has been found that foreign equity portfolios are skewed towards the equities of large firms (Kang & Stulz, 1997), information flows are an important determinant of cross-border equity transactions (Portes & Rey, 2005), and, even within countries, investors tend to hold stocks of local companies (Coval &

Moskowitz, 1999). These studies suggest that asymmetric information between local and non-local investors are an important factor for investment decisions. The logic of the above arguments that investors exhibit a home bias because of the prevalence of information asymmetries is equally applicable to decisions to invest in the equities of a foreign firm even if it is listed in the domestic stock exchange. Hence:

*Proposition 2: There is a positive relationship between the information costs that an investor in the host capital market would incur and the extent of CMLOF faced by a foreign firm.*

### **Unfamiliarity Costs**

Along with information costs, research has shown that firms must also contend with the fact that investors do not invest in firms they are not familiar with. Merton (1987) shows that due to the high costs of information gathering and processing, investors only invest in a subset of eligible securities that they are familiar with. A focus on the known or the familiar is sometimes referred to as a ‘habitat effect’ (Barberis, Shleifer, & Wurgler, 2005). Extant empirical literature provides support for Merton’s argument in international setting, where investments by investors in foreign markets are typically allocated to large, less risky, and prominently visible firms (Dahlquist & Robertsson, 2001; Kang & Stulz, 1997). Interestingly, familiarity can often have negative effects on returns. For example, Chan, Covrig, and Ng (2005) find strong support for irrational familiarity by revealing the overweighting of investment portfolios in investors’ home markets, and under diversifying the capital that is left for foreign investment across selected few “familiar” international markets.

Recent research also shows that the familiarity bias or local bias often manifests as a preference for geographic proximity (Ivkovich & Weisbenner, 2005). Coval and Moskowitz (1999) show that a geographic proximity effect works even within U.S. domestic stock

portfolios. These authors demonstrate mutual fund managers prefer to invest in firms headquartered close to their home cities. Similarly, investment biases can be regional, rather than national in nature. It has been shown that social identity triggered by group affiliations drives under-diversified and domestically biased portfolios (Fellner & Maciejovsky, 2003). Lauterbach and Reisman (2004) also support this idea by arguing that investors prefer domestic assets to mimic the economic fortunes and welfare of their neighbors, countrymen, and social reference group. That emotions related to identity and nationalism may actually trump pure rationality in investment decisions is further evidenced by the “patriotism” in portfolio allocation decisions of U.S. investors reported by Morse and Shive (2007). This geographical bias suggests that investors will be particularly apprehensive when it comes to buying securities issued by foreign firms. This lack of familiarity can contribute to CMLOF costs.

Familiarity matters also at security level investment decisions and the decision to seek foreign capital. The important role familiarity plays in investment decisions has been extensively studied in recent years. Kang and Stulz (1997) show that foreign investors in Japan prefer large, international manufacturing firms. In a recent study of large number of international funds with holdings in 11 developed countries, Covrig, Lau, and Ng (2006) investigated stock selection by domestic and foreign fund managers and found that domestic managers typically prefer smaller, high market-to-book firms. On the other hand, Cai and Warnock (2004) analyze foreign and domestic institutions’ positions in US securities and find that both foreigners and domestic investors prefer large, internationally diversified firms. Therefore, foreign companies that do not fall under these categories may face additional costs of raising capital on a local capital market, hence increasing its CMLOF costs.

Familiarity with foreign markets on the part of managers plays a role in their decision on whether to seek capital resources abroad or where to seek it. For example, Sarkissian and Schill (2004) find that geographic proximity of the foreign market play a dominant role in selecting overseas listing destinations. In addition, the international experience of top management teams, international scope of operations, and industry have all been shown to be factors which prompt firms to seek equity resources outside their local capital markets (Bell, Moore, & Al-Shammari, 2008; Blass & Yafeh, 2001; Hursti & Maula, 2007). While these findings suggest that internationalization increases the firm's visibility and decreases investors' unfamiliarity costs, research evidence clearly support the argument that investors prefer firms they are familiar with and that such familiarity often arises from size and proximity. Clearly, these place foreign firms at a distinct disadvantage in host country capital markets. Therefore, we suggest:

*Proposition 3: There is a positive relationship between host market investor unfamiliarity with the foreign firm and its home country and the extent of CMLOF faced by a foreign firm.*

### **Cultural Differences**

Culture is often defined as a system of shared values, beliefs, and attitudes that influences individual perceptions and behaviors. The role played by culture in economic outcomes is a relatively new but growing area of research. Finance scholars are increasingly recognizing how cultural differences among countries influence a wide range of capital market transactions (Guiso, Sapienza, & Zingales, 2009; Stulz & Williamson, 2003). Indeed, these differences can affect the level of trust and nature of financial contracting (Guiso, Sapienza & Zingales, 2008). In their recent series of papers, Guiso, Sapienza, and Zingales (2006, 2008, 2009) show that perceptions rooted in culture are important and generally omitted determinants of economic exchange. For example, they find that level of trust is related to amount of trade, portfolio

investment, and direct investment. Trust within a country also affects household and firm level investment and lack of trust can affect stock market participation rates. Given the importance of culture in economic exchange, it is only natural that cultural differences between countries will have a significant impact on a wide variety of cross-border economic transactions.

Two developments in the study of national cultures have had a profound impact on using cultural difference as an explanatory variable for a variety of organizational phenomena in recent years. First, Hofstede (1980) developed a framework for understanding national cultures involving multiple dimensions of culture. Second, Kogut and Singh (1988) aggregated cultural differences across countries along the dimensions identified by Hofstede (1980) and developed a composite measure for systematically measuring cultural distance across countries. Few concepts in international business have attracted as much application in diverse areas of research as cultural distance (Sousa & Bradley, 2006). As Shenkar (2001) points out, the cultural distance construct has been applied to multiple research questions from innovation and transformation to foreign expansion and the ease of transferring technology across borders (Gomez-Mejia & Palich, 1997), as well as from affiliate performance to expatriate adjustment (Black & Mendenhall, 1991). While the impact of cultural difference on consumer behavior and organizational behavior has received considerable research attention, it is increasingly being recognized that it may play an equally important effect on investor behavior.

In one of the first studies examining the importance of culture and investment behavior, Grinblatt and Keloharju (2000) found that investors are more likely to hold, buy, and sell the stocks of firms that are located close to the investor, that communicate in the investor's native tongue, and have chief executives of the same cultural background. Subsequent studies have supported these findings. Morse and Shive (2007) show that cultures with high levels of

patriotism have larger proportion of their investments allocated at home. Likewise, Chui, Titman, and Wei (2009) propose that cross-cultural differences in terms of individualism versus collectivism are related to trading activity levels and security pricing across countries. Chan, Covrig and Ng, (2005) find that portfolio allocations of mutual funds depend upon both cultural and economic familiarity. When a country is more remote from the rest of the world and has a different language, foreign investors are reluctant to invest in that country. On the other hand, when a country is more developed, larger in market capitalization, and has lower transaction costs, foreign investors will invest more. Thus, a growing body of empirical evidence is accumulating, particularly in finance research, that investor behavior is not entirely rational as originally believed and that cultural factors circumscribe investor rationality. Cultural differences can play a significant role in an individual's decision to invest in the stock of a company from a different country and can contribute to LOF costs even in financial markets.

*Proposition 4: There is a positive relationship between the cultural differences between the host country and home country and the extent of CMLOF faced by a foreign firm.*

#### **STRATEGIES FOR OVERCOMING LIABILITIES OF FOREIGNNESS IN CAPITAL MARKETS**

The existence of liabilities stemming from foreignness makes it an imperative for firms accessing international capital markets to engage in strategies designed to overcome these liabilities. While the problems of information asymmetry can be addressed to some extent with greater frequency and quality of disclosure and problems arising from unfamiliarity may diminish over time, one of the fundamental problems faced by foreign firms in international capital markets is what Schmidt and Sofka (2009) referred to as “legitimacy deficit.” Attaining legitimate status is critical to both the short and long term success of firms in host capital markets. In the case of firms attempting to acquire resources in a host country capital market,

legitimacy would be the perception that the firm is similar to other host country firms in that market, or would act in a manner consistent with shareholder wealth generation, or is endorsed by organizations that are known and trusted. Legitimacy is particularly important in new ventures as it is critical to the ability to acquire other resources, including capital (Zimmerman & Zeitz, 2002). This is because increased legitimacy has been associated with generating increased resource flows (Deeds, 2004). Hence, foreign firms have to engage in actions that increase their legitimacy in foreign capital markets. In this paper, we identify how four strategies - bonding, signaling, organizational isomorphism, and endorsements by reputable third parties - may moderate the relationship between the antecedent factors we discussed above and LOF in host capital markets. These strategies can be found at the top of our model in Figure 1.

### **Bonding**

One of the biggest developments that have facilitated the entry of firms into global capital markets is the establishment of stock exchanges requiring lower levels of transparency. For example, in 1995 the Alternative Investment Market (AIM) was established in the U.K. to cater the capital demands of small and medium sized firms. Since then, a number of the world's exchanges have started new trading platforms modeled after London's AIM market<sup>2</sup>. Yet, while firms have increased access to equity and credit markets around the world through exchanges requiring lower levels of governance and transparency, simply listing on these exchanges may do little to reduce CMLOF costs. As an alternative, firms can diminish their CMLOF costs by taking a more strategic approach by choosing to raise capital in host markets that protect

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<sup>2</sup> The Borsa Italiana introduced in early 2009 the AIM Italia. In Germany, the Deutsche Borse contains the Freiverkehr, which is modeled after London's AIM with lower listing requirements. Prague, Hong Kong, and Singapore have also subdivided their primary markets to compete for small and medium sized firms attempting to acquire capital resources. In the US, foreign firms have a growing number of new financial vehicles that can be used to raise capital, including Depository Receipts and Rule 144A listings.



minority investors to a greater extent than their home country's regulatory regime, and that requires greater transparency in corporate governance.

Starting with the influential papers by Coffee (1999) and Stulz (1999), the foreign listing literature in finance has argued that firms incorporated in countries with poor investor protection can credibly bond themselves to better investor protection by offering their shares in host markets with higher standards of investor protection. Offering shares on overseas markets as a means to improve a firm's corporate governance systems is often referred to as the 'bonding hypothesis' (Coffee, 1999; 2002). Under the bonding hypothesis, opting for a listing in a more demanding exchange provides a means for foreign issuers to credibly commit to stricter regulation and the protection of investor rights against managerial self-dealing or excess consumption of private benefits of control. In other words, offering shares on foreign exchanges can serve as a credible bonding mechanism in that the firm will be subject to the increased scrutiny of multiple external monitors in the cross listing country. Even more important than the decision to list in a foreign market is the choice of the specific exchange. Different exchanges even within a country have different disclosure requirements and therefore in order to "bond" a firm will have to list its securities in an exchange that demands very high standards of disclosure and governance.

Foreign firms that list on US exchanges "bond" themselves to the US regulatory regime, which provides higher investor protection than the firm's home market. By committing itself to stricter regulation the firm can enjoy greater access to capital markets. This occurs because, as Coffee (1999) argues, exposure to SEC enforcement and shareholder litigation decreases the principal-agency problem. Once foreign issuers list in capital markets that have stricter governance regulations than their own home market, the relative importance of variations

between the corporate laws and corporate governance of different countries should decline in the minds of potential investors. Studies have shown that firms originating in countries with low investor protection levels can achieve a range of benefits by listing in markets that uphold minority shareholder rights. For example, listing in a host country with better investor protection is associated with lower cost of capital (Hail & Leuz, 2009), more scrutiny by financial analysts (Lang et al., 2003), better access to external finance (Reese & Weisbach, 2002) and higher firm valuation (Doidge, 2004). Thus, in addition to seeking larger market capitalization, greater liquidity, higher valuations, performance and foreign sales, legal bonding is part of the international capital raising decision for a growing percentage of foreign firms (Claessen et al., 2003).

In previous sections we considered four antecedent factors of the CMLOF: institutional distance, information costs, unfamiliarity costs and cultural differences. Here we argue that their effects on the firm's CMLOF may be reduced by bonding. Hence:

*Proposition 5: Bonding on the part of the foreign firm negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

## **Signaling**

Bonding hypothesis suggests that the firm may reduce its CMLOF by choosing a highly regulated host market. However, even in less regulated markets it can mitigate negative effects of CMLOF by signaling its quality to investors. The importance of signals in capital markets has long been recognized, especially in research on the pricing of IPOs. Signaling theory refers to methods investors use in situations of information asymmetry where insiders (e.g., owners) of an IPO hold more information than outsiders (Spence, 1973). Researchers have focused upon uncovering a range of signals associated with the IPO firm that managers employ to convey its

value to potential investors (Certo et al., 2001; Filatotchev & Bishop, 2002; Sanders & Boivie, 2004; Zahra & Filatotchev, 2004). IPOs are characterized by information asymmetry in which owners have more complete information than investors regarding the quality of the firm (Beatty, 1989; Carter & Manaster, 1990). We believe that many of the signals identified in IPO literature may be equally efficacious in reducing CMLOF.

To combat the investors' lack of information about an IPO, a number of organizational attributes can serve as indicators of the strength of an organization at IPO (Beatty, 1989; Carter & Manaster, 1990). The various such signals identified in IPO research include insider ownership (Leland & Pyle, 1977), CEO equity ownership (Certo, Daily, Cannella, & Dalton, 2003), equity ownership by outside directors (Sanders & Boivie, 2004), blockholder and institutional ownership (Sanders & Boivie, 2004), founder as CEO (Certo, Covin, Daily, & Dalton, 2001; Nelson, 2003; Fischer & Pollock, 2004), size (Ibbotson, Sindelar, & Ritter, 1988) and age (Ritter, 1991). Other important signals identified in prior research include dividends (Bhattacharya, 1979), revealed risk (Beatty & Zajac, 1994), and the specific ways in which the proceeds of the issue would be used (Beatty & Ritter, 1986). Given that cross-listings and IPOs are the two primary means by which firms access foreign equity markets, a number of the above signals would prove to be useful in reducing the level of CMLOF experienced by a firm.

A McKinsey survey of more than 200 institutional investors who hold accounts worldwide revealed that their decision to invest is largely determined by the governance of a firm (Coombes & Watson, 2000). Hence it not surprising that, apart from a range of firm-level demographic characteristics such as age, size, industry affiliation, etc., corporate governance characteristics, such as retained share ownership (Loughran & Ritter, 2004), and board characteristics (Arthurs et al., 2008), have come to be regarded as important signals of

governance quality. The presence of outside directors is increasingly recognized as leading to good governance and hence can serve as a signal of good governance. In the US, research has found that independent directors impact a range of board decisions, including the removal of non-performing CEOs (Weisbach, 1988) and resist greenmail payments (Kosnik, 1987). Boards with higher proportions of outside directors have lower incidences of financial statement fraud (Beasley, 1996) while boards dominated by management are more likely to incur accounting enforcement actions by the SEC (Dechow et al., 1996). Evidence from the UK has shown that firms with a majority of outside directors exhibit greater reporting conservatism (Beekes et al., 2004). In addition, numerous studies in the field of accounting demonstrate that firms with independent directors engage in less earnings management (Bedard, Chtourou, & Courteau, 2004; Peasnell et al., 2000). Given the strength of empirical evidence suggesting the relationship between presence of independent directors and good governance, appropriate board composition can be a powerful signal to potential investors, especially for firms attempting to enter an overseas capital market. By signaling its value through “good corporate governance”, the firm may differentiate itself from other firms from the same country (Filatotchev & Bishop, 2002), and, therefore, reduce costs associated with CMLOF. Therefore, we suggest:

*Proposition 6: Signals of good governance on the part of the foreign firm negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

### **Organizational Isomorphism**

Isomorphism in organizational fields is a central concept of institutional theory (DiMaggio & Powell, 1983; Meyer & Rowan, 1977). Organizations seek to attain legitimacy through mimetic processes that result in their becoming similar to other organizations in an

organizational field (DiMaggio & Powell, 1983). Generally speaking, legitimacy may be considered ‘a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions’ (Suchman, 1995: 571). Firms considered legitimate by market stakeholders tend to succeed more frequently in competitive capital markets (Deeds, 2004). In fact, legitimacy is considered even more important for emerging firms entering a market because the organization’s chances of survival are significantly enhanced (Aldrich & Fiol, 1994; Baum & Oliver, 1992; Meyer & Rowan, 1977; Rao, 1994). Similarly, LOF studies have also emphasized the importance of strategic conformity relative to local firms to the performance of foreign subsidiaries (Miller & Eden, 2006).

There is evidence that firms from certain industries, or from certain countries, may have more success in some capital markets over others. For example, knowledge-intensive foreign firms may be able to overcome CMLOFs on U.S. exchanges not merely because of enhanced intellectual property protection, but also due to the manner in which the formal regulative institutional environment of the U.S. supports and promotes inventive and entrepreneurial activities. A recent edition of the World Competitiveness Yearbook shows that the U.S. regulatory environment offered higher intellectual property protection levels than its closest rival, U.K. Also, the first-to-invent patent issuing process of the U.S. (Cohen et al., 2002) also provides considerable protection to firms that are knowledge intensive. Further, as Hursti and Maula (2007) argue, technology firms tend to prefer large markets or markets where a large number of similar companies are already listed because of the low costs of information transfer. These authors conclude that “seeking an investor base that ‘understands’ the business of the IPO candidate is often cited as the reason for listing overseas” (Hursti & Maula, 2007; 838). These

findings are supported by the evidence of foreign listings of Israeli and Dutch IPOs provided by Blass and Yafeh (2001), as well as cross-listings of R&D intensive firms by Pagano et al. (2002).

Foreign companies from specific industries can overcome information and knowledge gaps by opting for markets where investors and analysts have an understanding and proven expertise in these industries. Particularly in technology or higher-risk sectors, the availability of such skills may substantially affect the availability of equity finance and the terms at which it is available. Better analyst coverage of such industries is likely to broaden understanding in the primary market, promote investor interest, and ultimately deliver higher valuations of the companies. If industry expertise is an important determinant of where to list and raise capital, one would expect to observe companies in the same industry clustered in exchanges that deliver this expertise. Previous studies have indeed found that companies opt for listings where industry peers are already present (Pagano et al., 2002). While the NYSE and NASDAQ exchanges provide trading platforms for the largest number of leading high-technology companies whose shares enjoy worldwide visibility and liquidity, Toronto's TSX and London's AIM exchanges have the most sophisticated and mature mining finance markets in the world, whereas the Hong Kong stock exchange is the destination market of choice for Chinese state-controlled companies seeking capital (Cetorelli & Peristiani, 2009). As these examples demonstrate, it is not uncommon for firms to seek capital markets where similar firms are already established and understood by resource holders. Hence, it is through a careful examination of their social identity that firms can potentially achieve legitimate status with influential capital market actors. As a result, this enhanced legitimization may lead to a reduction of its CMLOF.

*Proposition 7: Organizational isomorphism on the part of the foreign firm negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

## **Endorsements**

As Rao (1994: 31) notes “the very act of endorsement embeds an organization in a status hierarchy and thereby builds the reputation of an organization”. The value of third party endorsements (e.g., prestigious underwriters, audit firms, and alliance partners) in reducing the degree of uncertainty surrounding security issues is built upon the social status of the certifying organization. Therefore, a relationship with a high-status partner can be considered a powerful endorsement for the unfamiliar firm and thus act as a reputational source of legitimacy (Baum & Oliver, 1991; Podolny, 1994).

A wide assortment of organizational and extra-organizational attributes that serve as important cues regarding the quality of an unfamiliar firm to capital market resource providers have been investigated in prior research (Ritter, 1991; Ritter & Welch, 2002). Coffee (1999, 2002) and Stulz (1999), emphasize the role of “reputational intermediaries” in U.S. markets. These intermediaries include underwriters (in the case of capital-raising listings), auditors, debt-rating agencies, securities analysts as well as the exchanges themselves (via listing requirements) (Carter, Dark & Singh, 1998; Carter & Manaster, 1990; Loughran & Ritter, 2004). They provide additional scrutiny or monitoring that is unavailable in the home markets of foreign firms. These local investors are attractive to foreign investors, because they reduce information asymmetry, add value, and provide legitimacy. They have information about the operation of the local market, including access to deal flow as well as dense networks of contacts and also have considerable familiarity with the legal requirements of the local market.

This analysis suggests that foreign firms can reduce their CMLOF by using means external to an organization, such as endorsing and certifying by third party agents (banks-underwriters; audit firms, private equity investors, etc). However, the extent of this endorsement

effect is contingent on the institutional infrastructure of local capital markets. In some markets, such as the U.S. stock markets, formal arrangements with bank-underwriters and other third parties who act as “gate keepers” may be particularly salient means of reducing CMLOF among foreign firms attempting to issue local securities. In the U.K., however, foreign firms rely on more informal relations with their gatekeepers using networks and reputation considerations as means to reduce CMLOF.

*Proposition 8: Endorsements of the foreign firm by reputable third parties negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

## **DISCUSSION**

Liability of foreignness has been one of the most researched topics in international business since the beginning of the field in the early 1960s. LOF is central to the development of theories of the multinational firm, but most such theories accorded LOF what amounts to a “taken for granted” status. Starting with the pioneering work of Zaheer (1995), the last fifteen years have seen a sudden proliferation of empirical and theoretical work on LOF and many stimulating intellectual debates on the domain of the construct, its measurement, and strategies for overcoming it. It was natural that much of this work focused on LOF in product markets because much of the early internationalization efforts of firms in developed and emerging markets occurred primarily in product markets. While the strategies firms pursue in the product market domain can make the difference between success and failure, firms often need external financial resources in order to take advantage of the growth opportunities provided by their chosen product markets. Our study draws attention to the growing number of firms that choose to seek capital resources outside of their home capital markets and develops a framework to understand both the sources of CMLOF and strategies that firms can use to mitigate those costs.



Our study draws from the pervasiveness of the ‘home bias’ phenomena among investors around the world to explain how firms incur additional costs when raising funds outside of their home capital markets. As firms rush to cross-list their stock in multiple markets and choose to make their capital market debut in foreign markets through IPOs, it becomes important to examine the existence of LOF in capital markets. We identify four major types of costs that result in LOF in capital markets. These are institutional distance, information costs, unfamiliarity costs, and costs arising from cultural differences (Ahearne et al., 2004; Cai & Warnock, 2004; Chan et al., 2005; Daude & Fratzscher, 2007; Tesar & Werner, 1995). Each of these places the foreign firm at a disadvantage compared to domestic firms in host capital markets.

Drawing from institutional and signaling theories we identified four specific strategies that firms can use to overcome CMLOF. These are bonding, signaling, organizational isomorphism, and endorsements by third parties. Together these strategies enhance the legitimacy of the foreign firm and level the playing field with respect to domestic firms vying for capital resources.

Expanding the scope of LOF research to include the costs facing firms acquiring resources in host capital markets presents a number of additional research opportunities. Most important among them is the impact of the institutional environment of a country on the likelihood of success of specific strategies to overcome CMLOF. The recent accumulation of research examining the differences between the institutional environments of emerging and developed economies suggests that success of specific strategies firms employ to mitigate CMLOF costs may be a function of the institutional characteristics of the host country. For example, certain governance signals, such as stock-based executive compensation is so prevalent

in the U.S. that it has achieved a “taken for granted status” (Sanders & Boivie, 2004: 171) whereas this form of governance signal may be less accepted in other host capital markets. Likewise, large investment banks are relevant social actors in the US capital market, and could conceivably confer legitimacy to foreign firms seeking capital on US exchanges. On the other hand, investors contemplating investments in emerging market firms listing on London’s AIM exchange rely on the standing of Nominated Advisors (nomads) as a proxy for the quality of listed companies (Davidoff, 2007). Nomads, which are normally lower and medium-tier investment banks, serve as gatekeepers, advisers, and regulators of AIM-listed companies (Aaronson, 2007). As these examples suggest, it is important to recognize that the ability of governance signals and endorsement to reduce LOF costs may be contingent on both home and host institutional environments.

Along with this line of inquiry, authors have questioned whether governance signals will always convey substantive information to resource holders (Westphal & Zajac, 1994; Westphal & Zajac, 1998; Zajac & Westphal, 1995). It is quite possible that certain governance and endorsement signals may convey substantive information to investors in one institutional environment, yet be understood as merely symbolic, and perhaps discounted, in others. Investigations into the value of symbolic and substantive signals can help in understanding how the prevailing institutional logics (Zajac & Westphal, 2004) of capital markets are formed, how they change, and how differences in institutional logics across capital markets present differing costs and benefits to firms looking to acquire capital outside of their home market.

Much of our discussion in this paper was restricted to CMLOF in formal equity markets because firms have traditionally gained access to capital via public capital markets. However, private equity firms represent an innovation in the ability to provide capital to unquoted firms

(Wright et al., 2009). Hence, future research could explore the occurrence of CMLOF within informal capital markets. For example, foreign private equity firms entering overseas markets may face higher transactions costs in both identifying and monitoring firms to invest in. By virtue of their foreignness they also likely experience greater information asymmetries. In addition, studies have shown that CMLOF can have significant impacts on cross-border venture capital activity. Indeed, cultural differences and geographical distance can create problems in cross-border VC investments (Meyer & Shao, 1995) and can diminish the commitment of venture capitalists in foreign markets (Maula & Mäkelä, 2003). Bruton et al. (2010) also indicate that the extent and nature of agency conflicts associated with equity issuance may be different in different institutional environments. As a result, national institutions can moderate the effectiveness of signals and bonding strategies deployed by foreign firms to mitigate their CMLOF. Future analysis can usefully integrate institutional theory and economic sociology research to develop a more holistic view on the antecedent factors and moderators of LOF in different institutional contexts.

Finally, another promising avenue for future would be examining whether overcoming CMLOF in equity markets would lead to spillover benefits in other capital raising activities (for example, in credit markets), or even in product market activities. Such an examination would result in a better integration of LOF research in capital and product markets. Also, it would be interesting to examine how the benefits of being foreign in certain cases may overcome the costs associated with being foreign.

In this paper we argued for the expansion of the domain of the liabilities of foreignness construct to include liabilities faced in capital markets. The increasingly integrated global capital markets have greatly impacted the opportunities available to firms worldwide seeking to lower

their costs of capital. However, a significant body of literature has demonstrated a pervasive bias among investors against firms founded in dissimilar cultural and institutional environments. Indeed, overcoming investor bias represents real costs to the firm and is a steep challenge to the manager looking to acquire capital resources abroad. In this paper we identify a number of causes for investor bias and the resulting CMLOF and suggest a range of strategic responses that firms can employ to overcome them.

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**TABLE 1**  
**Empirical Evidence of the Existence of Liabilities of Foreignness in Product Markets**

Article	Study Focus	Operationalization of LOF	Sample	Findings
Li & Guisinger (1991)	Do foreign-controlled firms in the US fail more frequently than domestically owned firms?	Differences in bankruptcies and liquidations between foreign controlled firms in the US and the Dun and Bradstreet annual business failure rates.	Comparison of the number of foreign-controlled bankruptcies and liquidations per 10,000 of foreign controlled firms in the U.S. against the Dun & Bradstreet annual business failure rate index of U.S. firms.	Foreign-controlled firms fail less than domestically controlled firms.
Shukla & Van Inwegen (1995)	Do UK mutual funds investing in the US perform better than US mutual funds investing in the US?	Comparison of the gross returns of US and UK mutual funds.	108 US mutual funds and 19 UK mutual funds	Information and relationship advantages enable US mutual funds investing in the US to perform better than UK mutual funds investing in the US.
Zaheer (1995)	Is there a performance difference between foreign and local FX trading rooms?	"the difference between the average profits per trader of all local trading rooms and the foreign room's profits per trader in the same city" (p.350)	28 trading rooms located in New York and Tokyo	Trading rooms of foreign banks in a given location are less profitable than those of local banks.
DeYoung & Nolle (1996)	Are foreign-owned U.S. banks less profitable than U.S.-owned banks between 1985 and 1990.	Profit efficiency differences between foreign owned banks in the US and domestic banks.	62 foreign-owned U.S. banks, and 240 U.S.-owned banks.	Foreign-owned U.S. banks are less profit efficient than U.S.-owned banks between 1985 and 1990.
Hasan & Hunter (1996)	Are foreign-owned multinational banks operating in the US less efficient than US owned multinational banks?	Efficiency scores of foreign owned and US owned banks using a stochastic frontier approach.	70 Japanese-owned multinational banks, 984 US-owned multinational banks	Japanese-owned multinational banks operating in the US are less efficient than US owned multinational banks
Zaheer & Mosakowski (1997)	Is there a survival rate difference between foreign and local FX trading rooms?	Survival functions (probability that an event occurs after a certain duration, given initial starting conditions).	2667 trading rooms located in 47 countries	The survival rate of foreign- owned trading rooms was significantly lower than that of local trading rooms.

**TABLE 1**  
**Empirical Evidence of the Existence of Liabilities of Foreignness in Product Markets (cont.)**

Article	Study Focus	Operationalization of LOF	Sample	Findings
Thompson (2000)	Do foreign owned manufacturing subsidiaries have greater chances of survival than domestic owned firms in Denmark,?	Survival functions of domestic firms compared to the subsidiaries of foreign firms.	378 domestic subsidiaries and 239 foreign subsidiaries	Foreign owned manufacturing subsidiaries have lower survival probability than domestic owned firms.
Hennart, Roehl, & Zeng (2002)	Are all foreign firm exits from a country due to LOF?	Exits due to difficulties in human resource management, overoptimistic market forecasts, and difficulties dealing with the local government.	32 Japanese manufacturing affiliates who exited from the US	Exits proxy for LOF costs only in a small number of cases (13 out of 32 in this study)
Mata & Portugal (2002)	Do foreign and domestic firms experience different chances of survival?	Survival functions of domestic and foreign greenfield ventures	613 foreign owned and 593 domestic firms	No differences in gross exit rates between foreign and domestic greenfield ventures
Mezias, SMJ (2002)	Are there differences in the number of labor lawsuits faced by foreign and domestic firms?	The number of labor lawsuits judgements against firms	486 British, German and Japanese subsidiaries operating in the U.S. matched against 486 US firms.	foreign firms face more US labor lawsuits judgments than US-owned firms
Miller & Parkhe (2002)	Is the level of X-efficiency of foreign-owned banks lower than that of host country banks?	The X-efficiency of host country banks vs. foreign-owned banks	872 host country banks and 428 foreign-owned banks that operate in 13 host countries.	Foreign-owned banks exhibit lower X-efficiency than host country banks.

**TABLE 1**  
**Empirical Evidence of the Existence of Liabilities of Foreignness in Product Markets (cont.)**

Article	Study Focus	Operationalization of LOF	Sample	Findings
Miller & Richards (2002)	Examines the performance of host country and foreign-owned firms in the European Union to investigate the moderating effect of host country characteristics on the degree of liability of foreignness	The X-efficiency of host country banks vs. foreign-owned banks	700 host country and 257 foreign banks in the European Union	Host country firms are more X-efficient than foreign firms in highly competitive host countries. There are no X-efficiency differences in less competitive host countries.
Nachum (2003)	Are there performance differences between foreign and domestic firms in the financial services industry in the City of London?	The return on capital (ROC) of foreign firms compared to the average ROC performance of British-owned firms.	296 foreign owned financial services firms in the City of London.	Foreign financial firms have higher rates of return on capital than British-owned firms.
Sofka & Zimmerman (2008)	Investigates whether the amount of economic stress in a host country region influences the impact of liability of foreignness.	Investigates whether foreign producers experience LOF in the German car market and if so is there a difference in the magnitude of LOF across regions within the same country.	439 German and 759 foreign car models from 23 domestic and foreign car manufacturers.	Foreign firms face significant LOF in the German car market. However, they experience lower levels of LOF in regions experiencing greater economic stress.
Kronborg & Thomsen (2009)	Investigates how foreign ownership affects the survival of companies	Survival functions of domestic firms compared to the subsidiaries of foreign firms.	528 pairs of foreign-owned and domestic-owned manufacturing companies in Denmark over a 110 year period	Domestic companies have higher exit risk than foreign subsidiaries.
Schmidt & Sofka (2009)	Is there a difference between foreign subsidiaries and domestic firms in terms of host country knowledge spillovers?	Differences between foreign and domestic firms in (a) and knowledge spillovers from customers and (b) knowledge spillovers from universities based upon survey responses.	1129 companies located in Germany; 1020 domestic firms, 109 foreign MNC subsidiaries	Foreign MNC subsidiaries are significantly less likely to receive valuable knowledge from German customers and/or scientific sources than domestic firms.

**FIGURE 1**  
**Capital Market Liabilities of Foreignness:**  
**Antecedent Factors and Mitigation Strategies**

