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Corporate international diversification and the cost of equity: European evidence

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Abstract

This paper analyzes the impact of corporate international diversification (CID) on domestic and world betas through the notion of psychic distance between countries. Using a large European sample of 598 firms, our findings indicate that this dimension significantly influences corporate risk exposure. By isolating three additive components of the Foreign Sales Ratio (FSR), we obtain the most significant results by geographically partitioning the sample, provided that firms are further classified by sector. Our framework sheds new light on how the CID of firms belonging to Sweden and the United Kingdom, as well as the Consumer Cyclical, Consumer Non-Cyclical and Information Technology sectors, sometimes can reduce and sometimes increase firm betas.

JEL classification: F23; F30; G12; G15; G31

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1. Introduction

Whether corporate international diversification (CID) influences stock prices is a subject that has received a great deal of attention over the last three decades. This is still a relevant question

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for investors, insofar as they may require their diversified portfolio to exhibit the best possible asset allocation. Managers should also be concerned about the impact of the international capital budgeting process in their assessment of the cost of equity. However, this question is somewhat unresolved, mainly as a result of inappropriate specifications of an internationalization index and of the avoidance of other elements, such as industry-specific dimensions. Indeed, current literature is paying growing attention to industry factors, which tend to exhibit an increasing importance relative to geographical factors.[1]

Specifically, little research has attempted to take into consideration the psychic distance of a firm's international commercial markets, despite the fact that it is recognized as a key dimension in the internationalization process literature. In relation to this issue, the purpose of this paper is to develop a framework that introduces the diversification effect of the geographical breakdown of a firm's activities on stock betas. We partition the traditional measure, namely the Foreign Sales Ratio, in order to incorporate the psychic distance of each geographical area of destination. We pay particular attention to the sensitivity of world betas to the geographical dispersion of corporate activities, because no measure of psychic distance can fully account for the complex interrelationships between international stock markets. We test our set of internationalization indexes against a sample of European internationalized companies and compare their information contents with the Foreign Sales Ratio.

Our second objective is to show that the existing relationship between firm internationalization and systematic risk is not necessarily invariant to the industry or to the country the firm belongs to. The effect of expanding corporate international activities on shareholders' returns may vary greatly according to the industry's characteristics, notably the level of product differentiation, the level of entry barriers and ownership restrictions, as well as to the nationality of the firm. In the empirical part of this article, we provide evidence that a proper account of this double characteristic greatly improves the understanding of the effect of psychic distance on the behavior of stock returns. We show that there is some homogeneity in the sensitivities of stock betas with respect to their corresponding internationalization index for firms belonging to the same sector, but that the scale of these sensitivities depends on their country of origin. Failure to account for both components would lead to the neglect of very useful information.

This framework enables us to shed new light on the impact of CID on firms belonging to two countries (Sweden and UK), whilst also highlighting the impact on the Consumer Cyclical, Consumer Non-Cyclical and Information Technology sectors. Not only do we relate our findings to the previous literature on the effects of corporate international diversification, but we can also combine this evidence with an explanation relating to the psychic distance of the geographic destinations of internationalized firms.

The paper is organized as follows. Section 2 reviews the literature and introduces the psychic distance concept. Section 3 presents our model that incorporates this notion. Data, methods and the construction of the internationalization indexes are proposed in Section 4. Evidence regarding the effect of corporate international diversification is reported in Section 5. Section 6 proposes an interpretation of the various effects. Section 7 concludes.

[1] See Baca et al. (2000), Cavaglia et al. (2000), Gerard et al. (2002) and Phylaktis and Xia (2003). For the EMU equity markets in particular, see Ferreira and Ferreira (2006).