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IBR-1051; No. of Pages 16
ARTICLE IN PRESS
International Business Review xxx (2013) xxx–xxx
Contents lists available at ScienceDirect
International Business Review
journal homepage: www.elsevier.com/locate/ibusrev

Foreign direct investment in emerging markets and acquirers' value gains☆

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ARTICLE INFO

Article history:
Received 5 July 2012
Received in revised form 2 October 2013
Accepted 2 October 2013

JEL classification:
G34

Keywords:
Announcement period returns
Corruption
Emerging markets
Foreign direct investment
Physical assets
Political risk

ABSTRACT

We investigate the shareholder wealth effects of 306 foreign direct investment (FDI) announcements by UK firms in seventy-five emerging markets (EM). Our results show that acquirers enjoy highly significant gains during the announcement period of FDI. Perhaps surprisingly, the highest gains are accrued to acquirers investing in countries with high political risk and high corruption ratings. The type of asset acquired has also a significant effect on the gains of acquirers' shareholders, with the highest gains accrued to acquirers of physical assets. Also, investments in physical assets in EM with a high corruption rating elicit the highest gains. We contend that UK firms following resource-seeking strategies in EM with a high corruption rating are facilitated access to resources on favorable terms and this is viewed positively by the market participants. Our results are robust to alternative model specifications and the endogenous choice to expand internationally.

1. Introduction

Reflecting the importance of foreign direct investment (FDI) in shaping the modern corporation, a voluminous literature has emerged investigating whether FDI undertakings create or destroy value for the shareholders of participating firms (Bruner, 2004; Sudarsanam, 2010).[1] The majority of earlier studies document mixed evidence related to the impact of FDI undertakings on acquirers' returns, which primarily reflect information about the quality of FDI, numerous costs and benefits associated with individual transactions, and several other important elements (i.e., country risks, mode of entry) that affect the likelihood of future success of the FDI.[2] Numerous studies also attempt to further explore the major determinants of such variation on the distribution of acquirers' returns and have revealed the significant impact of several transaction-, country-,

☆ We thank two anonymous reviewers for helpful comments on an earlier version.

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[1] Firms expand internationally, or engaged into FDI, through the following ways: (a) exporting from to home to foreign market, (b) licensing a foreign company to produce the goods and services, (c) greenfield investment in production facilities in the foreign market, (d) merger with, or acquisition of, a firm already operating in the foreign market, and (e) joint venture or other strategic alliance with a firm operating in the foreign market. The last three methods are in general considered as *FDI* with cross-border acquisitions (CBA) to represent the single most important method of FDI participation (UNCTAD, 2006). We follow these definitions in the data collection in this paper.

[2] Most of previous research concentrates on the acquiring, or internationally expanding, firm's announcement period returns. Among others, Doukas (1995) and Francis et al. (2008) find positive shareholder wealth gains to announcements of CBA while Gande et al. (2009) show that the international diversification benefits are driven by both the financial and real dimensions of multinationality. On the contrary, Denis, Denis, and Yost (2002) find that international diversification decreases the market value of acquiring firms. Others have discussed the impact of various legal system and investor protection regimes worldwide on the gains of US and UK acquirers' shareholders and show that such gains are sensitive to such country-specific and institutional dynamics (see Barbopoulos et al., 2012; Bris and Cabolis, 2008, respectively). Scholars have also confirmed the impact of FDI entry mode on performance (Brouthers, Brouthers, & Werner, 2003), whereas others have shown that firms systematically choose their entry mode when making FDI (Hennart and Park, 1993; Kogut and Singh, 1988). López-Duarte and García-Canal (2007) have investigated the announcement period performance of a sample of Spanish firms engaged into FDI and show that the FDI entry mode shapes the distribution of acquiring firms' returns.

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http://dx.doi.org/10.1016/j.ibusrev.2013.10.003

Please cite this article in press as: Barbopoulos, L., et al. Foreign direct investment in emerging markets and acquirers' value gains. *International Business Review* (2013), http://dx.doi.org/10.1016/j.ibusrev.2013.10.003

and firm-specific factors.[3] Despite such findings, a new and important aspect to outward investment is the substantial increase of FDI flows into emerging markets (EM), which adds significantly to the level of complexity of FDI success in generating future cash flows for the firm. Along these lines, academic literature in international business and finance discusses the associated costs and benefits for firms undertaking FDI in EM. These can include strategic, behavioral, and economic benefits, lower costs, new and rich sources of inputs/resources, and fast growing markets which provide enormous market opportunities (Barbopoulos, Paudyal, & Pescetto, 2012; Berry, 2006; Erel, Liao, & Weisbach, 2012). To some extent, these benefits are seen by an internationally expanding firm as outweighing the institutional hazards (country risk and corruption), political and structural uncertainties, impact on firm overall strategy, weak legal institutions and government interference of many EM countries (Hoskisson, Eden, Lau, & Wright, 2000). As a result, the costs and benefits of FDI in EM should be directly reflected in the announcement period returns of the acquiring firms.

Existing literature on the shareholder wealth effects of FDI in EM is limited and available evidence on whether shareholders of acquiring firms benefit from the international business expansion is mixed. There have only been a few studies focusing on FDI in EM with the majority of them concentrating solely on one country, for example China (Gupta, McGowan, Misra, & Missirian, 1991) or one region, for example Africa (Owhoso, Gleason, Mathur, & Malgwi, 2002). There have been calls to take a broader research agenda encompassing all EM regions to consider inter-regional differences on the same basis as studies on developed-market FDI (Hoskisson et al., 2000). Moreover, as yet there have been little attempts to integrate theories from international business literature with theories from the finance literature in the specific realm of the market reaction to FDI announcements. Our study aims to fill these gaps by examining the short term market reaction to FDI in EM to capture shareholders' perception regarding the future performance of the firm influenced by the FDI announcement.[4] A suitable sample to undertake this research is represented by UK firms investing in EM.[5]

We extend the existing literature in a number of directions. *Firstly*, in order to capture a wide range of geographical, political and cultural diversity conditions we consider the EM regions of Africa, Asia, Eastern Europe, Latin America and the Middle East. *Secondly*, we combine key international business and variables supported by theories from the finance literature; in particular what benefits the firm's shareholders accrue and what factors are relevant in determining the market reaction to these announcements. Since prior research suggests that corruption affects FDI flows (Egger & Winner, 2005) and high corruption is characteristic of EM (Abed & Gupta, 2002) we incorporate corruption, a *time-varying* variable not previously investigated within the context of wealth effects of FDI.[6] In addition to corruption, we include a *time-varying* political risk index. The remaining variables include a cultural distance variable, and a variable that captures the type of asset investment in the FDI (tangible or intangible). The type of asset invested via FDI could be important in EM where there could be higher probability of political extraction than in developed economies. Connected to this we include a variable which captures the strategic aim of the firm in the FDI, i.e. resource or market seeking (Brouthers, Gao, & McNicol, 2008). Resource-seeking FDI involves obtaining resources from the host country which are either unavailable in the home country or too costly to obtain in order to achieve cost minimization. Market-seeking FDI involves investing in a host country in order to directly serve that market with local production and distribution. In our research on EM we would argue that this distinction is particularly important in understanding the market reaction to FDI as they can, for instance, provide access to vital raw materials or large new previously untapped markets. The UK colonial past in many EM, particularly in Africa, Asia and the Middle East and to a lesser extent in Latin America, provides also a useful cultural background to study the wealth effects of FDI for UK firms. Finally, the mode of entry into the foreign market is an important element that enters our empirical analysis, given that different entry modes affect FDI performance (López-Duarte & García-Canal, 2007).

Based on a sample of 306 announcements of FDI by UK firms in seventy-five EM countries over the sixteen-year period (from 1993 to 2008) our results show that there are benefits to EM international expansion for UK firms as on average they experience a highly significant shareholder wealth gain around the announcements of FDI. This indicates a positive perception of the FDI on future cash flows of the firm. More specifically, our contribution lies in identifying the interaction of the most relevant factors that should be considered important when assessing the merits of investing in EM. Our main findings are as follows: *first*, perhaps surprisingly, we find that the announcement period returns to be higher for FDI in EM countries with high political risk or high corruption ratings. This finding can be more fully understood when we consider the other factors that are significant in explaining the market reaction. *Second*, we show that the type of asset invested in, or acquired, has a bearing on the shareholder wealth effect. Investment in, or acquisition of tangible (physical) assets leads to significantly higher abnormal returns as opposed to intangible (non-physical) assets or agreements, even in EM with a high political risk rating. There is also a significant interaction effect between the type of asset investment and corruption. In fact, investments involving the acquisition of physical assets in EM with a high corruption rating elicit the highest gains. Our explanation for this result regarding a high level of host country corruption takes a strategic focus. Specifically, resource seeking FDI in a host country with high corruption rating elicits higher announcement period returns than a market seeking FDI as firms are facilitated access to valuable resources at a favorable price and thus FDI can create resource allocation efficiencies in EM with underdeveloped economic and legal frameworks. We also find evidence suggesting that cultural differences play an important role in the market reaction to announcements of FDI in EM. Lastly, our results confirm that the FDI mode entry plays an important role in shaping the announcement period returns of acquirers.

Overall, our findings have practical implications for both managers and shareholders in terms of the choice of location and strategy; since EM attract sizeable amounts of FDI and investors require an enhanced understanding of factors that have an impact on FDI strategies. Our contribution lies in identifying the

[3] For example, Asquith, Bruner, and Mullins (1983) show that acquirers' gains are related to the transaction's relative size whereas Sudarsanam and Mahate (2003) show that acquirers' growth opportunities affect their gains; Moeller et al. (2004) confirm that the size of the acquirer is an important determinant of acquirers' gains; other studies confirm that the target firm's status and the method of payment in M&A affect acquirers' gains (Draper and Paudyal, 2006).

[4] Emerging markets provide the ideal environment to investigate the interaction between corruption, political risk, type of asset acquired, strategic aims, and cultural distance. For instance, Meyer, Estrin, Bhaumik, and Peng (2009) discuss how institutions (rules and legal/regulatory framework) can significantly influence firm strategies such as foreign entry methods and this is particularly important for EM 'where institutional frameworks differ significantly from those in developed economies'.

[5] The World Investment Report (2009) (Annex B), for example, shows that in 2007 the total value of global CBA deals reached over 1.03 trillion US dollars, which represents a record increase of more than 62% over the value of 2006. In the same year, British firms' net purchases reached 21.5% of the global market.

[6] To the best of our knowledge, the only study to consider this issue is Pantzalis, Park, and Sutton (2008) who focus on the link between corruption and the value of international diversification. It is important to note that this paper explores the impact of FDI in EM on firm value and not on FDI flows which are derived from balance of payments data reflecting external financing of assets. Since EM typically have poor capital markets external financing is very prominent and this highly correlates with foreign owned assets.