Foreign direct investment in emerging markets and acquirers' value gains

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A B S T R A C T

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.

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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). 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. 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-,

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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.
and firm-specific factors.\textsuperscript{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 relating to EM within the same country, for example China (Gupta, McGowan, Misa, & 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.\textsuperscript{4} A suitable sample to undertake this research is represented by UK firms investing in EM.\textsuperscript{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.

\textsuperscript{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 Peady, 2006).

\textsuperscript{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, Bhauvik, and Peng (2000) 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.’

\textsuperscript{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.

\textsuperscript{6} To the best of our knowledge, the only study to consider this issue is Pantazis, Parr, 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.
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