

Chapter 2

Literature Review

The researcher has studied concepts, theories and related research used to determine the research guidelines as follows:

1. Foreign Direct Investment Theory
2. Corporate Financing Structure Theory
3. Financing Stability
4. Financing Cost
5. Agency Cost
6. Hypotheses Development

Foreign Direct Investment Theory

Foreign direct investment (FDI) is commonly defined as economic activities in which a domestic investor from a particular country or region acquires equity or voting rights in an overseas company. This acquisition grants the investor the authority to operate and manage the company, and the investment is made through cash, physical assets, or intangible assets. The Chinese Ministry of Commerce and Bureau of Statistics have also provided their definition of FDI, specifying that it involves Chinese investors acquiring more than 10% of the equity of foreign enterprises, along with tangible or intangible assets, and obtaining control over the operation and management of these enterprises.

Following World War II, some Western developed countries began using FDI as a means to revitalize their economies through international trade transactions between nations. The rapid growth of trade activities has sparked the interest of numerous scholars, leading to the development of various theories on FDI. These theories primarily analyze the motivations behind FDI from a macro perspective, often focusing on developed countries.

1. The Theory of Monopoly Advantage

In 1960, Hymer introduced the theory of monopoly advantage based on statistical data from American transnational corporations. He argued that overseas direct investment (OFDI) is driven by imperfect competition and the presence of monopoly advantages held by transnational corporations in the real market. According

to Hymer, these enterprises leverage the advantages they have accumulated in their home countries' relevant industries to offset the additional costs associated with foreign investment and generate profits.

Building on Hymer's theory, Kindleberger (1969, pp.11-12) and subsequent scholars such as Johnson (1970, pp.35-55), Caves (1971), and Pearson (1976, pp.320-333) further expanded the concept of monopoly advantage. They supplemented the theory by considering additional factors such as knowledge assets, product heterogeneity, and economies of scale.

J. Dunning categorizes the benefits that corporations can have in the international capital market as O-advantages, I-advantages, and L-advantages. O-advantages stem from the internal capabilities of investing companies, including their size, market position, management and leadership qualities, technical capabilities, brand recognition, organizational structure, and strategies employed. I-advantages arise from the greater control over products and manufacturing capabilities in overseas markets compared to domestic companies. L-advantages encompass rewards offered by recipient nations, such as preferential tax regimes, state involvement in project finance, and the provision of infrastructural services.

The eclectic paradigm suggests that recipient nations should not solely rely on the availability of resources to attract foreign investment. Instead, they should focus on creating an investment-friendly environment. According to this approach, if a company can simultaneously benefit from ownership advantages, location advantages, and internalization advantages, it can operate profitably through direct investment in a foreign market. For example, if a business benefits primarily from ownership or location advantages, it may choose to implement specific strategies such as exporting or franchising in a foreign market.

Overall, these theories highlight the importance of monopoly advantages, internal capabilities, and favorable conditions in recipient nations for understanding the motivations and benefits of overseas direct investment.

2. Life Cycle Theory

Vernon (1966, pp.190-207) introduced the product life cycle theory, which divides a product's life cycle into three stages: innovation and development, maturity, and standardization. According to this theory, an enterprise's decision regarding foreign direct investment (FDI) should change accordingly in each stage. During the innovation and development stage, the production and sales of new products should be conducted domestically to prevent technology leakage. This allows for the export of products from the home country, establishing a monopoly in the market

where there are no substitutes. In the maturity stage, as production technology becomes mature and demand increases, imitations or substitutes may emerge, diminishing the monopoly advantage. At this point, multinational companies can export technology to the international market through their subsidiaries invested abroad, initiating overseas expansion. In the standardization stage, enterprises may choose to make overseas direct investments to shift production to countries with lower production costs and labor wages, replacing exports. Domestic production of the product at this stage no longer involves further research and development.

Hong et al. (2019) conducted a study on multinational enterprises (MNEs) and their outbound foreign direct investment (FDI) to examine the impact on local employment. The findings indicate that outbound FDI motivated by market seeking for scale and scope expansion, natural resource seeking, or strategic asset seeking acts as a "strategic complement" by improving domestic employment for MNEs. The analysis is based on a firm-level sample of Japanese MNEs across 59 countries from 1996 to 2010. On the other hand, outbound FDI driven by market seeking linked to decreases in domestic demand or labor resource searching tends to operate as a "strategic substitute," reducing domestic employment by MNEs. The study has implications for philosophy, practice, and policymaking.

Duanmu (2015, pp.23-45) examined the influence of access to external funding on the likelihood of engaging in foreign direct investment (FDI) using data on privately owned firms (POEs) in China. The findings indicate that external financing is a statistically significant factor affecting the probability of POEs engaging in FDI. Industries with a strong reliance on external financing, high levels of technology, poor tangibility, and high inventories are more likely to require external finance for FDI. For POEs with group affiliation, the correlation between FDI and external financing is weaker; however, it is stronger for those that have substantial employment welfare policies in place.

3. Internalization Theory

The significance of the internalization theory lies in its contribution to the study and practice of international business. This theory examines the developmental context of multinational enterprises, the historical background of the theory, and the phenomena it has been able to explain. It also addresses the argument against the notion of "unanswered questions" in the field. Some of the areas that the theory explores include governance, location theory, dynamics, networked multinationals, innovation, entrepreneurship, and the significance of risk and uncertainty (Buckley, 2016, pp.74-82).

Proposed by Buckley & Casson (1976, pp.32-65), the internalization theory posits that foreign direct investment (FDI) results from the internalization of international transactions by enterprises. In an imperfectly competitive market, factors like technology, patents, sales, and other elements can impact the transaction price of intermediate products, leading to difficulties in confirming prices and high transaction costs. By incorporating intermediate products into internal business activities, companies can internalize market transactions and replace external market interactions. This internalization aims to reduce transaction costs.

When market transactions are internalized and conducted across borders, transnational corporations emerge, and foreign direct investment takes place. Internalizing market transactions can lead to the establishment of more multinational corporations and subsidiaries, driving international direct investment. A crucial prerequisite for a company to internalize a product is that the cost of internalization is lower than that of marketization. The theory primarily focuses on the intermediate product market, continuously reducing transaction costs and enabling enterprises to gain more benefits.

However, it is important to note that market internalization may not always be the optimal choice for small and medium-sized enterprises (SMEs). Instead, these enterprises may replace product internalization with information or knowledge to attain higher market value. Nevertheless, the theory may have limitations in explaining the direction of FDI by enterprises and the behavior of short-term foreign direct investment.

In summary, the internalization theory holds significant relevance for understanding and applying concepts in international business. It addresses the internalization of international transactions, the role of market dynamics, and the benefits derived from reducing transaction costs. However, it may need to be supplemented with other theories to fully comprehend the direction of FDI by enterprises and the intricacies of short-term foreign direct investment.

4. Eclectic Theory of International Production

British scholar Dunning (1977, pp.395-416) proposed the "Eclectic theory of international production" by integrating previous theories. According to Dunning (2001, pp.173-190), the eclectic paradigm remains a powerful and reliable framework for analyzing contextually unique theories of foreign direct investment and global production. The theory posits that enterprises need three advantages for foreign direct investment (FDI): ownership advantage, internalization advantage, and location advantage.

Ownership advantage explains the motivation behind enterprises' desire to engage in FDI. It encompasses factors such as the production technology, scale, management mode, financial assets, and sales strategies possessed by the enterprises. Internalization advantage elucidates how enterprises utilize their advantages to develop FDI strategies. It specifically refers to enterprises' behavior of internalizing assets to retain their advantages within the scope of their operations, thereby avoiding the limitations imposed by incomplete markets. Location advantage elucidates the direction of enterprise investment and the choice of FDI destinations. It pertains to the advantages offered by the host country's investment environment, including natural resources, local labor wages, transportation costs, and policy support for foreign investment.

By analyzing these three advantages, it can be determined that enterprises will engage in FDI when they possess all three advantages simultaneously. When enterprises possess only the first two advantages, they may choose to export their goods to the international market. If an enterprise possesses solely the ownership advantage, it may opt for technology transfer activities. Dunning's Eclectic theory of international production comprehensively explains enterprises' foreign direct investment, and the actual patterns of global investment validate the accuracy of this theory. Therefore, the eclectic theory of international production is considered a relatively comprehensive and highly recognized theory of foreign direct investment.

5. Foreign Direct Investment Theory of Developing Countries

With the expansion of international trade activities, developing countries have also participated in global trade exchanges, resulting in the emergence of numerous theories that align with the actual situation of foreign direct investment (FDI) in developing countries. Japanese scholar Kiyoshi Kojima, for instance, compared foreign direct investment between the United States and Japan and proposed the theory of marginal industrial expansion, also known as comparative advantage theory. This theory better explains the foreign direct investment activities of developing countries. The fundamental idea behind this theory is that foreign direct investment should focus on industries where the investor country is currently or potentially at a comparative disadvantage, which are often referred to as marginal industries. Developing countries possess significant advantages in labor-intensive industries, such as abundant and low-cost labor. Developed countries can thus transfer labor-intensive industries to these countries, leveraging more advanced production technologies and combining the host country's advantages, ultimately enabling the home country to achieve higher profits.

American scholar Wells (1977, pp.133-156) presented the theory of small-scale technology, considering the actual circumstances of developing countries. He pointed out that while developing countries may lag behind in large-scale technological research and development compared to developed countries, they possess unique advantages. For example, developing countries with small markets tend to develop specialized small-scale production technologies and produce unique national products. The strategy of offering products at a lower price enables them to attract foreign investments more effectively. This theory is regarded as the beginning of the theory of foreign direct investment by developing countries, which holds significant importance for developing countries engaged in FDI activities.

British scholar Lall (1983, pp.21-87) analyzed the investment motivations of multinational corporations in India and proposed the theory of technology localization. He highlighted that although the technological standard and scale of foreign investment activities in developing countries may not be on par with those of developed countries, small enterprises possess their own unique advantages. They engage in innovation and continuously learn from the advanced production methods employed by developed countries. By combining these characteristics with their own strengths, small enterprises develop a distinctive advantage that enhances the international competitiveness of multinational companies and enables them to participate more effectively in international investments.

Cantwell & Tolentino (1987) introduced the theory of technological innovation and industrial upgrading. Developing countries achieve technological innovation and upgrading through continuous experiential accumulation. They proactively learn from the experiences of other countries in transnational operations and production technologies, leveraging their unique advantages and characteristics to accumulate technological capabilities. This enables them to engage in more complex technologies when conducting overseas direct investments. The theory emphasizes that technological innovation plays a crucial role in driving developing countries to engage in foreign direct investment.

In the 1980s, Dunning (1981, pp.30-64) expanded on relevant theories of foreign direct investment in developing countries and proposed the theory of investment and development cycle. Dunning divided economic development into four stages based on gross national product (GNP) and combined it with foreign direct investment to analyze the occurrence and scale of FDI at different stages. Research on FDI activities in developing countries indicates that FDI of a country or enterprise is closely related to its level of economic development. When economic development

improves, the scale of FDI increases accordingly. Conversely, countries with lower levels of economic development exhibit less active outbound investment activities. Each level of economic development corresponds to a distinct situation of foreign direct investment.

The effects of FDI often yield highly conflicting empirical evidence (Chaudhuri & Mukhopadhyay, 2014), highlighting the complex interaction of various mechanisms that can produce contradictory outcomes. The evidence also underscores the importance of considering country-specific factors, such as the nature of non-traded goods, factor endowments, technological advancements, and political stability, when examining the impacts of FDI.

Corporate Financing Structure Theory

The main corporate finance textbook for a decade, authored by Dewing in 1919 and 1953, provides a wealth of institutional information but lacks systematic analysis (Jensen & Smith, 2000). It begins by exploring a corporation's formation and follows its journey through various policy choices until its potential demise through bankruptcy. Prior to the 1950s, corporate financial theory was predominantly normative, focusing on prescribing the best investment, financing, and dividend policies, yet neglecting the influence of individual motivations on these policies and the functioning of financial market equilibrium, resulting in logical contradictions.

Corporate financing structure, also known as capital structure, refers to the allocation of capital sources from the perspective of corporate financing methods, including internal financing and external financing. External financing encompasses equity financing and debt financing. The proportion of funds raised through different financing methods constitutes the corporate financing structure. The financing structure of an enterprise impacts its production decisions, investment and development direction, as well as the overall trajectory of the organization. The specific financing structure should be determined based on the enterprise's actual situation and the developmental status of the domestic economy.

Currently, the field of financing theory has undergone gradual development and maturation. Modern capital structure theory emerged following the landmark Modigliani-Miller (MM) theory, which marked a departure from earlier capital structure theories such as the net income method, net operating income method, and traditional compromise method. The modern era of capital structure theory is characterized by the integration of other economic theories, resulting in the

classification of modern enterprise financing structure theory into old and new categories. The old capital structure theory includes MM theory, tax difference school, bankruptcy cost school, and the tradeoff model. The new enterprise capital structure theory encompasses agency cost theory, control right theory, signal transmission theory, and the capital structure industrial organization model. These theories have exerted significant influence on the field of enterprise financing.

1. Old Financing Structure Theory

Modigliani and Miller (1958, pp.261-297) introduced the Modigliani-Miller (MM) theory in their paper titled "The Cost of Capital, Corporation Finance and the Theory of Investment," which, based on a series of stringent assumptions, concluded that the financing structure of a firm has no impact on its market value. However, as the assumptions of the MM theory deviate from real-world economic conditions, where perfect capital markets do not exist, economists have relaxed these assumptions and developed the tradeoff theory of corporate financing.

In 1977, scholars revised the MM model by incorporating corporate income taxes. The revised MM theory acknowledges that debt can reduce the tax burden on corporate finance and increase shareholders' after-tax income. However, it overlooks the risks associated with excessive debt for firms. Subsequently, scholars continued to refine the MM theory. Myers and Majluf (1984, pp.187-221) introduced the concept of equilibrium, leading to the development of equilibrium theory, which presents the optimal capital structure as a balance between various tax advantages and costs of debt. The tradeoff theory, emerging in the 1970s and 1980s, represents a significant advancement in the theory of corporate financing structure and marks the peak of its development. However, due to limited empirical support, the explanatory power of the tradeoff theory is relatively weak.

2. New Financing Structure Theory

Jensen and Meckling (1976, pp.305-560) introduced the agency cost theory to the study of capital structure, emphasizing that agency costs within a firm also impact its ownership structure. Agency costs arise due to conflicts of interest between principals and agents. This theory identifies two types of conflicts: the conflict between shareholders and managers, and the conflict between shareholders and creditors. In modern enterprises, shareholders hold ownership of the company while managers only control the right to operate it, leading to divergent interests and management conflicts. Additionally, information asymmetry between shareholders and creditors creates a conflict where shareholders possess more information about the company than creditors. The optimal capital structure is achieved when agency costs resulting

from these conflicts are minimized, and it depends on the balance between the benefits and costs of debt financing. The theory also suggests that different financing structures influence managerial behavior and investment decisions, thereby impacting the future growth and development of the firm.

Ross (1977, pp.23-40) proposed the signal transmission theory, which addresses information asymmetry in the market. Managers within an enterprise possess superior information and understanding of the business activities and investment prospects compared to external investors. This information asymmetry affects the market value of the firm and influences investment decisions, potentially leading to lower investment efficiency. Ross argues that external investors can evaluate a firm's prospects based on its debt level, or financing structure, thereby suggesting a positive correlation between enterprise value and debt level. Leland further posits that under equilibrium conditions, higher equity ownership by managers conveys greater project value and attracts more external investment, resulting in higher market value for the firm.

Since the 1980s, the theory of information asymmetry has gained increasing prominence in the study of corporate financing structure, with Myers and Majluf's (1984, pp.187-221) "financing sequence theory" being one of the most influential. According to this theory, due to information asymmetry and other constraints, different financing methods send different signals to the external investment community, and corporate financing structure and dividend policy serve as tools for signal transmission. Considering the associated costs, firms prioritize financing methods with lower costs. Generally, internal financing without transaction costs is preferred, followed by debt financing with principal and interest payments, and finally, equity financing. While this theory introduces financing preferences and arranges financing methods in a sequence, it does not explain the existence of specific optimal financing structures for firms.

The theory of control rights examines the influence of different financing methods on the distribution of corporate control rights and its impact on corporate value. According to this theory, to safeguard control rights, company management operators prioritize internal financing, followed by equity financing, and finally debt financing. However, to strike a balance between management and oversight, the optimal financing sequence should be reversed. Overall, the optimal capital structure calls for increased debt.

Financial Stability

Financial stability refers to a company's ability to maintain its financial position in the face of external shocks or changes in market conditions. It is a crucial aspect for any company as it determines its ability to meet financial obligations and sustain operations over the long term (Schinasi, 2004). Financial stability can be defined as the ability to maintain financial health and avoid distress caused by factors such as economic downturns, market changes, and poor management decisions. This essay will discuss the importance of financial stability for companies and the factors that can impact it.

Financial stability is important for companies for several reasons. Firstly, it ensures the ability to meet short-term financial obligations like bill payments, supplier payments, and managing cash flow. Secondly, financial stability provides a strong foundation for long-term growth and investment by attracting investors and lenders seeking stable and reliable companies. Thirdly, it helps minimize the risk of financial distress, including bankruptcy, legal issues, and damage to reputation (Reider & Peter, 2003; Owolabi & Obida, 2012, pp.41-51).

Several factors can impact a company's financial stability. Profitability is a significant factor as it determines a company's ability to generate revenue and manage expenses. A highly profitable company is generally considered more financially stable than one with low profitability. Liquidity and leverage ratios also impact financial stability as they indicate a company's ability to meet short-term and long-term financial obligations. Additionally, the management team plays a crucial role. Effective management decisions improve financial stability, while poor decisions can lead to distress. For instance, poor investments, excessive debt, and inefficient operations can all contribute to financial problems. External factors like market conditions, economic cycles, and regulatory changes also influence financial stability. Companies operating in industries affected by economic cycles may face challenges during a recession (Lindqvist, 2012, pp.1-15; Bakhtiari et al., 2020, pp.506-523).

Financial stability is critical for a company's success and sustainability. It provides a strong foundation for growth, attracts investors and lenders, and reduces the risk of financial distress. Factors affecting financial stability include profitability, liquidity, leverage, management decisions, and external factors. Companies should strive to maintain financial stability through sound management decisions, monitoring financial ratios, and staying informed about external factors impacting their financial health.

Financing Cost

Financing cost refers to the cost of capital for a company, which includes the cost of debt financing and the cost of equity financing. It is a significant factor that every enterprise must consider when managing its finances. These funds can be acquired through various financial instruments such as equity, debt, or hybrid instruments. The financial cost of an enterprise is determined by several factors, such as the cost of debt and equity, interest rates, credit ratings, and the company's financial risk. This essay will explore the concept of financial cost in detail and discuss its importance for enterprises.

Cost of Debt: Debt is one of the most common sources of financing for enterprises. The cost of debt is the interest rate paid by a company to its creditors for borrowing funds. It is determined by factors such as the creditworthiness of the company, prevailing interest rates in the market, and the term of the debt. A company with a high credit rating is likely to obtain debt financing at a lower interest rate than a company with a low credit rating. The longer the term of the debt, the higher the interest rate a company is likely to pay (Vanacker & Manigart, 2010, pp.53-69; Abdulsaleh & Worthington, 2013, pp.36-54).

Cost of Equity: Equity financing is another common source of financing for enterprises. The cost of equity is the return expected by the shareholders of a company for investing their money in the company. It is influenced by factors such as the risk associated with the company's operations, prevailing market conditions, and the dividends paid by the company. A company perceived as less risky is likely to obtain equity financing at a lower cost than a company perceived as riskier (Durand, 1952; Osei-Assibey, Bokpin, & Twerefou, 2012, pp.84-105).

The financial cost of an enterprise is an important factor that affects its profitability and sustainability. If the financial cost of a company is too high, it may impact the company's ability to generate profits and pay off its debts. This, in turn, can affect the company's credit rating and its ability to obtain future financing. Therefore, efficient management of the financial cost is essential for the long-term sustainability of enterprises. The financial cost also influences investment decisions. If the financial cost of a company is too high, it may discourage the company from undertaking new investments. Conversely, if the financial cost is low, it may encourage the company to undertake new investments, leading to increased profitability and growth. Therefore, enterprises must consider the financial cost of their investments before making any investment decisions.

The financial cost of an enterprise is a crucial factor that every company must consider when managing its finances. Factors such as the cost of debt and equity, interest rates, credit ratings, and financial risk determine the financial cost. Efficient management of the financial cost is vital for the long-term sustainability and growth of enterprises. High financial costs can affect profitability, credit ratings, and investment decisions. Therefore, enterprises need to carefully evaluate their financial cost and manage it efficiently to ensure long-term sustainability and growth.

Agency Cost

Agency cost refers to the costs that arise from conflicts of interest between a company's managers and shareholders. These conflicts arise due to the separation of ownership and control in the firm. Shareholders entrust their capital to the managers, who are expected to act in the best interests of the shareholders. However, managers may pursue their own objectives, which may not align with those of the shareholders. This results in agency costs that reduce the value of the firm. This essay aims to explore the causes, effects, and mitigation strategies of agency cost in enterprises.

The agency cost arises due to several factors. One of the major factors is the principal-agent problem. This problem arises when the principal (shareholders) hires an agent (manager) to act on their behalf, but the agent pursues their own interests rather than those of the principal. This may happen due to information asymmetry, where managers possess more information than the shareholders and use this information advantage for their own benefit. Additionally, managers may have different risk preferences than the shareholders, which may lead to divergent actions (Panda & Leepsa, 2017, pp.74-95; Ayunitha et al., 2020).

The agency cost has several adverse effects on the enterprise. Firstly, it reduces the value of the firm as resources are misallocated, and investments are made in projects that do not maximize shareholder wealth. Secondly, it results in a loss of trust between the shareholders and the managers, which may lead to conflicts and disputes. Thirdly, agency cost may lead to a decline in firm performance, as the managers may prioritize their own interests over those of the firm (Ayunitha et al., 2020).

Several strategies can be used to mitigate agency cost in enterprises. Firstly, the board of directors can play a crucial role in monitoring the managers and aligning their interests with those of the shareholders. The board can also ensure that the

compensation of the managers is tied to the firm's performance. Secondly, transparency and disclosure can help reduce information asymmetry and improve the monitoring of managers. Thirdly, the use of debt financing can help align the interests of shareholders and managers, as debt holders have the power to discipline the managers. Finally, the adoption of good corporate governance practices can help mitigate agency cost by ensuring that the managers act in the best interests of the shareholders (Geis, 2007, pp.955-1003).

The agency cost is a significant problem in enterprises that arises due to the separation of ownership and control. It leads to conflicts of interest between the shareholders and managers, which reduces the value of the firm. The causes of agency cost include information asymmetry and different risk preferences of managers. The adverse effects of agency cost include a decline in firm performance and loss of trust between the shareholders and managers. However, several mitigation strategies, such as effective corporate governance practices, transparency and disclosure, and debt financing, can help reduce agency cost and align the interests of shareholders and managers.

Hypotheses Development

1. The influence of financing structure on enterprises' overseas direct investment

Hypothesis on the influence of financing structure on enterprises' overseas direct investment as shown in Figure 2.1

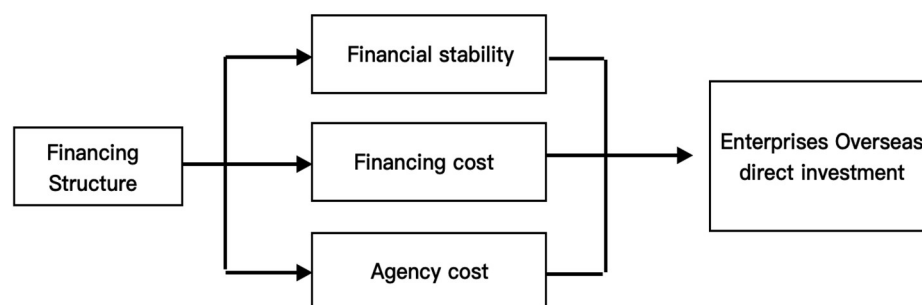


Figure 2.1 The influence of financing structure on enterprises' overseas direct investment

According to the financing sequence theory, when determining financing, enterprises usually prioritize their own funds and carry out internal financing first before considering external financing. Unlike domestic investment, overseas investment activities of enterprises often require a large amount of investment funds with high investment costs and longer operation times. The internal accumulation of the enterprise's own funds may not be sufficient to support subsequent investment activities, so external financing channels are often needed. External financing includes debt financing and equity financing.

Debt financing refers to a financing method where an enterprise conducts loan transactions with banks or other financial institutions to obtain financing. However, due to the high risk of overseas investment, project loans for overseas investment may have more requirements and difficulties in obtaining loans. Enterprises may also need to provide tangible assets as collateral, which can be challenging for small and medium-sized enterprises or strategic emerging industries. Furthermore, debt financing requires the repayment of principal and interest within a specified time, which may occupy a portion of the enterprise's free funds and introduce unnecessary financial risks.

On the other hand, equity financing involves selling or transferring the company's shares or issuing additional shares to obtain funds through refinancing. Equity financing does not require fixed asset collateral like debt financing, which can alleviate the financing pressure for some small and medium-sized enterprises. Moreover, the capital obtained through equity financing does not need to be repaid within a fixed period like loans, reducing fixed repayment pressure. Compared to debt financing, equity financing poses smaller potential financial risks. Enterprises can ensure the continuity of funds through equity financing, which is important for overseas direct investment that requires continuous working capital.

Considering the agency cost of the enterprise, the conflict of interest between shareholders and corporate managers can affect future investment decisions. Corporate managers will consider the potential financial risks associated with debt financing and may be more cautious in investment activities to protect the interests of the company and investors. Excessive debt financing can reduce the company's desire for investment. However, under different institutional environments, the relationship between debt financing and corporate investment may vary. In a good institutional environment, debt financing can help restrain enterprises from excessive investment, while the opposite may be true in a different institutional environment.

Equity financing allows both old and new shareholders to share the dividends brought by corporate profits. Dividend income is related to the income level and future development of the enterprise. Shareholders are willing to engage in investment activities with high yields. The funds obtained from equity financing have a wide range of uses within the enterprise and are not limited to specific purposes. They can be used for various production and operation activities of the enterprise, as well as for various investment activities at home and abroad, thereby improving investment efficiency. Therefore, equity financing supports enterprise investment more than debt financing.

Overall, the choice between debt financing and equity financing in the context of overseas investment takes into account factors such as financing needs, financial risks, agency costs, institutional environment, and investment efficiency, among others. Enterprises need to carefully evaluate these factors to make informed financing decisions that align with their investment goals and ensure financial stability.

Hypothesis 1: Financing structure will affect enterprises' overseas direct investment, and the higher the proportion of equity financing in financing structure, the more favorable enterprises' overseas direct investment.

2. Innovative research and development transmission mechanism

In Figure 2.2, the hypothesis shows that innovation research and development is a transmission mechanism that affects financing structure and overseas direct investment of enterprises.

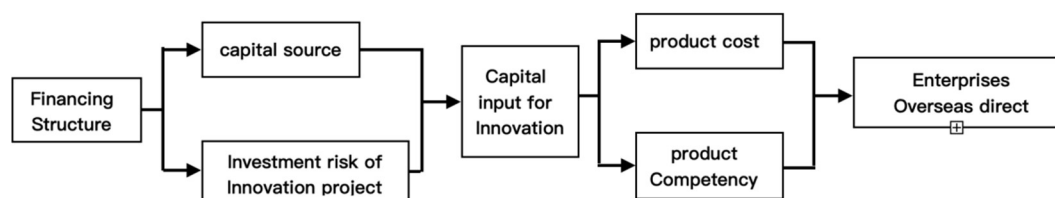


Figure 2.2 Innovation research and development as transmission mechanism of financing structure affecting enterprises' overseas direct investment.

With the constant change in the economic growth and development pattern of modern society, technological innovation has become a core factor in promoting economic development. Technological innovation, which enhances an enterprise's global development layout, is especially important for improving research and development (R&D) levels. Enterprises that continually enhance their production capacity and competitiveness gain advantages and establish a firm foothold in the global enterprise competition.

The scale of overseas direct investment (ODI) by enterprises is often greater when there is a higher level of investment in innovation and R&D. A higher level of R&D can help enterprises overcome technical bottlenecks and reduce production costs, thereby improving product competitiveness and promoting enterprise growth. This, in turn, helps enterprises expand their investment scale. Examining the relationship between corporate financing structure and ODI, enterprise innovation R&D can be used as an intermediary variable. Existing studies have shown that innovation R&D can promote ODI by enterprises. By discussing how financing structure affects enterprise innovation, the influencing mechanism between financing structure and ODI can be clarified.

Enterprise innovation input can be influenced by macro, micro, and supply factors. Financing structure can affect the technological innovation of enterprises, and different financing methods and structures have varying influences on enterprise innovation. For example, a study on listed companies in the information technology industry found that debt financing can promote innovation within a certain range, but can inhibit it when it exceeds a certain threshold. On the other hand, equity financing can promote innovation and development of enterprises. Debt financing places higher requirements on the risk control of capital operations, limiting the desire of external investors or banking institutions to invest or lend to enterprises. This results in less funding for technological innovation and reduced enthusiasm for it. Additionally, debt financing requires asset collateral, while research and development activities require a certain period and more funds.

According to the agency cost theory, conflicts of interest between shareholders and creditors result in excessive requirements on the cost of enterprise innovation financing. Financial institutions, such as commercial banks, carefully evaluate business assets and enterprise projects before providing loans to ensure profit returns. However, innovation and research achievements of enterprises are intangible assets that are difficult to evaluate reasonably. Therefore, banks are cautious in lending for this type of asset, making it difficult for enterprises to obtain

loans. Moreover, the different objectives of creditors and enterprises regarding innovation can lead to inefficient use of borrowed R&D funds. Creditors can only receive the principal and fixed interest and cannot enjoy the income increase brought by enterprise research and development. Consequently, excessive debt can hinder enterprise innovation. Enterprise managers also consider the long-term and fund-intensive nature of innovation investments, as well as the slow realization of project profits. This may lead to concerns about being held accountable and difficulties in ensuring sufficient funds for innovation R&D. Therefore, enterprises with a high proportion of debt financing in their external financing structure find it challenging to carry out innovative R&D activities. Excessive debt financing can have adverse effects on enterprise R&D and innovation, subsequently impacting ODI.

Equity financing can reduce repayment pressure for enterprises. In the absence of a major financial crisis, capital for enterprises is eternal and has high stability. Equity financing ensures the stability of research and development funding sources, attracts more external investment, and helps enterprises actively innovate. Equity investors, with a certain shareholding ratio, can obtain high potential earnings brought by innovation and development and help enterprises share risks arising from innovation uncertainty. Unlike debt financing, funds obtained from share sales do not need to be repaid within a specific period, as dividends are paid based on specific operating income at the end of the year. The long-term and fixed characteristics of equity financing also support high-risk and long-cycle technology research and development, ensuring the continuity of enterprise capital and innovation investment. This promotes the enthusiasm of enterprise innovation and facilitates the transformation of innovation benefits into capital value.

The current securities market tends to invest in stocks with good growth performance and high return on investment. High-quality innovation enhances enterprise competitiveness in the market. Enterprises introduce new shareholders through capital increases, bringing new vitality and ideas to the company's innovation. New shareholders can also directly introduce new technologies. In summary, by focusing on enterprise innovation and R&D, the relationship between financing structure and enterprise ODI can be established. A financing structure with a relatively high proportion of equity financing directly promotes enterprise innovation and R&D output, ensuring that investment funds for innovation play a maximum role. This results in the development of better and stronger innovative technologies and products, ultimately driving more enterprises to engage in ODI activities.

Hypothesis 2: Innovation research and development is a transmission mechanism of financing structure affecting enterprises' overseas direct investment, that is, the higher proportion of equity financing in external financing structure will increase enterprises' innovation input, and the improvement of enterprises' innovation research and development intensity will promote the occurrence of enterprises' overseas direct investment behavior.

3. Productivity transmission mechanism

Hypothesis 3: Productivity is a transmission mechanism of financing structure affecting enterprises' overseas direct investment as shown in Figure 2.3

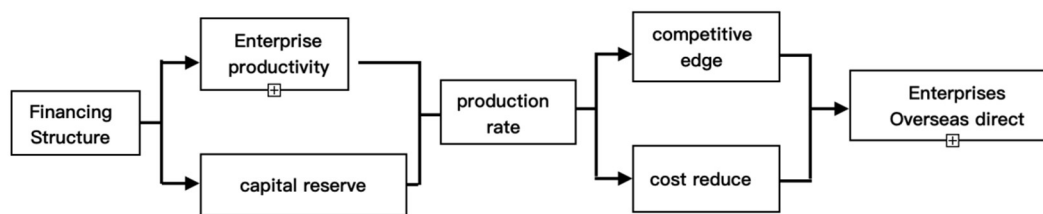


Figure 2.3 Productivity as transmission mechanism of financing structure affecting enterprises' overseas direct investment

Enterprise productivity is a major driver for conducting international trade exchanges. Previous studies have highlighted the importance of productivity in influencing enterprises' foreign direct investment (FDI). Gao Boyang et al. (2019) discovered that enterprises with higher productivity are more likely to choose overseas investment. The early monopolistic competitive advantage theory emphasizes that multinational corporations possess certain competitive advantages. Productivity serves as a representation of an enterprise's overall production efficiency, encompassing intangible assets related to production, such as technical ability, research and development capability, and management proficiency. These advantages help enterprises overcome challenges in host countries and compensate for deficiencies when competing with local enterprises.

The new trade theory also recognizes the influence of enterprise productivity on their participation in international trade. Only enterprises with high productivity are qualified and capable of engaging in overseas direct investment. Compared to low-productivity enterprises, those with high productivity demonstrate stronger

organizational and management abilities, as well as technical proficiency. A strong production capacity means that the marginal cost of products produced by these enterprises is low, enabling them to obtain higher profits. This advantage also helps in offsetting the fixed costs incurred during the process of foreign direct investment. Consequently, when studying the constraints of corporate financing and FDI, many scholars analyze productivity as a significant mediating factor. They find that lower financing constraints are associated with higher enterprise productivity, facilitating more effective FDI. Inspired by these findings, this paper also employs productivity to analyze the relationship between corporate financing structure and overseas direct investment.

Currently, China's demographic dividend is gradually diminishing, the return on investment for enterprises is low, and the issue of overcapacity is becoming more pronounced. Economic growth cannot rely solely on investment and factors of production. Sustainable growth requires continuous improvement in the economy's total factor productivity. In the previous analysis, debt financing, compared to equity financing, carries greater risk and higher costs. Debt financing prioritizes stable earnings and has a shorter term. Funds obtained through equity financing are typically used for longer-term projects, allowing for the accumulation of greater capital stock. External financing, compared to internal financing, significantly reduces the total factor productivity of enterprises. However, debt financing has a more pronounced negative effect, while equity financing can withstand higher risks and pursue higher returns.

Based on the above analysis, it is evident that productivity is interconnected with financing structure and enterprises' overseas direct investment. Financing structure influences enterprise productivity, and in turn, productivity promotes enterprises' overseas direct investment.

Hypothesis 3: Productivity is a transmission mechanism of financing structure affecting enterprises' overseas direct investment. Under the same conditions, equity financing will have more promotion effect on enterprise productivity, that is, the higher the proportion of equity financing in external financing structure, the stronger the enterprise productivity, the more conducive to enterprises' overseas direct investment.