Foreign direct investment, diversification and firm performance

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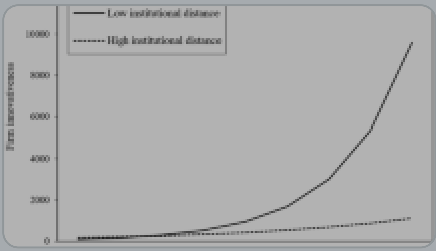
less harmful for diversified (multi-segment) than specialized (single-segment) firms. The larger gains to diversified firms suggest that operational and internal capital market efficiency gains are considerably greater in multi-segment than single-segment firms when both expand their core business overseas.



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Notes

1 During the period 1991–1994, foreign direct investment by multinational

information asymmetry, agency conflicts, costs associated with added layers of corporate bureaucracy, inefficient local management and workers, and other costs that may arise from cultural, political and economic differences with the host country in comparison with domestic investments.

5. Previous studies (e.g. Doukas and Travlos, 1988; Morck and Yeung, 1991, 1992; Doukas, 1995), however, address corporate expansion through the purchase of external growth opportunities such as international acquisitions.

6. An exception is Doukas and Travlos (1988), who examine bidders' stock price performance when they acquire a foreign target in related and unrelated industries.

11. Insider ownership information, included for reference, was also obtained from the Value Line Investment Survey.

12. To make sure that the four-digit SIC code of the company represents its core business, we also require that it accounts for 50% or more of its total sales. Other studies have routinely used only SIC codes to identify the core line of business of a corporation. Foreign investment activity based on the two-digit SIC code classification produces smaller diversification intensities.

13. An advantage of using event-study methodology is that it is not plagued by the limitations associated with the construction of an appropriate benchmark. This might be one of the reasons why previous diversification studies have produced mixed results. In the international context, the

finds a negative relation between diversification and firm performance in the 1960s, and a negative but weaker relation in the 1970s.

17. Lummer and McConnell (1990) show that the formation of international joint ventures increases a firm's value by 0.4%. Finnerty et al. (1986), however, find insignificant announcement effects for 110 international joint ventures. Similarly, Lee and Wyatt (1990) report significantly negative stock price reactions for US–foreign joint venture announcements. The overall evidence is different from that reported in McConnell and Muscarella (1985), which shows a slightly positive announcement effect for annual capital budget expenditure announcements in the USA.

18. The negative abnormal returns associated with foreign direct investments,

22. Barber and Lyon (1997) note that several biases (that is, new listing rebalancing, skewness, and a negative bias in continuously compounded returns) are introduced in long-term performance studies when the BHAR method is not used.

23. The BHARs are measured from day +3 to +500 (year 2) and +750 (year 3), respectively.

24. The time interval (year −1 to years 2 and 3) of the post-investment profitability measures accounts for the net improvement (deterioration) 1 year before the investment and afterwards. The start of the time interval is dictated by the availability of results nearest to the announcement year 0. Additional inspection shows that the profitability of firms 2 years prior to the

the squared assets of all segments prior to the announcement plus the new investment. This method is different from the conventional Herfindahl index, which can be constructed only for year −1 using the Compustat segment data tape.

28. This theory was introduced by Coase (1937) and subsequently developed by Caves (1971), Dunning (1973), Williamson (1975), and Buckley and Casson (1976).

29. We have also accounted for the effects of post-announcement investment activity on the long-term performance of the firm by constructing a subsequent investment dummy variable. The subsequent investment dummy variable is set equal to 1 if the firm invests from year 0 to years 2 and 3, and

the 3-year period after the initial announcement. These results are available upon request.

34. Similar results, available upon request, are found when we use the other two measures of performance (EBITD/total assets and EBITD/market value of equity).

35. The consistency between the market's negative (positive) reaction to foreign investment announcements and the long-term operating decrease (increase) in firm value indicates that shareholders have efficiently assessed the value of international diversification.

36. Our results are also consistent with the evidence that corporate divesting

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Appendix

Tobin's q estimates are obtained using the Perfect and Wiles (1994) method, which is a modified version of the Lindenberg and Ross (1981) algorithm for generating firm q values. The source of the data used to estimate q values is contained in the Compustat data tape, the Business Conditions Digest, and the Moody's Industrial Manuals. Perfect and Wiles (1994) determine the market value of the firm by the sum of:

1) year-end value of common stock;

2) preferred dividends capitalized by the Standard and Poor's preferred stock yield index;

3) year-end market value of the firm's long-term debt; and

of the long-term debt with maturity greater than 1 year; and *STDebt* is the year-end book value of the firm's short-term debt with maturity less than 1 year.

The following formula is used to estimate the *LTDebt* variable:

$$LTDebt_t = SBond_t E_{j=0}^{n-2} f_{t,t-j} \times \left\{ \left(\frac{R^A_{t-j}}{R^A_t} \right) [1 - (1 + R^A_t)^{-(n-j)}] + (1 + R^A_t)^{-(n-j)} \right\},$$

where *SBond* is the year-end book value of the firm's long-term debt in year *t*; $f_{t,t-j} = N_{t-1} / E_{k=0}^{n-2} N_{t-k}$; N_t is the sum of all new debt issued in year *t*; and R_t^A is the yield to maturity of a firm's debt at time *t* under the simplifying assumption that all debt issued in year *t* is priced to yield the average interest rate in *A*-rated debt for that year.

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