Foreign direct investment, diversification and firm performance

| Article | Published: 20 March 2003

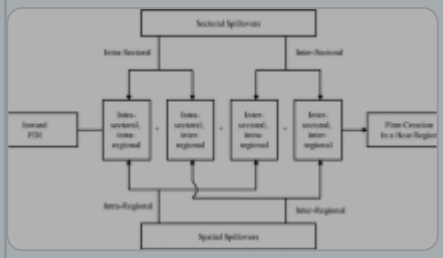
| Volume 34, pages 153–172, (2003) Cite this article

Journal of International Business Studies

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.

Corporate International Diversification and Performance: An Economic

Chapter | © 2020



Does foreign direct investment stimulate new firm creation? In search of spillovers through

Article | 19 September 2016

Corporate Diversification-Performance Puzzle in BRIC

Chapter | © 2020

Explore related subjects

Discover the latest articles and news from researchers in related subjects, suggested using machine learning.

4. Even though foreign direct investments are subject to many of the same influences and motivations as domestic investments (e.g. Agmon and Lessard, 1977; Errunza and Senbet, 1981; Adler and Dumas, 1983; Fatemi, 1984; Hisey and Caves, 1985; Doukas and Travlos, 1988; Morck and Yeung, 1991, 1992; Williamson, 1970), they are likely to be severely affected by greater costs of 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.

9. The construction of Tobin's q is described in the Appendix

10. Foreign sales/total sales ratios were collected from the Value Line Investment Survey.

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.

bidder returns at the announcement of conglomerate acquisitions in the late 1960s and early 1970s. Ravenscraft and Scherer (1987) record that conglomerate acquisitions during the 1960s were unsuccessful because of the post-acquisition poor performance and subsequent bust-up. Similar evidence is also reported by Kaplan and Weisbach (1992). Servaes (1996) 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

21. An alternative approach to control for industry effects is to use an industry indicator variable (Bradley et al., 1984).

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 [illegible]

27. The estimation of the Herfindahl index for the announcement year is estimated as the sum of the squared assets per business segment prior to the investment announcement plus the square of the new investment relative to 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).

significant bearing on the initial regressions, the reported results are based on regressions excluding these control variables. Only a very small fraction of firms is involved in subsequent foreign investments. Five per cent of the firms engage in foreign investment activity over the 2-year period and 7% in 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)

Google Scholar

Andrade, G. and Stafford, E. (1997) ‘Investigating the characteristics and determinants of mergers and other forms of investment’, University of Chicago, Working Paper.

Backley, P.G. and Casson, M. (1976) ‘The economic theory of foreign investment’, Economica 38: 1–27.

Google Scholar

Barber, B. and Lyon, J. (1997) ‘Detecting long-run abnormal stock returns: the empirical power and specification of test statistics’, Journal of Financial Economics 43: 341–372.

Holmes & Meier: New York.

Book Google Scholar

Campa, J.M. and Kedia, S. (2002) 'Explaining the diversification discount', Journal of Finance 57: 1731–1762.

Article Google Scholar

Caves, R.E. (1971) 'International corporations: the industrial economics of foreign investment', Economica 38: 1–27.

Article Google Scholar

Christophe, S.E. and Pfeiffer Jr, R.J. (1998) 'The valuation of US MNC

Denis, D.J., Denis, D.K. and Yost, K. (2002) ‘Global diversification, industrial diversification and firm value’, Journal of Finance 57: 1951–1979.

Article Google Scholar

Directory of American Firms Operating in Foreign Countries (1992), Uniworld Business Publications.

Directory of Multinational Enterprises (1992), Stockton Press: New York.

Doukas, J. (1995) ‘Overinvestment, Tobin's q and gains from foreign acquisitions’, Journal of Banking and Finance 19: 1285–1303.

market valuation, and size-adjusted evidence', Journal of Finance 39: 727–745.

Google Scholar

Fatemi, A.M. (1984) 'Shareholder benefits from corporate international diversification', Journal of Finance 39: 1325–1344.

Article Google Scholar

Finnerty, J.E., Owers, J.E. and Rogers, R.C. (1986) 'The valuation impact of joint ventures', Management International Review 2: 14–26.

Google Scholar

Graham, J.R., Lemmon, M.L. and Wolf, J. (2000) 'Does corporate diversification

Article Google Scholar

Kaplan, S.N. and Weisbach, M.S. (1992) 'The success of acquisitions: evidence from divestitures', Journal of Finance 47: 107–138.

Article Google Scholar

Lamont, O. (1997) 'Cash flow and investment: evidence from internal capital markets', Journal of Finance 52: 83–109.

Article Google Scholar

Lang, L., Ofek, E. and Stulz, R. (1996) 'Leverage, investment, and firm growth', Journal of Financial Economics 40: 3–29.

Lummer, S.L. and McConnell, J.J. (1990) ‘Valuation Effect of International Joint Ventures’, in S.G. Rhee and R.P. Chang (eds.) Pacific Basin Capital Market Research, Elsevier: New York, pp: 531–546.

Google Scholar

Mansi, A.A., and Reeb, D.M. (2002) ‘Corporate diversification, what gets discounted?’, Journal of Finance 57: 2167–2183.

Article Google Scholar

Matsusaka, J.G. (1993) ‘Takeover motives during the co-nglomerate merger wave’, Rand Journal of Economics 24: 357–379.

316.

Article Google Scholar

Morck, R. and Yeung, B. (1991) ‘Why investors value multinationality’, Journal of Business 64: 165–186.

Article Google Scholar

Morck, R. and Yeung, B. (1992) ‘Internalization: an event study test’, Journal of International Economics 33: 41–56.

Article Google Scholar

Morck, R. and Yeung, B. (2001) ‘Why Firms Diversify: Internalization *vs* . Agency

Google Scholar

Scharfstein, D.S. (1998) The Dark Side of Internal Markets II: Evidence from Diversified Conglomerates, National Bureau of Economic Research: Cambridge, MA, NBER Working Paper No. 5969.

Book Google Scholar

Servaes, H. (1996) 'The value of diversification during the conglomerate merger wave', Journal of Finance 51: 1201–1225.

Article Google Scholar

Singh, H. and Montgomery, C.A. (1987) 'Corporate diversification', Strategic

Williamson, O.E. (1970) Corporate Control and Business Behaviour: An Inquiry into the Effects of Organizational Form on Enterprise Behaviour, Prentice-Hall: Englewood Cliffs, NJ.

Google Scholar

Williamson, O.E. (1975) Markets and Hierarchies, Free Press: New York.

Google Scholar

Acknowledgements

Additional information

Accepted by Tom Brewer; outgoing Editor, September 2002. This paper has been with the author for 1 revision.

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:

where *RC* is the replacement cost of the firm's assets; *Comval* is the year-end value of the firm's common stock; *Perfval* is the estimated year-end market value of the firm's preferred stock (that is, firm's total preferred dividends capitalized by the Standard and Poor's preferred stock yield index); *LTDebt* measures the value 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:

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

where *SBond* is the year-end book value of the firm's long-term debt in year *t*; *f*

About this article

Cite this article

Doukas, J., Lang, L. Foreign direct investment, diversification and firm performance. *J Int Bus Stud* **34**, 153–172 (2003). https://doi.org/10.1057/palgrave.jibs.8400014

Received	Revised	Accepted
01 September 2001	01 August 2002	01 September 2002
Published	Issue Date	
20 March 2003	01 March 2003	
DOI		
https://doi.org/10.1057/palgrave.jibs.8400014		