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Cost of Debt and Political Connection of Firms in Vietnam

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Abstract

The purpose of the paper is to present a proposed study on the relationship between the interest rate charged on debt and political connection of firms in Vietnam. Data on cost of debt and political connection from 600 Vietnamese public firms over a period from 2016 to 2018 is gathered to examine the research hypotheses. The present study extends the previous research that finds politically connected firms (PCON) are generally considered as higher risk than that of non-PCON firms by both the market and audit firms in emerging economy, by providing the evidence in Vietnam that lenders also view these firms as higher risk.

Keywords: Cost of Debt; Political Connection; Politically Connected Firm; Emerging Economy.

1. Introduction

In recent years, there are many studies on the relationship-based of non-western economies due to their growth and the subsequent importance of these economies since the last decade, and Vietnam is undeniable among these countries. Vietnam's political environment can be broadly said to be similar to that of Chinese's political environment but it is also noticeable different, and similar to Chinese economy, the phenomenon of politically connected (PCON) firms.

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In the early stage of the 1997 Asian financial crisis the stock prices of PCON firms fell lower than that of non-PCON firms. This difference is explained by the suggestion that the market saw PCON firms as firms that inefficient and the government being incapable of support these firms [1]. Similar studies have been conducted in Western economy, Chinese and others ASIAN country but none has been conducted in Vietnam. The studies until now on this subject are just discussed and provide evident that both the market and auditors view non-PCON firms being lower risk than PCON firms and in these studies, it is suggested that the reason for this to be happen is that PCON firms are considered to be inefficient. In addition, Reference [2] shows that PCON firms have higher level of leverage, which in turn indicates that PCON firms are at high level of risk. The present study, therefore, aims to extend the understanding of PCON firms by investigating (1) whether these firms have a higher cost of debt capital given their correlation with higher leverage, (2) whether the government efforts have any effects on the cost of debt. It is expected that the cost of debt of PCON firms would be higher than that of non-PCON firms since the PCON firms are viewed to be associated with higher risk and leverage to that of the non-PCON firms. The study further investigates whether two attributes of the corporate governance (1) managerial ownership, (2) the CEO is politically connected, affect the cost of debt of PCON firms. The study utilizes hand-collected data from the annual reports of the firms that were published on Ho Chi Minh stock exchange (HOSE) from 2016 to 2018. The first ever "Vietnam Corporate Governance Code of Best Practices" for Public Companies was issued on August 13, 2019 by the State Securities Commission of Vietnam (SSC) in Ho Chi Minh City. The code was developed with support from the International Finance Corporation (IFC) and the Swiss State Secretariat for Economic Affairs (SECO). The Code contains a series of recommendations on best corporate governance practices, primarily for Vietnamese public and listed companies. With standards that go beyond the minimum legal and regulatory requirements, the Code aims to encourage companies to work towards international best practices and integrate with its regional ASEAN counterparts who already have similar codes. The Code is divided into 5 areas including 10 principles and sub-principles. The most important principles in the Code concentrates on the responsibility of the Board, an area that requires further improvement in many Vietnamese firms. The remaining four principles cover issues in control environment, transparency and disclosure, shareholder rights, and stakeholder relations. The Code also includes provisions relating to responsible business, such as promoting gender diversity and encouraging a stronger focus on environmental and social issues. One of the present study's purpose is to evaluate whether or not that the Code has address the PCON firms' corporate government in the aspects of managerial proportion and the political connection of the CEO. The results of this study are expected that the interest rates charged by lenders to non-PCON firms are significantly lower than those charged to PCON firms. This is in line with our expectation that lenders perceive PCON firms to be riskier. This finding is in line with the previous findings by [1,3] who found PCON firms to be perceived riskier by the market and by audit firms, and by [2] who provided evidence that PCON firms are highly leverage. Based on [4], politically connected companies enjoy easier access to debt financing, lower taxation, and stronger market power. These benefits increase when companies are connected through their owner, these benefits are generally larger when the firm operates in a country with high corruption, low protection of property rights, a highly interventionist government, or a non–democratic government. Even though these connections provide significant benefits, connected firms under–perform their peers on an ex– ante basis. Therefore, connections, by driving benefits to relatively poorly performing firms, distort the allocation of funds and investment decisions, which in turn show that to the lenders PCON firms, are riskier than that of non-

PCON firms. It is also expected that there is an association between CEO who is politically connected in PCON firms and the interest rates being charged, and an association between the proportion of managerial and the interest rate. Whilst a number of studies have investigated political connections and cronyism, and a small number of studies including [5] has investigated the cost of debt, there has been appeared no study on political connections and the effect of political connections on debt pricing for the PCON firms. Although [3] has conducted a similar research, the data was collected in Malaysia and just the CEO duality and the independent of the audit committee were examined.

2. Literature Review and Hypothesis Development

2.1 Cost of Debt

Only small number of studies has investigated the cost of debt and the determinants of debt pricing. [5] in a study of IPOs considered the effects of auditor type on the cost of debt. These authors find that big audit firms enhance the credibility of financial statements and, as such, are associated with lower borrowing costs. These authors find, however, that the choice of auditor becomes less important over time as a determinant of interest rates charged on debt over time. In fact, this correlation diminishes quickly as a young firm establishes a history with its lenders. Reference [6] investigates the correlation between both the cost of debt and equity capital and the level of voluntary disclosures made in financial statement reporting. These authors find that firms in industries with greater external financing needs have higher levels of voluntary disclosure levels which, in turn, are associated with lower costs of debt and equity. Reference [7] has a study similar to this research topic, however the data of that research is unique to the political conditions in Malaysia and using the different indications of corporate government from the current study.

2.2 Political connection

Vietnam is a one-party state ruled by the Communist Party of Vietnam (CPV) which provides strategic direction and decides all major policy issues. The country is led by the so-called “four royal pillars”: CPV General Secretary, State President, Prime Minister and National Assembly Chair until the death of late President in 2018, which prompted General Party Secretary to assume 2 positions. Policy, which priorities stability, retaining the political status quo, domestic economic development and international integration, is made on a consensus basis by the Politburo. Regional security, especially in relation to the South China Sea, is a major foreign-policy priority for the CPV. Party leaders and the leaders of the government, are selected every 5 years at the National Party Congress. The most recent Congress was held in January 2016; followed in May 2016 with a national election to elect the 500 Deputies who make up the National Assembly, Vietnam’s legislative body. Next National Congress is due in 2021 but that would mean the whole 2020 would be spent on the Congress at the lower levels to elect representatives to attend the National Congress. Vietnam is one of South East Asia's most politically stable countries. Dissension is not accepted and internal conflict is strictly controlled. Land rights can be a source of social tension. Strict restrictions on freedom of speech can affect the use of the internet, particularly the use of social media and personal blogs. Cyber Security Regulation, which has been in effect since January 2019, has called for improved cooperation by international service providers with local office establishment and local data storage. Mainstream media outlets remain under the control of the government. With the presence of a single party, there are no major changes in the political conditions in Vietnam when the term is passed. That means Vietnam's political connections are long-lasting and the conditions under which PCON firms are "out of favor" are at a lower risk than other countries. Nevertheless, due to high inequality, low levels of property rights, Vietnam's highly interventionist PCON government firms are considered risky based on [4]. By providing them with easy access to bank credit, the government has been selective in supporting those companies. These firms were primarily owned by the state and funded by the government. Also selected by the government, companies preferred to obtain investment capital at favorable prices. This provides businesses with a significant advantage in terms of credit scores, better markets and a relatively safer economic environment, but in fact this damages firms because of the attention generated by firms rather than their actual value. Vietnam is an emerging economy with a high level of corruption, rising the influence of the political connection. Some of the examples of favoured firms are state-owned corporations. These firms were and are receiving a lot of advantages compared to the usual standards of the industries. State-owned companies tend to pose a challenge to Viet Nam's economy due to misallocation of resources and inefficiencies. In recent years, in the sense of international economic integration, the restructuring of state-owned enterprises (SOEs) to improve their performance has become an important task in Vietnam. It also reflects the government's dedication to restoring economic institutions and developing a market-oriented economy. Changes in foreign ownership limits, a growing economy, and a strong performing stock market have attracted significant interest from foreign investors in earlier divestments from SOEs. The theories of [8,9] explain why political, synonymous with government, connections with firms come into existence. Politicians, or government figures, seek relationships with firms as a means of controlling them so that they act to achieve goals that are conducive to the government's agenda to reward its supporters. For their political contributions and votes, the PCON firms receive benefits such as profitable contracts or subsidies. The benefits flowing from political connections make the PCON firms inefficient and possibly even foster a culture of inefficiency given the firms "protected" status. Political connection in Vietnam has been well documented which provides an excellent opportunity in which to study the correlation between political connection and the cost of debt. Reference [1] provides evidence that politically favoured firms were expected by the market to, and did in fact, lose subsidies at the onset of the Asian financial crisis owing to the government inability to support them. This caused their stock prices to fall more than non-PCON firms. Conversely, the market anticipated that the government introduced capital controls to subsidize PCON firms, and consequently those firms recovered faster than the non-PCON firms when the capital controls were implemented. Reference [3] provides evidence that during this financial crisis period audit firms assessed politically favoured firms as being of higher risk than non-PCON firm resulting in their being charged higher audit fees. Subsequently, the costs of auditing politically favoured firms fell when the Vietnam government introduced the capital controls. Each of these two studies provides evidence that the market and audit firms viewed PCON firms as risky. Further, Reference [2] finds that PCON firms are significantly associated with higher leverage which suggests that these firms are inherently more risky than non-PCON firms. Hence, lenders will have reason to consider PCON firms to be of higher risk and we posit a positive correlation between cost of debt interest rate pricing and firms with political connections. To examine this relationship, the first hypothesis is formally stated as the following.

H1. There is a negative relationship between the interest rate charged on debt and politically connected firms.

Additionally, the present study seeks to investigate whether two board attributes within PCON firms impact on their cost of debt. First, it investigates whether Political connected Chief Executive Officer (CEO) in PCON firms increases the perceived risk by lenders and leads to a higher cost of debt. In Vietnam, having political connection is an advantage since the country has high level of corruption so PCON firms have higher risk than that of non-PCON firms. With CEO that is politically connected, the pressure of the government on the firms as well as the benefits on the financial field in term of ease of loan on the bureaucracy processes increase. This study investigates whether CEO who is a politically connected in PCON firms impacts on the perceived risk by lenders to indicate the different in the level of connection with PCON have within themselves. It is expected that Political connected CEO in PCON firms will increase the perceived risk by lenders leading as the level of politically connected are deepen, to such firms experiencing higher costs of debt. To explore the association between cost of debt and political connection of firm, the second hypothesis is established as follows.

H2. There is a negative relationship between the interest rate charged on debt and politically connected firms with Political connected CEO.

Additionally, the current study discovers whether PCON firms with a higher proportion of Managerial ownership (MANA) will have higher interested rate since the managerial ownership under agency theory, Reference [10] stated that risk to be a significant and positive determinant of the level of managerial ownership while managerial ownership is also a significant and positive determinant of the level of risk. The result supports the argument that managerial ownership helps to resolve the agency conflicts between external stockholders and managers but at the expense of exacerbating the agency conflict between stockholders and bondholders, they have high power to the board and make the firms become riskier. The third hypothesis, thus, is developed as the following.

H3. There is a positive relationship between the interest rate charged on debt to PCON that have a higher proportion of Managerial ownership Structure**.**

3. Methodology

3.1 Sample

The sample consists of 600 non-financial firms on Ho Chi Minh Stocks Exchange (HOSE) since the financial firms are usually operated with different regulations. The sample is chosen to make sure that the data covers a wide range of firms based on the industries that they are operating as their main field. The following table presents the target respondents classified by the industry they have been operating in.

The data on these firms‘ end of the year financial statement (audited if available) for the period of 2016-2018 will be gathered.

Table 1: Characteristics of Target Firms

Industry Classification	**Number of Firm**
Information technology	12
Health care	36
Energy	30
Materials	84
Industrials	81
Consumer Staples	111
Consumer Discretionary	48
Utilities	54
Communication Services	6
Real estate	138
Total	600

3.2 Measurement of Variables

3.2.1 Dependent Variables

The dependent variable, Interest Expense (IR), is measured as the interest expense of the firm divided by its average short-term and long-term debt during the year. The interest expense for the year is disclosed in the income statement and the short-term and long-term debt is disclosed in the balance sheet of the financial statements incorporated in the annual reports.

3.2.2 Independent Variables

The major experimental variable of interest in this study is politically connected firms (PCON). Firms are identified as being PCON firms if they are identified as such by either [1] or [11], and is operationalized is an indicator variable with '1' if the firm is identified as being politically connected, and '0' otherwise. Data on the composition of the independence of the audit committees, and on CEO who is a politically connected were manually collected from the 2016 to 2018 annual reports that were published on HOSE. The variable MANA is measured as the proportion of shares that owned by the directors and their family. The first hypothesis is that PCON firms will be associated with higher costs of interest rates on debt. To control the effects that CEO who is a politically connected may have on interest rates charged to a firm, an indicator variable CEO is used. It is coded '1' if the CEO is in the party, used to be in the party, is a relative of person in power, and '0' if the CEO is not a politically connected. To examine the second hypothesis as whether there is a positive correlation between interest rates and PCON firms with CEO who is politically connected, an interaction term PCON CEO is used. To test the third hypothesis that is if there is a positive correlation between interest rates and PCON firms with a higher proportion of managerial ownership, an interaction term PCON MANA is used.

3.2.3 Control Variables

Based on prior studies on cost of debt capital [12,5,6,13], the following variables are included in the regression, the number of years since incorporation or the age of firm (AGE), whether audited by a big audit firm (AUDITOR), leverage or the amount of debt a firm uses to finance assets (LEV), cash-flow of the net amount of cash and cash-equivalents being transferred into and out of a business (CF), total assets or the total assets that the company has (SIZE), property, plant and equipment or the tangible fixed assets/total assets (PPE), sales growth (GROWTH), whether the firm has a negative equity (NEGEQ), current ratio or current assets/current liabilities (CR) and whether the firms have reported a loss on the current financial year (LOSS) as control variables. A firm age is expected to be negatively associated with the cost of debt in line with the reputation effect posited by [14] that firms over time are able to create good credit histories that that reduce the perceived risk to lenders. It is expected that the financial statements of firms audited by big audit firms would be more credible to lenders hence the expectation that big audit firms would be negatively associated with cost of debt. More highly geared firms are more likely to be considered risky by lenders so it is expected that leverage and cost of debt will be positively associated. A higher cash-flow is expected to reduce a lenders' perceived risk as these firms are more likely to be able to service their debts. Larger firms are expected to be associated with lower costs of debt as they are perceived as less risky by virtue of their having more assets in place and greater opportunities for economies of scale [15]. The correlation between cost of debt and property plant and equipment is expected to be negative as borrowers with PPE are in a better position to provide security on their loans. Secured loans enjoy lower interest. Sales growth (GROWTH) is measured as the change in sales revenue from the previous year scaled by sales revenue in the previous year. Firms experiencing sales growth would be considered less likely to default on their loans. The coefficient on the variable GROWTH is expected to be negative. Firms with negative equity are considered to be higher risk to a lender and would be levied a higher interest rate. A firm's current ratio (CR) is measured by its current assets divided by its current liabilities. Firms with higher current ratios are more likely to be able to meet their current obligations and are expected to be associated with lower costs of debt. Lenders are likely to consider firms reporting a loss in the financial year as more risky borrowers. Such firms are expected to be associated with higher interest rates.

3.2.4 Regression models

The regression models utilized in the study are presented as follows

(1) $$IR = \beta 0 + \beta 1PCON + \beta 2AGE + \beta 3AUDITOR + \beta 4LEV + \beta 5CF + \beta 6SIZE + \beta 7PPE + \beta 8GROWTH + \beta 9NEGEQ + \beta 10CR + \beta 11LOSS + \beta 12 - 14YR + \beta 15 - 24INDUST + \varepsilon$$

(2) $$IR = \beta 0 + \beta 1PCON + \beta 2CEO + \beta 3MANA + \beta 4PCON * CEO + \beta 5PCON * MANA + \beta 6AGE + \beta 7AUDITOR + \beta 8LEV + \beta 9CF + \beta 10SIZE + \beta 11PPE + \beta 12GROWTH + \beta 13NEGEQ + \beta 14CR + \beta 15LOSS + \beta 16 - 18YR + \beta 19 - 28INDUST + \beta 29CEOduality + \varepsilon$$

All preceding variables such as independent variables, dependent variables and control variables are defined as the following

IR	interest expense for the year divided by its average short-term and long-term debt
PCON	the firm is politically connected
CEO	chief executive officer is also a politically connected
MANA	proportion of managerial ownership of the firms
AGE	number of years since the firm was incorporated
AUDITOR	audited by a big auditor firm
LEV	sum of total short-term and long-term debt divided by total assets
CF	cash flow from operations divided by total assets
SIZE	natural logarithm of total assets
PPE	gross property, plant and equipment divided by total assets
GROWTH	sales revenues in year t minus sales revenues in year t - 1 divided by sales revenue in year t-1.
NEGEQ	firm reported negative equity
CR	current assets divided by current liabilities
CEO duality	the CEO of the company is also the chairman of the board
LOSS	whether the firms have reported a loss on the current financial year
INDUST	firm industry

4. Conclusion

The purpose of the present study is to propose a study on the relationship between cost of debts and political connections of firm in Vietnam based on the data from 600 non-financial firms on HOSE over a period of 2016-2018. In this study, cost of debt is measured by the interest expense of the firm divided by its average short-term and long-term debt. A political connected firm is a firm with at least one of its large shareholders (anyone controlling at least 10 percent of voting shares) or one of its top directors (CEO, president, vice president, or secretary) is a member of parliament, or a minister, or is closely related to a top politician or party [11]. This study contributes to the advance of theory in the field, firstly with the localization of the correlation between PCON and the cost of debt. Secondly, the study provides evident and data for further studies on the categorization of political connections. Finally, by associating the PCON with the managerial proportion of the corporate governance element, this study aims to justify that whether Vietnam an emerging country with First Code of Corporate Governance is sufficient with the current demand of the economic environment. The current study concentrates on collecting data from HOSE in the span of three years as the same as the previous studies on this research direction, the external validity problem may exist. Furthermore, the impact of the two corporate governance attributes including the CEO characteristic and the proportion of managerial ownership on the cost of debt can be debated.

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