

Derivatives hedging, geographical diversification, and firm market value

Bengt Pramborg

Department of Corporate Finance, School of Business, Stockholm University, Stockholm SE-10691, Sweden

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Abstract

This paper examines the value effect from different aspects of hedging activity and foreign operations, using a sample of Swedish firms over the period 1997–2001. A main finding is that there seems to be a positive value effect from hedging transaction exposure, but that translation exposure hedging does not add value. Further, the results suggest that firm value is positively related to geographical diversification and firms' net long positions in foreign currency. The latter may be caused by the depreciation of the Swedish currency during the sample period.

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1. Introduction

The purpose of this paper is to investigate whether firms' hedging activities are rewarded with higher market values. In the perfect capital market of the classic Modigliani and Miller proposition I, risk management is irrelevant to firms. Shareholders can hedge on their own by holding well-diversified portfolios, so there is no value creation by hedging away risks for an individual firm. Recent theories derive optimal hedging policies by introducing frictions into the Modigliani and Miller model.¹ An increasing number of empirical studies have been

E-mail address: bpg@fek.su.se (B. Pramborg).

¹ See e.g. Stulz (1984) for a rationale based on managers' risk aversion, Smith and Stulz (1985) for rationales based on structure of taxes or transaction costs of financial distress, and Froot et al. (1993) for a rationale based on the underinvestment problem that would result from costly external financing in combination with variable cash flows. DeMarzo and Duffie (1995) propose a rationale based on managers' private information.

performed to investigate these theories and the evidence suggests that firms hedge largely in order to mitigate market imperfections consistent with theoretical recommendations.²

Important for this study is Hagelin's (2003) evidence concerning Swedish firms' use of currency derivatives. He found evidence implying that firms hedge transaction exposure with currency derivatives to increase firm value by reducing indirect costs of financial distress or alleviating the underinvestment problem. However, there was no evidence that translation exposure hedges were used to increase firm value.

A few recent studies have examined the risk reducing effect from hedging. Allayannis and Ofek (2001) found that, on average, firms use currency derivatives to reduce exchange rate exposure, rather than to speculate. Hagelin and Pramborg (2003) examined whether hedging reduces foreign exchange rate risk. They found that firms that hedge have lower exchange rate exposures, given the level of inherent foreign exchange exposure, than firms that do not hedge. It follows that firms' hedging activity may increase firm value. Allayannis and Weston (2001) investigated whether the use of derivatives affects firm value. The evidence suggests that there is a positive relation between firm value and the use of foreign currency derivatives, and, assuming that most firms use currency derivatives to hedge, that hedging causes an increase in firm value.

This paper adds to the findings of Allayannis and Weston (2001) mainly by studying whether hedging different types of exposure, i.e. transaction exposure and translation exposure, are rewarded by investors. An advantage in this study is that the use of survey data makes it possible to use improved measures of foreign operations and hedging.³

The results indicate that firms that are diversified geographically and hedges are valued at a premium. In addition, positive net exposure to foreign currency affects firm value positively. This result may be specific to the period under study in which the Swedish currency depreciated substantially. In periods of depreciation firms with long positions benefit. An important result is that any value effect from hedging comes from hedging transaction exposure, but not from hedging translation exposure. To the best of the author's knowledge, this is the first study to empirically document this result.

The paper is organized as follows. The next section describes the sample and discusses effects from the choice of sample period. Section 3 contains the variable definitions. Empirical results are presented in the fourth section, which is followed by the conclusions.

2. Sample description

The paper focuses on Swedish firms' foreign operations and hedging activities for the period 1997–2001. The sample is based on three consecutive questionnaires sent to non-financial Swedish firms listed on the Stockholm Stock Exchange. The first, used by Hagelin (2003) was sent to 160 firms in October 1997, and contained questions regarding the year 1997. The second, used by Hagelin and Pramborg (2003), was sent to 275 firms in March 2000, and contained questions regarding the years 1998 and 1999. The third was sent to

² See e.g. Nance et al. (1993), Mian (1996), Géczy et al. (1997), and Haushalter (2000).

³ However, the usual disadvantages associated with the use of survey data apply, e.g. that the respondents misinterpreted the questions, or provided incorrect answers.

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