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Market expansion versus cost reduction: a financial analysis of foreign direct investment advantages for multinational enterprises

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Abstract

By testing a large sample of US-based multinational enterprises (MNEs), we attempt to microscope the relations between FDI advantages and excess market value created thereby. Two most commonly pursued FDI advantages—market expansion and cost reduction—come under the analysis. We find that the overseas divisions of US-based MNEs have significant market expansion advantage over the domestic divisions, but do not have significant cost reduction advantage. The cross-sectional variation in excess market value of US-based MNEs finds an explanation in the market expansion advantage when firm equity risk is held constant, but it cannot be explained by the cross-sectional variation in the cost reduction advantage. Given the result of our study, we also deliberate on the relations of FDI advantages with the degree of international involvement by MNEs.

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Keywords: Foreign direct investment; Market expansion; Cost reduction; Excess market value

1. Introduction

Owing to a rapid pace of economic globalization over the last two decades, foreign direct investment (FDI) has become a popular vehicle by which firms achieve their strategic objectives. The worldwide FDI flows have amazingly grown from US$ 46 billion in 1980 to US$ 644 billion in 1998 (World Bank, 1999). In this process, multinational enterprises (MNEs) are particularly active in generating excess values through FDI. As claimed, it is in

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the interest of MNEs to locate production or market activities abroad where they can benefit from market power expansion as well as location-specific advantages.[1]

Among a variety of strategic advantages that MNEs pursue through FDI, two stand out conspicuously, i.e. market expansion and cost reduction. While market-expansionary FDI seeks to enlarge market power through direct sales and other related activities, cost reduction minded FDI goes after cheap labor, raw materials, or other advantages in the host country. Theoretically, both types of FDI contribute to the viability of investing firms. But are they reliable as claimed and strategically worthwhile compared to MNEs' domestic operations? Are they both equally effective in creating excess values for MNEs? How are they related to the degree of MNE's international involvement as enticement? Our study intends to answer these questions through an analysis of these two major FDI advantages. It examines the relationship of these strategic advantages with excess values generated thereby. With an empirical test on the performance of 157 US-based MNEs in recent years, we in particular distinguish the market-expansionary FDI and the cost-reducing FDI, and investigate their respective effect on the excess value generation. First, our findings show that overseas divisions of US-based MNEs does have significant market expansion advantage over domestic divisions. Second, the cross-sectional variation in excess market value of US-based MNEs is mainly related to the market expansion advantage. Third, the FDI of US-based MNEs does not have significant cost reduction advantage over domestic divisions, and the excess market value of US-based MNEs cannot be attributed to the cost reduction advantage of FDI inclusively.

The organization of this paper is as follows. Section 2 conducts a literature review in the field of FDI studies. Section 3 lays out an empirical model of excess market value in relation to FDI advantages. Section 4 discusses data sample. Section 5 analyzes test results. Section 6 summarizes the findings of this paper.

2. Literature review

The early genre in the field heavily focuses on the justification of FDI and its strategic validity. Errunza and Senbet (1981) call attention to the existence of excess market value associated with international operations, and claim that MNEs can earn higher rents than local competitors in home countries. The advantage that MNEs possess over local firms of home countries simply indicates a departure from market perfection, from the perspective of economics. If the market were perfect, home country firms would have access to product and factor markets that are otherwise only available to MNEs, and they would be at no relative disadvantage. By the same token, MNEs would have no special incentive to invest abroad. From this vantage point of view, the existence of imperfections in the product and factor markets rationalizes FDI. There are other studies that underline the increase of MNE's market strength and the creation of excess value for shareholders as the result of FDI. They either document significant positive gains for shareholders associated with international operations in general (Agmon and Lessard, 1977; Brewer, 1981; Errunza and

[1] Studies in this area include Kindleberger (1969), McManus (1972), Buckley and Casson (1976), Hymer (1976), Dunning (1981), and Rugman (1981).