



## Do Geographic Effects Matter? A Literature Review

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### ABSTRACT

This paper provides a broad review of studies on geographic effects. Geographic effects have both corporate finance and asset pricing implications. A wide range of geographic effects topics are summarized in this study, including board structure, investment decisions, payout policy, innovation, mergers and acquisitions, lending and borrowing, and pricing discrimination. This paper provides a connection of geographic effects with two basic corporate finance issues: Information asymmetry and agency problems.

**Keywords:** Geographic Proximity, Information Asymmetry, Agency Problem, Corporate Decisions, Lending and Borrowing, Pricing Discrimination

**JEL Classifications:** G30, G38, G20

### 1. INTRODUCTION

Geographic effects have been substantially addressed by previous studies over the past decades. This exogenous factor is considered to have an indelible impact on both corporate finance and asset pricing. Geographic proximity contributes to reduce information asymmetry and agency problems between firms and shareholders. Local investors face low information acquiring costs and communication costs. They have the advantage to directly inspect local firms, obtain information and form social network with local managers. As a result, the information asymmetry issue is less severe between firms and local investors. Local investors are effective monitors of local firms and contribute to reduce agency problems. The increasing importance of geographic effects contributes to two classic aspects of finance: Information asymmetry and agency problems.

The sheer volume of papers that have been written on this subject not only extends the previous literature, but also paves a way for future research. There has been a long-standing debate on whether geographic effects matter? Lerner (1995) and Knyazev et al. (2013) show that distance matters for board structure. Geographic proximity to headquarter makes it more convenient and less costly for shareholders to serve on the board. In addition, geographic location also affects firms' financing and investment

decisions. As mentioned by Almazan et al. (2007), there are more acquisition opportunities when firms are located near industry partners. With additional acquisition opportunities, firms are more willing to hold cash and take advantage of these opportunities. Uysal et al. (2008), Kang and Kim (2008), and Erel et al. (2012) use US or international data to confirm that bidders exhibit home bias tendency and that proximate bidders are more likely to be involved in post-acquisition governance activities. Becker et al. (2011) acknowledge that home bias of payout policy while Gao et al. (2011) point out that geographic effects are not as important as before. Additionally, Landier et al. (2009) take a different view from others and examine how employment policy changes with geographic variation.

In several recent studies, Dougal et al. (2015) show that firm investment is sensitive to the investment of nearby firms from different industries. Sulaeman and Wei (2014) provide evidence that firms benefits from the presence of local institutions. Similarly, Chhaochharia et al. (2012) conclude that local institutional investors are more effective monitors. Ayers et al. (2011) finds that corporate managers are less likely to use financial reporting discretion in the presence of local monitoring institutions than distant monitoring institutions. Baik et al. (2010) examines the role of geographic proximity of institutional investors on firm stock prices and show that level and changes in local institutional

ownership predict stock returns. These studies provide evidence that both firms' location and financial institutions' location have economic implications. Given the importance of geographic effects, this paper intends to collectively examine literature on this topic and provides an overview of previous studies from several aspects. A wide range of topics is addressed, including board structure, investment decisions, payout policy, innovation, mergers and acquisitions (MA), lending and borrowing, and pricing discrimination.

Generally speaking, this paper surveys and summarizes previous work on geographic effects. The scope of this paper is basic and fundamental issues of geographic effects. My study contributes to existing literature on location and provides a link between geographic effects and fundamental corporate finance issues, including information asymmetry and agency problems. In addition, this paper offers strong support on geographic effects and guideline for corporate managers and institutional investors when they make investment decisions. External factors, such as location, matter for firms and financial institutions.

The paper is organized in the following sections. Section 2 outlines the most widely used measures of geographic distance and diversification. Section 3 focuses on how geographic variations affect corporate decision making, such as board structure, investment, M&A, payout policy, employment policy, IPO, and innovation. Section 4 concentrates on lending and borrowing between banks and firms. Section 5 shows pricing discrimination caused by geographic variations. Section 6 offers a conclusion.

## 2. GEOGRAPHIC MEASURES

Various geographic measures have been documented in previous literature. These measures try to intuitively describe the physical distance among firms. Based on this principle, zip codes, geographic diversifications, models, and metropolitan statistical areas (MSA) are adopted to measure geographic distance and how diversified firms are geographically.

Zip codes are often used as geographic proximity. For instance, Lerner (1995) discusses how distance determines the venture capitalist board membership. Zip codes of the firm headquarter and venture capital headquarter are used to compute geographic distance. Dummy indicators are useful with data and information that cannot be quantified. To test the geographic influence on knowledge flows of interfirm alliances, Beneish et al. (2008) set the geographic proxy as a dummy variable being 1 when the paired firms are based in the same region and 0 otherwise. Kang and Kim (2008) also used identifier variables while analyzing the geography of block acquisition. In their paper, in-state variable is used when the bidder and the target are located in the same states. Likewise, to explore the relationship between geographic diversification with abnormal returns after acquisition of the tobacco industry, Beneish et al. (2008) employ a new state dummy being 1 if the target is in a state where no previous operations for a tobacco firm is in the acquisition.

Beneish et al. (2008) also measure existing geographic diversification, which is the ratio of the number of states where

tobacco firm has operations to the total number of states. Another method to measure geographic dispersion is to directly count the number of states that the firms are located including the branches (Khanna and Tice, 2001). The more states a firm is located, the more dispersed the firm is, leading to higher distribution costs.

Different models are designed to capture geographic length and concentration. Ellison and Glaeser (1994) develop a model to measure and compare the geographic concentration of an industry taking localized industry-specific spillovers, natural advantages and pure random chance into consideration. This method controls for the differences in firm size and geographic areas. Uysal et al. (2008) propose a model to identify the arc length between the acquirer and target by matching the city and state with their latitudes and longitudes. The distance between two places is then estimated using Haversine Formula. Tian (2011) uses the same methodology in order to calculate the distance between the developing firms and venture capital investors.

The aforementioned measures, however, may fail to capture certain geographic resources without considering neighborhood metropolitan areas. More recent and popular measure is to use consolidated MSA code. For example, John et al. (2011) use several geographic measures to investigate if geography matters for corporate payout policy. To begin with, they classify firms based on whether they are located in the ten largest consolidated MSA areas with a dummy variable being 1 and 0 otherwise. Then, they use metropolitan area to calculate the distance between a firm and the nearest MSA large city. Almazan et al. (2007) construct several measures for industry clustering depending on the closeness of the firms' headquarters using MSA code. The first measure is the natural log of the number of firms in the same industry for a specific MSA. The second one is a dummy being 1 when the firm belongs to the MSA that has more than ten firms in the same industry. Likewise, Gao et al. (2011) use MSA to define firm's headquarters which is related to corporate decision makings such as funding decisions, capital structure, and payout decisions.

## 3. GEOGRAPHIC EFFECTS ON CORPORATE DECISION MAKING

### 3.1. Board Structure

Board of directors and board structure play an important role in the operation of a corporation. Their major responsibilities include establishing rules and objectives to govern the corporation, choosing and evaluating chief executives, making an investment, financing and payout decisions, and maximizing a firm's overall value and performance. Thus, how the board is structured is key to a corporation's success. Financial intermediaries tend to show up on the boards of private firms that they finance to obtain detailed knowledge and closer observation of these emerging firms. Lerner (1995) examines how distance influences the venture capitalists' appearance as insider investors on the board of the private firms that would have a hard time getting external funds otherwise. Venture capitalists want to be more involved in private firms and to monitor the operation of firms. Supervision would generate considerable costs including transaction costs, commute costs,

and labor costs. As a result, being proximate to the private firms would certainly reduce related costs. Lerner (1995) focuses on the biotechnology industry and find that venture capitalists are twice as likely to be on the board of the private firms whose headquarters are within 5 miles away from the venture capital offices than those more than 500 miles away. Venture directors are present in 50% of the firms that are 60 miles from their office. This paper contributes to explaining the valuation of venture capital across states. It follows that geography adds to financing accessibility and corporate monitoring.

In addition, distance approximation influences the board structure by attracting more independent directors to the board (Knyazeva et al., 2013). Consistent with Lerner (1995), Knyazeva et al. (2013) also bring up the cost-related theory stating that localization would reduce the related costs such as time costs of the potential future directors and information asymmetry. As a result, distance is expected to have a negative influence on the willingness of potential directors to serve on the board. They conclude that when a large number of them are near the firms' headquarters, future directors are more likely to serve on the board. They also extend previous literatures by suggesting that being close to local directors, firms tend to have more independent board and more local independent directors. The findings by these two articles are a consequence of adjustment for information asymmetry and agency problems since the importance of local labor markets is reduced when the firms are well-established and highly observable, compared to private and small ones.

### 3.2. Investment and Funding Decision Making

Corporate decisions involve activities, such as valuing investment opportunities and optimizing capital structure, with the primary goal of maximizing shareholders' wealth. A firm's location impacts its investment and funding decision in various ways. Khanna and Tice (2001) conduct an intensive study on the bright side of internal capital markets by examining how focused incumbents and discount divisions of diversified firms react regarding investment when low discount firms enter into the markets. They show that the wider the geographic dispersion, the higher distribution costs will be. However, unlike previous works, Khanna and Tice (2001) argue that more diversified firms make better investment decisions for the benefit of higher productivity from winner picking and diversification outweighs the associated costs.

It is widely accepted that firm specific factors such as size and profitability affect capital structure and cash holdings. Almazan et al. (2007) extend empirical determinants of capital structure by considering physical locations. They show that geographic factors impact how firms finance and how liquid the corresponding asset market is. Almazan et al. (2007) develop a simple model to measure firm leverage considering the leverage need for acquisition within industry location clusters. They firstly show that firms are more likely to pursue acquisitions when they are located near their industry counterparts. Given more acquisition opportunities, they further investigate how firms correspond to it in terms of their capital structures. Two competing theories are discussed. The first theory demonstrates that the clusters make it easier for firms to sell their assets, which would result in a higher

leverage (Williamson, 1988; Shleifer and Vishny, 1992). The second theory takes acquisition into account and argues that firms are inclined to hold more cash to take advantage of the acquisition opportunities. Almazan et al. (2007) provide empirical evidence supporting the later proposal.

### 3.3. M&A

M&A are indispensable aspects of corporate and management strategy that have been well explored by previous researchers. Improving financial performance is the main reason that firms seek M&A. However, performance of acquiring firms is not necessarily positively related with acquisition activity (King et al., 2004). Thus, additional motivations such as diversification and CEO compensation also contribute to the performance of M&A activities. More importantly, geographical proximity has impacts on worldwide M&A decisions and M&A post-returns. In particular, Uysal et al. (2008) explore if acquisition decisions of US public firms from 1990 to 2003 can be attributed to geographic factors. Their evidence shows that the number of local M&A transactions is over two times that of non-local M&A. Local acquirers generate higher returns which are preserved by using target termination fee contracts. The rationale behind the results is consistent with the reduced information symmetry. Local bidders have the natural information advantages including evaluation of soft information and lower costs. Geographic proximity can be used as a proxy for information difference.

Following the similar rationale, Kang and Kim (2008) document similar evidence, such as preference to closer targets and higher post acquisition returns. Unlike Uysal et al. (2008), they extend the impacts of geographic proximity into corporate governance level and post-acquisition operating performance. They show that proximate bidders are more likely to be involved in the post-acquisition governance activities than remote bidders. In addition, Erel et al. (2012) provide international evidence. They analyze 56,978 cross-border M&A outside of the United States ranging from 1990 to 2007. Their results show that the closer two countries are, the more likely the acquisitions occur between these two countries. The more acquisition decisions involving monitoring activities can be explained by information asymmetry theory. Geographic proximity provides an advantage for investors to gain private information about targets, reduced communication and transportation costs and more interaction with nearby targets. Thus, the key role of location is emphasized for M&A decisions and motivation to monitor the targets.

Beneish et al. (2008) further connect geographic effects, M&A and political issues. They show that positive abnormal returns can be obtained for diversified acquisitions by well-developed large firms in tobacco industry which provides an opposite view against previous literatures. Also, they employ a brand-new explanation for the results other than information asymmetry. Diversified acquisitions protect shareholders' wealth from expropriation by politicians and governments. The idea is that the more diversified the tobacco firms are, the larger influence they would have on politicians. As a result, tobacco firms will make more contribution to districts. Moreover, financial surplus can be transformed into physical and intangible assets by diversification which ultimately

reduces the amount of non-necessary attentions. Their research identifies the bright side of acquiring firms that benefit from diversification due to lower expropriation costs and provides an explanation for sources of economic gains in acquisitions.

### 3.4. Payout Policy

Payout policies are motivated by firms' aspiration to signal their market value, their promising future operating performance, and retained earnings. They are influenced by taxes, agency problems, asymmetric information, transaction costs, and some other factors. Recent studies examine the geographic effects on payout policies. Investors have a geographic preference for firms and investors' base could affect corporate policy decisions. Becker et al. (2011) demonstrate geographic variations in corporate payout policies. When the headquarter of a firm is located in the area where there is a large number of seniors, that firm is more likely to pay dividend and initiate dividend. Firstly, investors have a preference for local stocks and have home bias due to information asymmetry. They can actually "see" and easily gain information of local firms. The second reason is that senior investors usually have greater demand for dividend payout because they need more cash for consumption costs and that they are charged for lower dividend taxes.

Nevertheless, John et al. (2011) provide opposite evidence. They show that the faraway firms are 13% more likely to pay constant and higher dividends and the firms that face severe cash flow problem pay higher dividends. Information asymmetry and agency costs are the main causes of the findings. The location of a firm deters investors from the monitoring and observing the activities of investors, which raises more agency costs and problems. Consequently, investors require that firms pay higher dividends to compensate for their potential loss of rights. Moreover, constant and regular dividends are required to act as the commitment by the firm signaling good operating conditions and promising future cash inflows. Remotely located firms are more likely to pay constant and regular dividend instead of one-time share repurchases.

A more neutral view is brought out by Gao et al. (2011) who document that the headquarter locations have less power on corporate payout policy compared with other policies such as financing policy and capital structure decisions. Firms in the same MSA area have the tendency to form the common decisions as to whether to pay dividends or repurchase shares. Closer locations give managers an interaction advantage, letting them share information among each other, have a closer knowledge of management policy and in turn have an impact on decision making for the managers around the same area. Therefore, firms in the same MSA areas tend to behave similarly in terms of payout policies. Future research could focus on investigating if geographic proximity leads to firms being similar in other firm specific characteristics.

### 3.5. Employment Policy

Locations not only affect firms' financial decisions, but also the employment policy. Different from previous studies that focus on industry clusters in geographic location, Landier et al. (2009) concentrate on the location dispersion with firm employment decisions. They show that the more dispersed the firm is, the less

friendly it is to the employees. Additionally, it is more likely for a branch to experience layoff when it is located far away from the headquarter. As a result, firms tend to demonstrate a pecking-order preference when it comes to devastation. Again, the results attribute to information asymmetry along with social interaction. The quality of information is negatively related to distance. The more interactions with managers, the more they get to know employees. Quality of information, familiarity with employees and visible information all play certain roles when managers make employee related decisions.

### 3.6. IPO

Financing agents have a local preference when they decide where to go for the public listing. In an efficient market, it makes no difference as to where to list. Sarkissian and Schill (2004) use all the foreign listings in the 1998 hand-collected dataset to investigate home bias and local preference from the financing agents' point of view. They observe that the majority of firms prefer to list abroad on the market that they feel more familiar and have a higher return correlation with. Such result reflects the investor home bias. Investors are more willing to invest in firms that are widely known. To attract investors, firms must go public in the nearby markets where they could gain more geographic proximity than more remote capital markets.

### 3.7. Innovation

Knowledge flows between firms have been considered as an essential matter for innovation. Investors have home bias while making investment decisions and firms also have a local preference as for acquisitions and various policy decisions. A natural question to ask is whether knowledge flows among firms have such preference. Jaffe et al. (1993) use patent citations as a proxy for knowledge flows and compare the geographic location of such flows. They show that citations to a certain patent are more likely to come from the same country and the same state. The capability of utilizing the knowledge flows and citation contributes to explaining localization of citations. Furthermore, Gomes-Casseres et al. (2006) show that the alliance partners share greater knowledge flows than non-alliance pairs and the alliance effects are greatest when they are close to each other geographically. Geographic proximity offers firms communication convenience and flexibility.

### 3.8. Corporate Governance

Ownership structure is essential for corporate governance. Recent studies address the importance of institutional ownership, especially local institutional ownership, on corporate governance. The rationale is that local institutional investors face low information acquiring costs and low information asymmetry. Therefore, they should have stronger monitoring influences and incentives on firms.

Sulaeman and Wei (2014) explore the asset pricing implication of local institutional investors. They show that firms experience higher liquidity, faster information incorporation, lower costs of equity capital, and less financing frictions when the presence of local institutional investors is high. Additionally, Baik et al. (2010) provide evidence that both the level and change in local institutional ownership have predictable power for further stock

prices. The advantage of being local is more evident for local investment advisors, high local ownership institutions, and high local turnover institutions. From the perspective of corporate finance, Chhaochharia et al. (2012) examine local investors and corporate governance. Firms experience improved corporate governance and are more profitable when they are largely owned by local institutional investors. Moreover, firms are less likely to be involved in earnings management. Ayers et al. (2011) show similar evidence that corporate managers are less likely to use financial reporting discretion when local institutional investors' ownership is high. Taken together, these studies show that the location of both firms and financial institutions is essential for corporate governance.

#### 4. GEOGRAPHIC EFFECTS ON LENDING AND BORROWING

Lending and borrowing are significant for firms, especially small and emerging firms, to get enough funding to operate. Lending and borrowing are associated with a cost referred to as interest, which motivates lenders to be willing to provide loans. Due to information asymmetry and interaction costs, distance matters for both lenders and borrowers. Contrary to previous literature, Petersen and Rajan (2002) document two evidence showing location is not as important for small firms. The data shows that from 1973 to 1993, distance between lenders and small firms has grown gradually and their communications become more impersonal. The data shows that the changes is due to the improvement of bank employee productivity, easier communication by technology equipment, higher availability of borrowers' credit records and the growing easiness of processing loans. Technology improvement also alleviates the information asymmetry and monitoring problems.

A recent study on contract information from 15,000 small business loans by Degryse and Ongena (2005) yields the opposite view. They argue that interest rates decrease with distance between the small firms and lenders. They extend their discussions by introducing competitions between lending banks and finally reach the conclusion that loan rates increase with distance between small firms and lending banks. Transportation costs count for the price discrimination between lending banks. Increased distance eases the price competition for lending banks, thus increasing borrowing costs for small firms. Distance seems to be less correlated than other social factors and yet plays an irreplaceable role in lending and borrowing. In addition, Berger et al. (2005) confirms the impact of distance by investigating the lending practices of large and small banks. They argue that large banks are willing to provide loans to firms that are further away. They are also more involved in interactions and less constrained to credits than small banks. Information asymmetries are not as severe for large banks as for small lenders. Large banks rely less on soft information that is gained through personal contact and observations. Along this line, Tian (2011) examines venture capital stage financing. Their results reveal that the further-away venture capitalists are from the emerging firms. The larger amount of financing rounds, the shorter duration between every round, and the smaller amount of funds will be invested in each round. The results are consistent

with monitoring hypothesis. Monitoring activities involve time cost, transformation costs and communication costs. Thus, when monitoring costs are low, venture capitalists attempt to reduce their staging cost by reducing financing rounds whenever possible. Massa et al. (2013) employ geography-based instruments and show that the supply uncertainty of the firm's bond investor base has a negative and significant effect on the leverage of the firm.

#### 5. GEOGRAPHIC EFFECTS ON PRICING

Pricing includes not only corporate pricing decisions but also pricing discrimination by lenders when processing corporate loans. Provided that the market is perfect and efficient, there should not be any pricing discriminations. However, in real market, pricing discriminations exist due to various factors. Lederer and Hurter (1986) start by designing a complex model to investigate the behavior of how two identical firms set locations and prices. Eventually, both of the two select the location where they can decrease the total cost in the market and at the same time could maximize profits. They then conclude that firms should not locate accordantly if they have the same product, same production costs, communication costs and distribution costs. If these factors are different, firms should locate in the area where creates them a uniform and unique demand distribution. This model and method can also be applied to location problems involving product differentiation and product attributes and firm competitors with multiple facilities.

From a different aspect of view, Carey and Nini (2007) document that interest rates on corporate loans are different for borrowers based on their locations. Borrowers and lenders also exhibit home bias. Borrowers tend to issue in their home market and banks like to include local equities in their portfolios. This trend contributes to interest rate spreads and pricing discrepancies among different financial markets. Market preference limits price competition. Prices are thus hard to converge in two markets. Exceptionally, Carey and Nini (2007) construct a pecking order of borrower's issue market preference. They propose that the borrowers' first choice would be stay home when they can, then they are more likely to issue in Europe than elsewhere if they have to issue abroad, causing pricing discriminations among different markets. Except for external lending, Goetz et al. (2013) assess how geographic diversification influences insider lending of bank holding companies. Geographic diversification is firstly measured by the strategy that adopts state-time variations. This measure is then applied in to a gravity model of investments in foreign states to develop a second measure of geographic diversification. They find out that geographic diversification again contributes to insider lending and imply that geography intensifies agency costs and monitoring problems.

#### 6. CONCLUSION

There is no doubt that previous studies share common characteristics as to the special issue of geographic effects. Firstly, every paper enhances our understanding and the role of location in financial activities. Secondly, these papers provide extension to previous studies.

Previous literature classified information as soft and hard information. Soft information is the information that cannot be easily codified into quantitative variables. Thus, the interpretation of such information can vary from individuals and would be hard to communicate with distant agents. By contrast, hard information is easily communicated since it can be quantified and interpreted independently (Petersen, 2004). Essentially, geographic effects can be attributed to the precise nature of information advantages that arise from geographic proximity which links distance with information flows, information asymmetry problem and agency problems that result in leading to home bias. Information advantage can be provided by geographic proximity. The closer, the better access to information and the easier to gain private and soft information. Monitoring is an effective way to alleviate agency problems. However, monitoring involves substantial costs such as communication and transportation costs which are likely to increase as distance increases. Therefore, geographic proximity allows firms to capture the role of information advantages and reduced monitoring costs. Geographic proximity in a way reduces information asymmetry and contributes to diminishing the agency problems.

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