

# Overseas Expansion And Shareholders' Wealth

Dr. Ike Mathur, Finance, Southern Illinois University  
Dr. Amjad Waheed, Finance, Southern Illinois University

## Abstract

*The effects of overseas expansion on shareholders' wealth were studied in this paper. The results for a sample of 179 announcements of overseas expansion showed positive and significant cumulative average residuals (CARs). The results for initial overseas expansion were more positive than for subsequent overseas expansion. Five different methods of expansion were examined. Announcements of exports resulted in the highest, positive and significant CARs. CARs for licensing, opening an overseas subsidiary and acquiring a growing concern were marginally significant, while CARs associated with joint venture announcements were positive but insignificant. The results did not indicate that any differences were associated with the degree of industrialization of the host country.*

## I. Introduction

Numerous studies have demonstrated that international diversification is advantageous from a risk reduction viewpoint. Low levels of correlation among international asset returns imply that gains are associated with international diversification. Grubel (1968), Levy and Sarnat (1970), Lessard (1973) and Logue (1982) among others, using a mean-variance portfolio framework, demonstrate that it pays to diversify across national borders, primarily because risk is pooled in projects that are less than perfectly correlated. Solnik (1974) found that the systematic risk of U.S. companies, which he measured at 27 percent, can be reduced to 11.7 percent by holding an efficient international portfolio. Agmon and Lessard (1977) found that the higher the degree of international involvement of a multinational corporation (MNC), the lower its market-assigned measure of systematic risk. Errunza and Senbet (1984) found a significant positive relationship between the degree of international involvement of a firm and its excess value, which they measure as the difference between market value and book value of the firm.

Investing in MNCs and direct investing in foreign firms are two methods of diversifying internationally. If there are no barriers to achieving international diversification through the acquisition of financial instruments issued in foreign countries, then either diversification alternative is acceptable. However, Mathur and Hanagan (1983) identify a variety of barriers that may prevent investors from achieving international diversification through direct investments in foreign financial instruments. The principal barriers mentioned by them are lack of fully integrated capital markets, exchange rate diversification, transaction costs, access to information, and host country regulations.

The presence of these barriers to direct international diversification indicates that investors cannot successfully diversify internationally directly. On the other hand, MNCs not only can cope with these barriers but they also possess certain unique advantages not enjoyed by investors (1). Principal among these advantages are imperfections in factor and product markets, financial economies in the values of intrafirm transfers and in cost of debt, and efficient management of financial assets and liabilities.

The above discussion leads to the conclusion that from the investors' perspectives MNCs, in general, are better vehicles for achieving international diversification and risk reduction than direct diversification by investors. Investors would, therefore, prefer to diversify by buying shares in MNCs than by buying stocks of companies domiciled in foreign markets. Additionally, it can be hypothesized that investors would react favorably to any pronouncement by a firm indicating that it is increasing its involvement in international business activities.

Firms can engage in a variety of different activities to increase their international business exposure. A minimal involvement in international business might be for a purely domestic firm to grant a license to an overseas firm. The domestic firm then receives royalties but does not make any strong commitments abroad. The second level of involvement would be to start exporting to foreign markets. A higher level of involvement is implied with the formation of a foreign joint venture. Acquiring a going concern overseas would be the fourth type of internationalization, while opening a manufacturing subsidiary would be the fifth form of international involvement. In general,

these five different types of international expansions sequentially are indicative of the increasing degree of international involvement.

The purpose of this study is to examine the effects of these different types of international involvements on shareholders' wealth. In general, it is hypothesized that investors would react favorably to any pronouncement by a firm indicating that it is increasing its involvement in international business activities. It is also hypothesized that the reaction to the announcement of a firm's initial involvement in international business would be highly favorable since it signals to the market the firm's intent to move toward internationalization of its operations. Finally, it is hypothesized that announcements of international business activities related to developing countries would have a more favorable response compared to announcements related to developed countries because the advantages of diversification are greater in developing than in developed countries.

The data and methodology are discussed in the second section of the paper. The empirical results are presented in the third section while the conclusions are contained in the last section.

## II. Data and Methodology

### A. Sample and Data Description

The sample analyzed in this study contains U.S. manufacturing firms engaged in international activities over the twenty-five year period from 1963 through 1987. The sample is limited to only those firms whose stock was trading on either the New York Stock Exchange (NYSE) or American Stock Exchange (AMEX) on or after July 2, 1962 and which had no foreign business activities prior to this date. The first selection criterion was imposed due to the data restrictions of the Center for Research in Securities Prices (CRSP) NYSE/ASE Daily Returns tape, which has data on securities starting July 2, 1962. The second restriction was imposed to allow examination of the market reactions from the very first time that a company could undertake international business activities. The listing of companies from CRSP was crosschecked against Moody's Industrial Manuals to ensure that the sample contained only those firms that did not have any foreign operations at the beginning of the analysis period. The sample consisted of announcements by public companies of expanding overseas by entering into a licensing agreement, by exporting, by forming a joint venture, by acquiring a going concern overseas, and by starting a manufacturing subsidiary. 70 firms were identified that met the two criteria mentioned above. Details and announcement dates of their subsequent international business expansions were obtained by searching the *Wall Street Journal Index*.

### B. Methodology

The stock price reaction to the announcements was tested by using the standard event study methodology pioneered by Fama, Fisher, Jensen, and Roll (1969). The market model denoted below is utilized to study the stock market reaction to overseas expansion activities by the firms in this study:

$$R_{jt} = a_j + b_j R_{mt} + e_{jt} \tag{1}$$

$R_{jt}$  = rate of return for the  $j$ th security  
 $a_j$  = intercept  
 $b_j$  = slope  
 $R_{mt}$  = return on the market portfolio  
 $e_{jt}$  = error term  
 $t$  = date

The average standardized residual for day  $t$  is estimated as

$$AR_{jt} = \frac{1}{N} \sum_{j=1}^N \frac{R_{jt} - \bar{a}_j - \bar{b}_j R_{mt}}{S_{jt}} \tag{2}$$

where the parameters are estimated from equation (1) over the period  $t = -136$  days to  $t = -16$  days relative to the announcement date,  $N$  is equal to the number of firms in the sample, and

$$S_{jt} = \left[ V_j^2 \left[ 1 + \frac{1}{D} + \frac{(R_{mt} - \bar{R}_m)^2}{\sum_{j=1}^D (R_{mj} - \bar{R}_m)^2} \right] \right]^{1/2} \tag{3}$$

- $V_j^2$  = residual variance of security  $j$  from estimating (1),
- $D$  = number of days in the estimation period,
- $R_m$  = mean market return.

Standardized cumulative average residuals (CARs) are calculated for various windows.

Two assumptions are implied in this study. First, it is assumed that stock markets are efficient. This implies that stock prices reflect all publicly available information regarding a firm and that any changes in the future expected earnings of the firm will be instantaneously reflected by changes in these stock price of the firm. Second, it is assumed that all significant news regarding public companies, which are expected to have some impact on the future prospects of such companies, will appear in the *Wall Street Journal*. These assumptions are widely accepted and used in modern finance literature.

## III. Empirical Results

### A. Overall Sample of all Overseas Expansion Activities

As explained previously, a firm can expand overseas by

licensing, exporting, forming joint ventures, acquiring going concerns, and by creating its own affiliates. 179 such event announcements were identified from the *Wall Street Journal Index* for the sample in this study. The results indicate that the shareholders of firms announcing overseas expansion activities experience statistically significant abnormal return of 1.57 percent over a seven day interval from -3 to +3 around such announcements (Table 1a). This result is consistent with the hypothesis that there are gains associated with diversifying internationally. These gains may reflect investors' beliefs that overseas expansion activities enhance the firms' cashflows, or provide more stable cashflows, or both (2).

### B. Subsample of Initial Overseas Expansion Activity

The announcements of firms going overseas for the first time should produce significantly positive market reactions, since these announcements can be viewed by investors as initial signals by firms of their intent to internationalize their operations. A study by Fatemi (1984) estimated average and cumulative average residuals for a portfolio of 18 firms going abroad for the first time. He found positive abnormal returns of about 18 percent during the fourteen months preceding the initial foreign diversification by firms.

TABLE 1

#### CUMULATIVE AVERAGE RESIDUALS FOR OVERALL AND SUBSAMPLES

WINDOW	CARs	t VALUE
a. Overall Sample of All Overseas Expansion Activities, N = 179.		
(-15 to +15)	0.71%	.85
(-5 to +5)	1.61%	1.43
(-3 to +3)	1.57%	4.77***
(-1 to +1)	1.09%	2.86***
(-2, 0)	1.42%	3.37***
(-1, 0)	1.04%	3.32***
(0)	0.39%	1.77*
b. Subsample of Initial Overseas Expansion Activity, N = 70.		
(-15 to +15)	2.49%	1.08
(-5 to +5)	3.17%	1.27
(-3 to +3)	2.87%	4.30***
(-1 to +1)	2.31%	3.45***
(-2, 0)	2.63%	3.94***
(-1, 0)	2.07%	4.04***
(0)	0.89%	2.78***
c. Subsample of Subsequent Overseas Expansion Activities, N = 109.		
(-15 to +15)	-0.43%	0.23
(-5 to +5)	0.60%	0.81
(-3 to +3)	0.74%	2.66***
(-1 to +1)	0.30%	0.90
(-2, 0)	0.63%	1.16
(-1, 0)	0.38%	1.01
(0)	0.07%	0.04

\*\*\* Significant at  $\alpha = 0.01$   
 \*\* Significant at  $\alpha = 0.05$   
 \* Significant at  $\alpha = 0.10$

The present sample contains 70 firms that were purely domestic firms at the beginning of the sample period. Table 1b shows a statistically significant increase in returns around announcements of these firms initial overseas expansion activity. The seven day CARs in the (-3 to +3) window around the announcement date are 2.87 percent, which are significant at the 1 percent level. The sheer magnitude of the CARs leads to the conclusion that investors place a positive value on the firms' strategy of moving from being purely domestic firm to becoming more internationalized.

#### *C. Subsample of Subsequent Overseas Expansion Activities*

The overall sample was subsampled to examine the market reaction to announcements subsequent to the initial overseas expansion activities. There were 109 subsequent activities identified, and the results are summarized in Table 1c. The CARs for the (-3 to +3) window surrounding the event date showed an average CAR of 0.74 percent, which was significant at the 1 percent level. However, CARs for the other windows shown were not statistically significant. These results, in conjunction with the earlier results, seem to indicate that investors place considerable emphasis on the firms' initial forays into the international arena and that such expansion modes seem to have lesser significance for them on subsequent occasions.

#### *D. Licensing*

Licensing is generally considered to be very desirable for the licensor because the fees and royalties associated with licenses are substantially greater than the variable costs associated with the granting of the license and monitoring its terms (Caves, 1971). Based on this premise that the licensor derives significant marginal profits from licensing, positive price reactions should be observed when overseas licensing agreements are announcements. For the 18 firms included in this subsample, the CARs for the (-3 to +3) window were 2.07 percent, which were statistically significant at the 10 percent level. As shown in Table 2a, CARs for other windows were positive but not significant. The results, in general, indicate that despite its ease of implementation, licensing is not viewed as a source of significant gains associated with the internationalization of the firm (3).

#### *E. Exporting*

A variety of reasons are advanced to explain exports. Melvin (1969, 1970) argues that increasing returns to scale stimulate exports (4). Differences in foreign and domestic good price ratio may also result in exports. Others have pointed out that differences in taxes, tastes, preferences, and endowments, as well as protection from political risk may help explain exports. On the other hand, exports generally do not allow firms to properly gauge demand for their exported products, or to gain information about

foreign markets and competitors. Table 2b indicates that the market reaction to the announcement of exports is highly significant for the (-3 to +3) window with a CAR of 1.95 percent (5). These results indicate that, in general, investors view exports in a very positive light.

#### *F. Joint Ventures*

Joint ventures are considered desirable because they allow firms to team up with partners who might be able to provide complimentary strengths, such as intimate knowledge of the market, or channels of distribution (Treece, 1983). However, joint ventures detract from the autonomy that firms would enjoy if they were operating by themselves. The results for joint venture announcements in Table 2c indicate positive but statistically insignificant results for all windows. These results indicate that investors do not appear to view joint ventures as a significant internationalization activity.

#### *G. Acquiring a Going Concern Overseas*

The two modes for foreign direct investment (FDI) are acquiring a going concern overseas, and opening a manufacturing subsidiary overseas (6). FDI has the advantage of allowing firms to monitor their overseas markets and to adapt to the changing needs of these markets by adjusting the product mix offered to customers. FDI signals a higher degree of commitment to the host country, thereby perhaps ameliorating some of the problems associated with exporting. Finally, FDI reduces systematic risk for the firm.

Acquiring a going concern overseas allows a firm to become established more quickly in the host country. Certain marketing benefits may also accrue to the acquiring firm. Wilson (1980) examined the characteristics of firms who invested abroad. His results indicate that firms more likely to expand overseas by merging are characterized by high product differentiation, and limited foreign experience. The present study included a subsample of 18 firms announcing acquisitions of firms overseas. The results, shown in Table 3a, indicate insignificant CARs for all windows with one exception. The exception is the announcement date for which the return is 1.28 percent, significant at the 10 percent level. Doukas and Travlos (1988) found positive but insignificant CARs for the (-1 to +1) window, which is similar to the results reported here. In general, it appears that investors do not place a positive value on internationalization by overseas acquisition.

#### *H. Opening a Manufacturing Subsidiary Overseas*

Opening a manufacturing subsidiary overseas is the second form of FDI. The results for the subsample of 31 firms that announced the opening of a foreign manufacturing subsidiary are shown in Table 3b. The CARs for the (-3 to +3) window are 1.62 percent and significant at the

5 percent level. CARs for other windows are not significant. In general, while it appears that this mode of internationalization is not particularly well received by investors, it does appear to be the most desirable method for FDI.

### *I. Developed vs Developing Countries*

The literature cited previously indicates that expansion into developed countries should have benefits that are lower than expansion into developing countries because the former are more closely integrated with the U. S. economy. Also, expansion into developing countries provides better opportunities for capitalizing on imperfections in factor and product markets. On the other hand, expansion into developing countries exposes the firms to higher degrees of political and business risk.

The overall sample was divided into developed and developing countries based on their degree of industrialization (7). The subsample of developed countries contained 91 announcements, while the developing countries subsample had 80 announcements (8). The results in Table 4a show CARs of 1.38 percent for the (-3 to +3) window for expansion into developed countries. Positive and statistically significant CARs are observed for a number of other windows also.

TABLE 2  
CUMULATIVE AVERAGE RESIDUALS FOR LICENSING, EXPORTS AND  
JOINT VENTURES

WINDOW	CARS	t VALUE
a. Licensing, N = 18.		
(-15 to +15)	2.19%	0.72
(-5 to +5)	0.13%	0.08
(-3 to +3)	2.07%	1.78*
(-1 to +1)	1.44%	0.78
(-2, 0)	2.15%	1.37
(-1, 0)	1.32%	1.30
(0)	0.65%	0.97
b. Exports, N = 88		
(-15 to +15)	1.36%	0.82
(-5 to +5)	1.68%	1.18
(-3 to +3)	1.95%	4.37***
(-1 to +1)	1.09%	1.91***
(-2, 0)	1.44%	2.31***
(-1, 0)	0.99%	2.10***
(0)	0.19%	0.48
c. Joint Ventures, N = 24		
(-15 to +15)	1.13%	1.05
(-5 to +5)	2.58%	0.98
(-3 to +3)	0.97%	1.48
(-1 to +1)	0.27%	0.69
(-2, 0)	0.85%	0.97
(-1, 0)	0.72%	1.07
(0)	0.13%	0.43

\*\*\* Significant at  $\alpha = 0.01$

\*\* Significant at  $\alpha = 0.05$

\* Significant at  $\alpha = 0.10$

The CARs for announcements of expansion into developing countries are also given in Table 4 and are statistically significant for a number of windows including the (-3 to +3) window. While the CARs for expansion into developed countries appear to be higher than the corresponding CARs for developing countries, tests for the null hypothesis of equal CARs in the two subsamples could not be rejected. The results indicate that investors are indifferent to the degree of industrialization of the host country.

#### IV. Conclusions

The proposition that international diversification is beneficial was examined in this paper. In general, the results indicated that investors reacted positively to efforts by firms to increase their international business activities. As predicted, it was found that initial announcements of overseas expansion were much better received by investors compared to subsequent expansions. Among the different methods of expansion, exports were valued most highly by investors. In general, FDI expansion announcements had neutral reactions, perhaps indicating that investors view FDI as a defensive measure. Finally, based on the observed results, the different methods of expansion may be ranked in descending order as exports, licensing, opening of a subsidiary, acquiring a going concern, and forming a joint venture.

#### Footnotes

1. Mathur and Hanagan (1981, 1983) discuss how MNCs can handle these barriers.
2. A control sample of purely domestic firms was not utilized to study the market reaction, if any, to domestic expansion activities. It is feasible that some portion of the gains reported here would have been observed even if the expansion activities were strictly domestic. This issue will be explored in a subsequent paper.
3. A note of caution may be in order here. The relatively small sample size of 18 may contribute to the lack of statistical significance for the results.

TABLE 3

#### CUMULATIVE AVERAGE RESIDUALS FOR FOREIGN DIRECT INVESTMENTS

WINDOW	CARs	t VALUE
a. Acquiring a Going Concern Overseas, N = 18.		
(-15 to +15)	-2.58%	-1.16
(-5 to +5)	-0.24%	-0.22
(-3 to +3)	-0.06%	-0.99
(-1 to +1)	1.22%	1.14
(-2, 0)	1.38%	0.96
(-1, 0)	1.46%	1.56
(0)	1.28%	2.10*
b. Opening a Manufacturing Subsidiary Overseas, N = 31		
(-15 to +15)	-0.42%	0.06
(-5 to +5)	2.58%	0.69
(-3 to +3)	1.62%	2.17**
(-1 to +1)	1.42%	1.59
(-2, 0)	1.38%	1.58
(-1, 0)	1.03%	1.30
(0)	0.49%	0.72

\*\*\* Significant at  $\alpha = 0.01$   
 \*\* Significant at  $\alpha = 0.05$   
 \* Significant at  $\alpha = 0.10$

TABLE 4

CUMULATIVE AVERAGE RESIDUALS ASSOCIATED WITH DEGREE OF  
INDUSTRIALIZATION OF THE HOST COUNTRY

WINDOW	CARs	t VALUE
a. Expansion into Developed Countries, N = 91.		
(-15 to +15)	0.07%	0.13
(-5 to +5)	1.18%	0.72
(-3 to +3)	1.38%	3.22***
(-1 to +1)	1.22%	2.45***
(-2, 0)	1.19%	1.82*
(-1, 0)	1.06%	2.22**
(0)	0.47%	1.73*
b. Expansion into Developing Countries, N = 80		
(-15 to +15)	1.19%	1.16
(-5 to +5)	2.00%	1.36
(-3 to +3)	1.18%	2.39***
(-1 to +1)	0.56%	1.00
(-2, 0)	1.40%	2.44***
(-1, 0)	0.86%	2.15**
(0)	-0.07%	-0.20

\*\*\* Significant at  $\alpha = 0.01$   
 \*\* Significant at  $\alpha = 0.05$   
 \* Significant at  $\alpha = 0.10$

4. Exports are defined to include foreign sale contracts, and contracts to manufacture custom-made goods or provide custom-made services overseas.
5. Even though there were only 70 firms in the study, for some firms repeat export announcements were also counted due to the extended time between announcements, thus resulting in 88 export announcements.
6. Joint ventures are also a form of FDI. However, some joint ventures may involve strictly non-FDI contributions such as technology and/or managerial skills. Therefore, they were discussed separately in the previous section due to this ambiguity.
7. The classification is based on standards developed by the International Monetary Fund and the World Bank.
8. In the case of 8 announcements either the country was not mentioned in the news, or the company decided to expand in both a developed and a developing country at the same time. Therefore, these 8 announcements were excluded from the subsamples.

## References

1. Agmon, Tamir and Lessard, D., "Investor Recognition of Corporate International Diversification," *Journal of Finance*, September 1977, pp. 1049-1055.
2. Caves, R., "International Corporation: The Individual Economics of Foreign Investment," *Economia*, February 1972, pp. 163-168.
3. Doukas, John and Travlos, N. G., "The Effect of Corporate Multinationalism on Shareholders' Wealth: Evidence from International Acquisitions," *Journal of Finance*, December 1988, pp. 1161-1175.
4. Errunza, Vihang R. and Senbet, Lemma W., "International Corporate Diversification, Market Valuation, and Size Adjusted Evidence," *Journal of Finance*, December 1984, pp. 727-743.
5. Fama, Eugene, Fisher, Lawrence, Jensen, Michael C., and Roll, Richard, "The Adjustment of Stock Prices to New Information," *International Economic Review*, February 1969, pp. 1-21.
6. Fatemi, A. M., "Shareholder Benefits from Corporate International Diversification," *Journal of Finance*, December 1984, pp. 1325-1344.
7. Grubel, H. G., "Internationally Diversified Portfolios: Welfare Gains and Capital Flows," *American Economic Review*, December 1968, pp. 1299-1314.
8. Jacquillat, B. and Solnik, B. H., "Multinationals are Poor Tools for Diversification," *Journal of Portfolio Management*, Winter 1978, pp. 8-12.

9. Lessard, D., "International Portfolio Diversification," *Journal of Finance*, June 1973, pp. 619-632.
10. Levy, Heim, and Sarnat, M., "International Diversification of Investment Portfolios," *American Economic Review*, September 1970, pp. 668-675.
11. Logue, Dennis E., "An Experiment in International Diversification," *Journal of Portfolio Management*, Fall 1982, pp. 22-27.
12. Mathur, Ike and Hanagan, K., "Risk Management by MNCs," *Management International Review*, Vol. 21. No. 2 (1981), pp. 22-37.
13. Mathur, Ike and Hanagan, K., "Are Multinational Corporations Superior Investment Vehicles for Achieving International Diversification?" *Journal of International Business Studies*, Winter 1983, pp. 135-146.
14. Melvin, J. R., "Increasing Returns to Scale as a Determinant of Trade," *Canadian Journal of Economics*, November 1969, pp. 389-402.
15. Melvin, J. R., "Commodity Taxation on a Determinant of Trade," *Canadian Journal of Economics*, February 1970, pp. 62-78.
16. Rugman, A. M., *Multinationals in Canada: Theory, Performance and Economic Impact*. Boston: Martinus Nijhoff, 1980.
17. Solnik, Bruno, "Why not Diversify Internationally Rather than Domestically?" *Financial Analysts Journal*, July/August 1974, pp. 48-53.