



The effect of investor origin on firm performance: Domestic and foreign direct investment in the United States[☆]

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ABSTRACT

This paper evaluates the causal relationship between the source of origin of FDI and the performance of the target firm. The empirical analysis uses new data on a comprehensive sample of public U.S. firms that received FDI between 1979 and 2006. To account for the possibility that performance differences arise due to the selection of superior target firm rather than the change in ownership, I use propensity score matching to create similar comparison groups of target firms prior to acquisitions. The analysis reveals three major findings. First, acquiring firms from industrialized countries lead to labor productivity increases of 13% in the target firm three years after the acquisition compared to targets acquired by domestic firms. Firms that received developing country firm acquisitions, on the other hand, exhibit lower labor productivity gains four years after acquisition, compared to targets acquired by domestic firms. Second, targets receiving FDI by firms from industrial and developing countries also experience increases in profits, compared with firms receiving acquisition by domestic firms from the United States. Third, compared with domestic acquisitions, foreign industrial firm acquisition FDI tends to increase their targets' employment and sales, whereas targets acquired by firms located in developing countries experience a decrease in both revenues and total number of employees. These findings suggest that target firms are subject to significantly different restructuring processes depending on the origin of the acquiring firm.

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1. Introduction

Historically, the majority of foreign direct investment (FDI)¹ flows has taken place predominantly between industrialized countries and from developed to developing countries. In recent years, however, developing country firms started engaging in outward FDI activity. The recent upsurge in cross-border mergers and acquisitions (M&As) from emerging countries such as China's Lenovo purchase of IBM Thinkpad and India's Tata Motor's acquisition of Ford's Jaguar and Landrover has raised great attention in policy circles, but yet, little is known about how these emerging market acquisitions are different from acquisitions by acquirers from developed countries.

Traditionally, the business rationale for M&A is that the new combination of assets will be more productive than the sum of its parts (Dunning, 1981; Hymer, 1976). Theories for FDI have relied on

differences in relative input costs and market access as motivations for developed-market investment flows to emerging markets (Yeaple, 2003). Helpman et al. (2004) suggest that firms that invest abroad have to overcome larger fixed costs and barriers. As a result, foreign acquiring firms have to be more productive than their peers. In addition to technology transfer, industrial country acquirers often seek lower labor costs in emerging markets. For emerging market acquirers, the rationale for cross-border M&A might be different. Endowed with a relatively larger and cheaper labor force, it is likely that emerging market acquirers may relocate (or insource) manufacturing activity while keeping existing distribution networks in the host country of the acquired business (Chari et al., 2009). Therefore, the changing composition in acquirers raises the question whether heterogeneity among acquirers has consequences for target selection, implementation of M&As, and, therefore, post-acquisition target performance. Although existing studies have shown superior performance in foreign-owned firms compared with domestically owned firms (e.g., Harris and Ravenscraft, 1991; Swenson, 1993; Doms and Jensen, 1995; Haskel et al., 2007), little is known about the differences in performance within the group of acquired firms and whether the act of acquisition improves target firm performance. This paper fills this gap by estimating the causal effects of acquirer origin heterogeneity on target firm performance.

I use a newly-constructed data set to examine whether the post-acquisition performance of U.S. target firms differs when the buyer is

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¹ FDI includes "Greenfield" investment in new assets in a foreign country and acquisition of pre-existing foreign assets, also termed "Brownfield" FDI. In this paper, I concentrate exclusively on brownfield FDI in the United States.

either a U.S. domestic firm, an industrial country firm, or a developing country firm. I assemble a comprehensive sample of acquired U.S. public firms by linking daily M&A transaction information from SDC Thomson to each target firm's financial statement in Compustat. The U.S. provides a particularly suitable setting in which to study M&As given its role as the world's most sought after target country, with a combined value of cross-border and domestic M&A deals of \$1.47 trillion in 2007.²

When comparing the impact of domestic and various foreign acquisitions on U.S. target firm performance, there are two main empirical challenges. First, the issue of selection arises in that better post-acquisition performance might be a result of more skillful selection (also referred to as “cherry picking” of targets) rather than the change in ownership per se. Second, one would ideally compare the performance of a target firm that is acquired by a domestic firm with the performance of the same target had it been acquired by a non-U.S. industrial country firm or a developing country firm.³ However, these counterfactuals are not observable because at any given point in time a target firm experiences only one of three events – it is acquired by either (1) a domestic firm, (2) an industrial country firm, or (3) a developing country firm. This creates a missing data problem. To solve these issues, I use propensity score matching to construct a comparison group of domestically acquired target firms that is similar on a set of important observable characteristics to the group of targets acquired by industrial country firms or developing country firms. In evaluating the target firm performance after the acquisition, I use measures of labor productivity, profits, sales, and employment as outcome variables.

I find that over a period of five years following acquisition, compared to U.S. domestically acquired targets, targets acquired by industrial country firms experience a significantly higher growth rate in labor productivity of up to 13%, whereas for targets acquired by developing country firms, the growth rate in labor productivity is 23% lower. Moreover, targets acquired by industrial country firms and by developing country firms exhibit higher average profits compared with acquisitions by U.S. firms – by ten and nine percentage points, respectively. The data show that compared with domestic acquisitions, sales also tend to increase in industrial country firm acquisitions – by up to 29% compared to a similar group of domestically acquired firms, whereas sales decline by up to 20% for targets acquired by developing country firms compared to a similar group of domestically acquired firms. Finally, whereas industrial country firm acquisitions lead to an increase in employment of 24% in their targets, targets of developing country firm acquisitions reduce their total number of employees by up to 26%.

Several sensitivity analyses are performed to assess the validity of the findings. I first show that the results are robust to different propensity score specifications. Additionally, I use a small sample of announced deals that were subsequently withdrawn and find no differences in target performance between domestic withdrawn and foreign withdrawn deals. To illustrate the importance of controlling for selection and creating appropriate comparison groups, I redo the analysis without propensity score matching and show that the results are different. Lastly, I perform robustness checks on various subsamples of the data to make sure that the results are not specific to one particular feature of the data.

This paper provides some of the first findings on the differences in various aspects of target post-acquisition performance as a result of acquirer origin heterogeneity. Previous studies do not differentiate between the investor origin, since the comparison is conducted only between foreign-acquired and non-foreign-acquired firms.⁴ There-

fore, average effects estimated across groups could mask differences in performance between each of the groups.

Examining the impacts of foreign and domestic acquisitions on target firms also reveal important policy implications. The U.S. government has sometimes taken a hostile attitude toward foreign acquirers of U.S. target firms.⁵ Another source of concern about foreign acquisitions is the potential loss of American jobs. Domestic M&A transactions do not provoke the same sort of concerns as their cross-border counterparts.⁶ Understanding the impacts of cross-border M&As sheds light on whether these political concerns are validated by the post-acquisition economic performance of the different types of acquisitions.

I begin with a theoretical and empirical background on why investor origin impacts target firm performance based on existing literature. Section 3 provides a description of the data. Section 4 outlines the details of the identification strategy using multiple treatment propensity score matching combined with a difference-in-differences estimator. Section 5 presents the empirical results and discusses the different ways in which gains are realized among the varying types of acquirers. Section 6 provides robustness checks, and Section 7 concludes with a discussion of the implications of these results for both future research on FDI and economic policy.

2. Empirical and theoretical background

A burgeoning literature in international economics has conducted causal analyses on foreign ownership and firm performance (Djankov and Hoekman, 2000; Conyon et al., 2001, 2002; Harris and Robinson, 2003; Bertrand and Zitouna, 2005; Girma, 2005; Benfratello and Sembenelli, 2006; Fukao et al., 2006; Girma and Görg, 2007a,b; Heymann et al., 2007; Arnold and Javorcik, 2009, just to name a few). These papers focus on ex-post performance changes in the target firm after foreign takeover. This literature has found mixed evidence on whether foreign-owned firms perform better than domestic-owned firms. To disentangle correlation from causality, Arnold and Javorcik (2009), for instance, create a carefully selected group of non-acquired firms using a propensity score matching technique combined with a difference-in-differences estimator.

Essentially, previous studies have treated all foreign acquirers as homogeneous when exploring the question of whether foreign acquisition leads to higher productivity.⁷ In contrast, the present paper regroups acquired target firms by acquirer firm origin. This study asks the following: Are there differences in the target firm performance after the acquisition? And if so, how do these effects differ within the group of all acquired firms? To answer this question, I also take into account the domestically acquired targets which are usually buried in the comparison group of all non-foreign-acquired targets in other studies. Since domestic acquisitions play a dominant role, especially in the United States, previous papers might have overlooked important insights into M&As by not comparing domestic acquisitions directly with foreign acquisitions.

Broadly, acquiring additional capital may increase profits via two channels. First, the industrial organization theory of multinational firms suggests that multinationals have access to firm specific assets (Markusen, 2002) that can translate into operating with superior technology or better management strategy and know-how. Helpman et al. (2004) propose that firms that invest abroad have to overcome

⁵ See the article “Love me, love me not” in the July, 2008 issue of *The Economist*.

⁶ For instance, Whirlpool's bid to buy Maytag in 2005 was received with enthusiasm, while a potential buyout of the same company by a Chinese-owned firm was perceived with concern by both American politicians and media.

⁷ Notable exceptions are Girma and Görg (2007b) who differentiate acquirers by country groups in their investigation on wage premia and recent work by Javorcik and Spatareanu (2010) that examines the impact of investor origin on vertical spillovers from foreign direct investment.

² Source: SDC Thomson.

³ The same can be said of comparisons between target firms that are acquired by industrial country firms and by developing country firms.

⁴ A notable exception is Girma and Görg (2007b).

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