

EIBA 2008 Annual Conference Tallinn Estonia

Track 8 Business Administration, Finance and Accounting

Competitive paper

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VALUE CREATION IN FDIS: EMPIRICAL EVIDENCE FROM FOREIGN ACQUISITIONS BY FINNISH FIRMS

This study examines stock market reactions i.e. wealth creation in foreign manufacturing investments. In addition to empirically examining the wealth effects of investing firms, the study examines the impact of several investing firms and investment related factors on the wealth effects. The data of the study is based on 297 foreign acquisitions made by Finnish firms between 1986 and 2006. The results indicate that, on average, foreign acquisitions have significant value creating effects for investing firm shareholders, i.e., value creation of foreign acquisitions generally proves to be a fact. However, the value creation seems to depend significantly from the investing firm and their investment strategy related decisions. The most significant variables seem to be international and target country specific experience, target country of the investment, and the degree of ownership acquired.

Key words: foreign direct investment, value creation, event study.

1. INTRODUCTION

During the last thirty years the growth in foreign direct investments (FDI) has been clearly higher than the growth of gross national product or international trade. The FDI flows have been growing in particular during 1994-2000 and 2003-2006 (see e.g. United Nations 2007). A characteristic feature of the investments has been foreign acquisitions, the share of which was about two-thirds in 1987-2005. In some key markets, like in the USA, the share surpassed even 75% (see e.g. United Nations 2007). Strategic investments have attracted the attention of scholars in a number of business disciplines, especially in the areas of strategic management, international business, finance and industrial economics. Previous research investigating mergers and acquisitions in the USA and in many Western European countries focused until early 1990s on domestic acquisitions. However, because of the great growth in FDI flows an increasing amount of attention has also been directed to the value creation in these investments, especially in foreign acquisitions.

This study investigates stock price reactions to the announcements of the foreign acquisitions of Finnish firms. Thus, the primary purpose of the study is to find out if FDI's increase shareholders' wealth. Previous findings in the area have been ambiguous. The results in some studies indicate that there has been more positive wealth gains associated with foreign acquisitions than in domestic ones, but the results in other

studies indicate that foreign acquisitions have not created value for acquiring firm shareholders (see e.g. Campa & Hernando 2004).

In addition to investigating whether FDIs in general increase shareholders' wealth, we also investigate a series of refined hypotheses: how selected investing firm, investment and target country related features influence incrementally to the value creation. Although the main interest has been in value creation in general, most of the studies have included some additional features related to the investing firm and investment in order to have a better understanding of the value creation effects. However, several studies have included only very few additional features. Furthermore, most value creation studies made so far focus on foreign acquisitions by firms from large domestic markets, mainly from the USA, the UK, and Germany, or foreign acquisitions made into those countries. The amount of research focusing on value creation in foreign acquisitions made by firms from small domestic markets like Finland and other Nordic countries has been very limited so far and the results have been mixed. Thus this study should clearly make contribution to the present state of knowledge of value creation in foreign acquisitions.

The structure of the paper is as follows: section two includes a literature review and development of predictions for the empirical part; in section three the methodology of the study is discussed; in section four the main features related to the sample are reviewed; section five includes the results of the empirical study, and section six includes a summary and key conclusions based on the study.

2. LITERATURE REVIEW

2.1. General aspects related to value creation in FDIs

There are several theories and motives for the existence of foreign direct investments (FDI). According to the so-called internalization theory FDIs occur when a firm can increase its value by internalizing markets for certain of its intangible assets, e.g. 1) technological know-how, 2) marketing ability and related consumer goodwill, and/or 3) effective and dedicated management (see e.g. Buckley & Casson 1976, and Morck & Yeung 1991 & 1992). According to the internalization theory such intangible assets have some characteristics of public goods in that their value increases in direct proportion to the scale of the firm's markets. They are also based largely on proprietary information and thus cannot be exchanged at arm's length for a variety of reasons arising from the economics of information as well as from the public good characteristics. To realize the potential additional value of employing these intangible assets abroad, a firm must internalize the market for them. This can be accomplished by engaging in FDI. A value-maximizing firm does this if the expected gains from applying its intangibles abroad exceed the expected cost of running a foreign subsidiary. The theory thus implies that when firms possessing significant assets expand abroad, shareholders' wealth increases owing to the increased scale over which such intangible assets are applied. (see Morck & Yeung 1992).

There are also other theories and motives for FDI (see e.g. Hood & Young 1979, or Cantwell 1990). These are based e.g. on the availability of new markets, access to scarce specialized resources, opportunities to achieve production efficiencies, the possibility of overcoming trade barriers and improving a firm's competitive position (see e.g. Root 1987). Potential benefits include also reduced market risk and the possibility of stabilizing the overall returns on investments because economic conditions and major political climates tend to be uncorrelated across different international market areas (Caves 1982). All these theories suggest that a firm's value increases when the company makes a FDI (see e.g. Morck & Yeung 1992).

Previous empirical evidence related to value creation in FDI has been somewhat mixed. Almost all studies seem to indicate that FDI/foreign acquisitions provide positive value creation for the shareholders of the acquired companies (Campa & Hernando 2004, Diepold 2005). Table 1 summarizes results in 23 studies focusing on the value creation for the shareholders of the acquiring firms. From those studies seven indicate non-significant value creation whereas majority (16 of 23) of the studies indicate significant positive value creation also for the shareholders of the acquiring firms. All four studies focusing on acquisitions made in the USA show positive value creation, but otherwise there is no clear systematic difference (origin or target countries, sample size, or timing of investments) between studies providing support vs. non-support for the positive value creation. From the point of view of this study an interesting finding is that whereas Kallunki, Larimo and Pynnönen (2001) found positive value creation in FDI by Finnish firms, the Finnish subsample in the study by Diepold (2005) did not found respective support. Noteworthy is that the Finnish subsample by Diepold was extremely small, only 16 big acquisitions in various EU countries. On the other hand, the results by Diepold indicated clearly highest value creation for the shareholders of the Swedish acquiring firms whereas earlier Johnsson (1995) did not found any significant value creation for the shareholders of Swedish companies making foreign acquisitions. Based on the above theoretical argumentation and earlier results for the empirical part of the study we expect that:

Hypothesis 1: Foreign acquisitions have positive value creation effect.

Diepold (2005) found in his study of large cross-border European acquisitions that the average return to acquiring firms on the day of announcement was 0.15 – no abnormal return – and that the share of positive returns was 51.4% of the sample. From the studies where abnormal returns have been found Lopez-Duarte and Garcia-Canal (2007) found that the average abnormal return in FDI by Spanish firms was 0.27 per cent on the day of announcement and the share of positive abnormal returns was 53.4% of the sample. However, in the subsample both figures were lower – the mean abnormal return 0.23 and the share of positive cases 47.1%. Thus the wealth creation had been higher in greenfield investments than in acquisitions by Spanish firms.

2.2. Relationships between various firm, investment and target country specific features and value creation

In addition to the general effect of FDIs, especially foreign acquisitions, on value creation several studies have analyzed also the effect of various investing firm, investment and home country of the investment related variables on value creation. Do shareholders rely on the management of the investing firm to make the right decisions related to the home country and other features of the investment or does the value creation vary depending on the specific features related to the FDI? In the following we shall review the impact of selected variables on value creation. As we will see, the results have been very mixed.

Investing firm related features

One of the key features related to the investing firm included to earlier studies is the earlier **foreign direct investment experience**. The first foreign investment is a significant strategic move to the investing company – a greater strategic move than the later ones, if we exclude the relative size of the investment. Therefore it could be expected that the wealth creation would also be greater in cases of no or limited prior FDI experience than in cases of extensive prior FDI experience. However, if the firm is making its first FDI, the management may lack the knowledge of how to make the investment in an “optimal way” and how to manage it. In cases where the investing firm already has several prior FDIs, the probability is that the management has better knowledge of how to make the investment and how to manage the foreign unit. The results in earlier studies have been mixed. Fatemi (1984) and Hu et al. (1992) found a negative relationship, Fatemi and Furtado (1988), Merchant (1995), Eun et al. (1996), and Kallunki et al. (2001) could not find any statistically significant relationship whereas Markides and Ittner (1994), Markides and Oyon (1998), and Meschi (2004) found that international experience had a positive impact on value creation. Thus, the influence of prior international experience on value creation is not evident. However, based on the greater strategic moves in the first than later investments we expect that:

Hypothesis 2: The value creation in the first FDI by the investing firm is greater than in later investments.

Target (host) country experience may also affect the value creation. The argumentation related to target country specific experience is similar to the above discussed general foreign direct investment experience. If the investing firm does not have any prior FDI in the target country, the investment usually means a greater strategic move than in an investment where the investing firm already has unit in the target country. However, how to operate in the target country market is learned as a by-product of doing business there. Therefore it could be expected that the risks in making and managing the FDI are greater in cases of no prior investments in the target country than in cases where the investing firm already has target country specific experience.. Kallunki et al. (2001) did not found any relationship between target country experience and value creation, but the sample size was relatively small. Lopez-Duarte and Garcia-Canal (2007) found a positive wealth creation both in first and in later FDIs made in the target countries. In greenfield investments a positive wealth creation was found only in

first investments in a specific target country whereas in acquisitions the situation was just the opposite. Clear support for the positive relationship between first investment in the target country and positive value creation provide the results by Doukas and Travlos (1988). Thus related to the prior international experience in general, we assume that the first investment in a specific country means clearly greater strategic move for the investing firm than the later ones, and therefore also the value creation should be higher than in the later investments.

Hypothesis 3: The value creation in the first FDI by the investing in the target country is greater than in later investments.

Investment related features

One key feature of interest in FDI studies has been the field of industry, especially R&D-intensity of the field of industry. In foreign markets companies have to overcome the liability of foreignness problem. One way to overcome those problems are the intangible assets accrued by the firm in the own home country. Earlier empirical studies have shown that stock market reactions to FDIs are influenced positively by the degree of accumulated intangible assets by the investing firm (Morck & Young 1992; Chen et al. 2000) although recently López-Duarte and Garcia-Canal (2007) did not found any significant difference depending on the degree of R&D spending in foreign acquisitions made by Spanish firms. At the industry level several fields of industries having low R&D spending are low growth industries whereas several high R&D spending industries like mobile communication industry are high growth industries. Therefore higher value creation could be expected also depending on the R&D spending in the field as total. Therefore we expect:

Hypothesis 4: The value creation is higher in investments made in high than in low R&D-intensity fields.

Another characteristic of the investment that may affect its valuation effects is the **relative size of the investment**. Smaller investments may be easier to manage and therefore less risky than big ones where e.g. the integration of the foreign unit to the parent can be a very troublesome operation. On the other hand there is empirical evidence that small acquisitions have often caused rather more problems than big ones. Sometimes also the commitment of the management of the investing firm to a small investment may cause problems (see e.g. Business International 1988). Small acquisitions may also be expected to have a distinctly smaller impact on value creation than big ones. Empirical results from domestic acquisitions have indicated that the size of the target firm relative to the acquiring firm has been found to be positively correlated with the returns to acquirers (e.g. Jarrell & Poulsen 1989) and according to the results by Kitching (1973), Markides and Ittner (1994) and Shelton (1996) this was the case also in foreign acquisitions. Although in the study by Cakici et al. (1996) relative size did not have any significant impact on the value creation in foreign acquisitions made in the USA, we expect that the larger the relative size of the investment, the larger the return to the investing firm.

Hypothesis 5: The value creation is higher in relatively big than in relatively small foreign acquisitions.

One additional key strategic decision in FDIs is the share of **ownership acquired**. The main alternatives are partial acquisition vs. full acquisition. In full acquisitions the great advantage is that the investing firm does not have to share the decision making and profits from the operation, but it demands more financial and management resources than a joint venture. A joint venture/ partial equity stake acquisition means shared decision making and shared profits, but it does not demand as much financial and management resources as a wholly-owned unit/full acquisition. A partial acquisition allows the investing firm a “getting to know the partner” period and may potentially be associated with lower integration costs than wholly-owned units/full acquisitions (e.g. Kitching 1973). The latter alternative may also be a less expensive way for oligopolistic firms to prevent their competitors from acquiring the target (Caves 1982). However, several studies seem to indicate that the decision-making and integration of partial acquisitions is very problematic (see e.g. Kitching 1973 and Larimo 1993). Although the empirical results in some studies like Chen et al. (1991); Hu et al. (1992); Markides and Ittner (1994); Merchant (1995) indicate positive value creation also in IJVs and partial acquisitions, studies including both wholly vs. partially owned FDIs indicate higher value creation in the former than in the latter cases. From the results in recent studies e.g. López-Duarte and Garcia-Canal (2007) found significant positive value creation in full foreign acquisitions whereas partial acquisitions did not provide any significant value creation for the shareholders of the acquiring Spanish companies.

Hypothesis 6: The value creation is higher in total than in partial foreign acquisitions.

A fourth generally reviewed investment related aspect in foreign acquisition studies including value creation studies is the degree of relatedness of the acquisition. The variable was planned to be included also in this study. However, the analysis of the sample indicated only five clearly unrelated types of acquisitions. Therefore the variable is not included to the study.

Nature of the home country of investment

One specific target country specific feature included into several FDI studies is the level of development of the target country. The most commonly used analysis is between developed and developing countries. In developed countries the infrastructure is more developed, the political situation is usually more stable, standard of living and consumption higher, and if the acquiring firm is also from a developed country then the consuming and distribution patterns are more similar to those existing in the home country of the acquirer than if the target country is a developing country. If the target country is a developing country, then there may be more problems with the infrastructure, political stability, standard of living and purchasing power of the consumers, consuming patterns and distribution chains may differ more from the situation in the home market of the acquiring firm, etc. A positive aspect in developing countries is often a higher economic growth rate, but problems related to the clearly

lower purchasing power and problems with the infrastructure may have much more impact on the valuation of the investment.

Hypothesis 7: The value creation in foreign acquisitions is higher in investments made in developed than in developing countries.

Another target country specific variable of great interest has been the **cultural distance** between the home country of the investing firm and target country of the investment. Culture can be viewed as the collective programming of the mind that distinguishes the members of one group or category of people from another (Hofstede 1980). Studies indicate that organizational cultures are to a great extent influenced by national cultures (e.g. Terpstra & David 1991). Consequently, one can expect that the greater the cultural distance between two countries the more difference is likely to be seen in organizational characteristics and practices (Kogut & Singh 1988). Similarity between the national cultures may facilitate greater trust and organizational stability through shared norms and values. Therefore, one might expect easier integration and greater value creation when the cultural distance between the home country of the investing firm and the target country of the investment is small. Markides and Ittner (1994), Kallunki et al. (2001), and Merchant (2002) did not find empirical support for their assumption expectations of negative relationship between cultural distance and wealth creation and in the study by Gerpott and Jakobin (2007) the positive impact depended on the measure of cultural distance. However, the results by Datta and Puia (1995) and López-Duarte and Garcia-Canal (2007) indicated clear empirical support for the positive relationship between short/low cultural distance and value creation. Thus also in this study a negative relationship between cultural distance and value creation is expected.

Hypothesis 8: The value creation is higher in foreign acquisitions made in culturally close than in culturally more distant countries.

A third target country specific variable included into several FDI studies is the **country risk** in the target country of the investment. A low country risk in the target country means stable operation environment and therefore it is easier to make long term plans e.g. related to scale of production, supplier and distributor agreements etc. for the unit than in cases of high political risk. Short term planning and uncertainty of the future influences often negatively the financial result of the unit, the firm has to ready to make even radical changes in the plans quickly etc. and therefore apparently also the expectations of the wealth creation of the acquired unit are lower than in cases of low country risk. Against expectations Merchant (2002) and Gerpott and Jakobin (2007) did not found empirical support for their assumptions of clear negative relationship between country (political risk) and wealth creation. However, López-Duarte and Garcia-Canal (2007) found in their study clear empirical support for the positive relationship between low target country instability and wealth creation. Thus, for the empirical part of the study also we expect:

Hypothesis 9: The value creation is higher in foreign acquisitions made in low than in high country risk countries.

3. METHODOLOGY, VARIABLE OPERATIONALIZATION AND SAMPLE SELECTION

3.1. Methodology of the study

Empirical analyses are conducted by using so-called event study methodology. Event study methodology has been developed to measure the effect of an unanticipated event on stock prices (Kothari and Shanken (2007) is a useful review of modern event study methodology). As pointed out by McWilliams and Siegel (1997), often inadequate attention is paid to theoretical and research design issues in management research using event study approach. This criticism and proposals are taken carefully into account in the study.¹

An event period of +/-10 trading days around the announcement day is used to investigate stock prices reactions to the FDI announcements. An estimation period of 250 trading days² is used to estimate the market model parameters from the following time-series regression:

$$(1) \quad R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it},$$

where R_{it} is the return on the stock of firm i on day t , R_{mt} is the market return on day t , α_i is the market model alpha, β_i is the market model beta, and ε_{it} is the (white noise) error term such that $E(\varepsilon_{it}) = 0$, $\text{Var}(\varepsilon_{it}) = \sigma_{\varepsilon_i}^2$ and $\text{Cov}(\varepsilon_{is}, \varepsilon_{it}) = 0$ for all $s \neq t$.

Daily abnormal returns, AR_{it} , are obtained by matching the parameters estimated from Equation (1) with the daily returns from an event period as follows:

¹ The major criticism presented in McWilliams and Siegel (1997) related to event studies concerns too little attention being paid to the following aspects: sample size, outliers, length of the event window and confounding effects.

– The sample size in our study is 297, which is more about ten times bigger than the average of the smallest subsamples reported in the event study examples in Table 1 of McWilliams and Siegel (1997).

– Outliers are checked graphically by investigating the cumulative abnormal returns. No obvious outliers are present in the data. In addition due to the relative large sample size, the contribution of single observation is small which further alleviates the potential outlier problems. Furthermore, the Boehmer et al. (1991) t -statistic is used to eliminate the effects of possible event-induced increase in the cross-sectional variances of abnormal returns. Harrington and Shrider (2007) argue further that all events induce variance.

– Confounding effects are very difficult to control fully. We have done this by keeping the event window short and eliminating those event days for which there is earnings announcement +/-1 days around the event day.

² Footnote (on page 325, connected to the word 'days' in the sentence "An estimation period of 250 trading days...") in response to comment Rev 2.5

"We use an estimation period for approximately one year of trading days. For example, Kwok and Brooks (1990) find in their simulation study that different estimation period lengths do not materially change test results."

$$(2) \quad AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{mt}),$$

where $\hat{\alpha}_i$ and $\hat{\beta}_i$ are the market model parameters estimated in Equation (1), R_{it} is the return on the stock of firm i on day t , and R_{mt} is the market return on day t .

Diffusion in daily stock prices may cause problems in a small and infrequently traded stock market. The problem of diffusion arises because in infrequently traded stock markets daily returns are not independently and identically distributed over time (see, for instance, Theobald and Price 1984 for the theoretical investigation of implications of diffusion in the context of stock market seasonalities). Thus, the results based on individual days may be biased because of the diffusion, and the conclusions should therefore be based on abnormal returns cumulated over longer time intervals. Cumulative abnormal returns are calculated for different windows in the event period:

$$(3) \quad CAR_{it} = \sum_{s=1}^t AR_{is}.$$

Two different kinds of test statistics are applied for testing the statistical significance of abnormal and cumulative abnormal returns for these portfolios. The first one is Patell's (1976) "standardized-residual method". It is based on the cross-sectional average of standardized (cumulative) abnormal returns determined for by dividing the stock's (cumulative) abnormal return by the estimation period regression standard deviation (adjusted for forecast error). The second test statistic is the "standardized cross-sectional" test proposed by Boehmer et al. (1991). The event period abnormal returns are first standardized by the estimation period standard deviations (again corrected for prediction error) after which the test statistic is obtained in a manner of usual t -statistic for testing the mean of standardized (cumulative) abnormal returns across the firms in the sample. This test has the advantage of taking into account the possible event-induced variability in abnormal returns. A detailed description of these tests and general event study methodology can be found in Cambell, Lo and MacKinlay (1997 Chapter 4).

3.2. Variable operationalization

Variables related to the nature of the investing firm

International experience of the investing firm (Intexperience). In the measurement of international experience the share of foreign sales from total sales, the length of experience in foreign manufacturing operations in years, the number of countries in which the firm has established subsidiaries and the number of FDIs made by the firm have been used (see e.g. Hennart & Larimo 1998). In this study international experience was proxied by the number of foreign manufacturing investments made by the firm prior to making the reviewed FDI because foreign sales experience does not necessarily give similar type of experience needed in FDIs. The data for the variable was received from the FDI register of Finnish firms established by one of the authors.

Target country experience (Tcexperience). Target country specific experience has also been proxied by using various measures. In some studies the number of years elapsed between the establishment of the affiliate and the establishment of the parent's first manufacturing unit in the target country whereas in some studies dummy variable earlier operation vs. no earlier operation has been used ((Harris & Ravenscraft 1991; Eun et al. 1996, Larimo 2003). The latter alternative was chosen in this study. Thus, the target country experience variable takes the value zero if the investing firm has no prior manufacturing unit and value one if the investing firm already had manufacturing operations in the target country. The data for the variable was received from the FDI register of Finnish firms established by one of the authors.

Variables related to the nature of the investment

Research and development intensity (RDintensity) has been proxied using firm level or industry level data. Because several of the reviewed companies were operating in several fields of industries with various levels of R&D intensity, industry level data (=SIC code of the industry of the investment) was decided to be used. OECD has classified industries where the field on average uses below 1.0 % of its value added for R&D as low tech/intensity sectors, fields using 1.0-3.99 % of its value added for R&D are medium tech/intensity sectors, and fields using 4.0% or more high tech /intensity fields. The information by Nordic Statistical Secretariat of the groupings of various SIC industries to the above three groups were used.

Relative size of the investment (Relsize). The size of the investment can be measured using absolute size or relative size based on total sales or market capitalization. In this study relative size of the investment is used as e.g. in the study by Cakici et al. (1996). The relative size was counted based on the total sales of the target firm in the year preceding the investment in relation to the total sales of the acquiring firm in the year preceding the investment. The investments were classified into two main groups: small including very small (relative size less than 1%) and small (size 1.00-4.99%) and large including relatively large (size 5.00-9.99%) and large (size 10.0% or more).

Ownership arrangement (Ownership). Ownership arrangement has in several studies been operationalized as a dummy variable which takes the value one if the investment was a wholly-owned unit/full acquisition (ownership 95–100 %), and zero if the investment was a joint venture/ partial acquisition (ownership 10–94 %)(see e.g. Hennart & Park 1993). This operationalization was also used in this study.

Variables related to the nature of the home country

Level of development (Econlevel). A dummy variable was used for the grouping of countries into developed and developing countries. The first one included all North American, Western European and Asian OECD countries and the latter one all the others

Cultural Distance (Cultdis). Cultural distance was computed in the manner suggested by Kogut and Singh (1988) using a composite index based on differences between Finland and the target country of the investment along the four cultural dimensions (power distance, uncertainty avoidance, individuality, and masculinity and femininity) identified by Hofstede (1980). Data for the index of the various cultural dimensions for each target country of the sample FDIs and Finland were obtained from Hofstede (1980 and 2001). The respective measurement is the most commonly used way of measuring cultural distance and it has been used also in several earlier empirical value creation studies like in Datta and Puia (1995), Gerpott and Jakobin (2007), and Lopez-Duarte and Garcia-Canal (2007). The median was calculated and in addition target countries classified into three groups: low distance (less than 1.5), medium distance (1.5-2.99), and high distance (3.00 or more).

Country risk (Corisk) has been operationalized in earlier studies using scores by various companies focusing on risk evaluations (Euromoney, Political Risk Services etc.) Following Gerpott and Jakobin (2007) the Euromoney country risk scores were decided to be used, because the Euromoney scores seem to have been used commonly in empirical strategic FDI decision studies. In the ratings, 1 means extremely high country risk and 100 extremely low country risk. A classification of countries into different groups is more or less arbitrary. In this study three groupings were used: 0 to 49 (high), 50-74 (medium), and from 75 to 100 (low country risk).

3.3. Sample selection

Until the mid-1980s the amount and value of FDIs by Finnish firms was very modest. However, from the mid-1980s until the early 1990s Finland, as also the other Nordic countries, was characterized by rapid internationalization of manufacturing operations. During 1988–90 outward FDI flows exceeded the corresponding flows during the previous 20 years. In 1991–92 there was a clear slowdown in the amount and value of FDIs as also in several other Western European countries. Starting again from 1993 there was again a growth trend both in the amount and value of FDIs and the flows were especially high in 1998 and 2000, but in 2004 and 2005 the flows were negative changing as positive flows again in 2006 (Bank of Finland, Balance of Payment Statistics). In Finland, as well as in other Nordic countries, the majority of the amount and value of FDIs has been made by the 30 largest manufacturing companies (see e.g. Benito, Larimo, Narula & Pedersen 2002).

The basic sample of this study consists of all foreign acquisitions in manufacturing sector made by listed Finnish firms during the time period from 1989 to 2006. In total 418 foreign acquisitions made by various listed firms could be identified (not all of these firms had been listed already in 1989, but some clearly later). To be included in the sample the investment had to fulfill the following conditions: a) the date of the investment announcement could be identified in the leading business magazine (Kauppalehti or from the press releases of the firm), b) the acquiring firm's stock price returns were available from the Helsinki Stock Exchange, c) related to the size of the investment, the turnover of the acquisition target firm had to be at least one million

euros (before the year 2001 the respective value in FIM changed to Euro value in 2000) d) the share acquired had to be at least 25 percent, and e) the major confounding announcements (i.e. earning, dividends, share repurchases) could be identified.

Daily stock returns for a sample of Finnish firms listed on the Nordic Exchange (OMX, <http://omxgroup.com>) are calculated as logarithmic closing price differences. Days when the preliminary information concerning the firms FDI were given to the HeSE are used as announcement days. These are also the days when the information was published in major business newspapers in Finland. To be selected for analysis a stock had to have the required time-series of returns both in the estimation and the event periods and at least 11 price observations in the event period.

All the above conditions were fulfilled in 297 foreign acquisitions made by 48 firms in 42 target countries. Only extremely few of the reviewed acquisitions were the first FDI's made by the companies. In most cases the firms had made already ten earlier FDI's. At the target country level ca. one third of the acquisitions were first investments in the country and in ca. two-thirds of the cases the companies had made already at least one earlier FDI in the same country. Most of the investments were either in low or medium R&D industries, only ca. 13 percent in high R&D sectors. Based on the relative size ca. two-thirds of the cases were very small or small (relative size less than 5 %) and ca. one-third relatively big or big (relative size 5% or more). Over two-thirds of the cases were total acquisitions and ca. one third partial acquisitions. Almost 75% of the acquisitions were made in developed countries - USA, Germany, and Sweden as the main target countries - and somewhat more than one fourth in developing countries. Based on cultural distance the distance between Finland and target countries was from 0.09 (Estonia) to 5.01 (Japan) 1.57 as the median. In ca. two-thirds of the cases the distance was 1.50-2.99. Based on political risk most – ca. two-thirds - of the acquisitions were made in countries where the risk was evaluated to be low (developed countries) and ca. one-third in medium or high risk countries.

4. STOCK MARKET RESPONSE TO THE ANNOUNCEMENTS OF FOREIGN DIRECT INVESTMENTS

Figure 1 shows the cumulative abnormal stock returns in the event period for days -5 to +10. A clear increase in abnormal occurs in the period +/-1 days around the FDI announcement. The largest change is on the event day, which shows up as the largest jump in the CAR graph.

Daily abnormal returns around the announcement day are reported in Table 2. Panels A and B of the Table indicate that there are no statistically significant positive abnormal returns at the 5 % level on any of the days before the announcement day (day -1 abnormal return is on the borderline with the BMP statistic). The announcement day (event day) return is positive and statistically significant while the post event day abnormal returns for days +1 through +5 are not statistically significant (days +1 and +4 are again on the borderline). Panel B confirms the result indicating that only for the period +/-1 around the event days the returns are statistically significant. The signs of

the abnormal returns are almost invariably positive over the event window and in particular on the event day. Panel C indicates that 152 (54%) out of the 280 returns are positive, and 183 (62 %) out of 294 CARs over the ± 1 event window are positive. Thus, the results strongly suggest that investors generally consider foreign direct investments to create positive wealth. Thus the hypothesis 1 is supported.

Table 3 summarizes the results concerning the refined prediction powers of the effects of the various specific features discussed in Section 2 on the CAR. The analysis is worked out on investigating mean behavior in $CAR(-1,1)$ on classes of various background factors. The t -statistics are again the BMP-statistics, which implies that due to the standardization in some cases non-significant values close to zero may show different sign than the close to zero non-significant abnormal returns.

Acquiring firm related features

The results of Table 3 indicate that whether or not a firm has earlier FDI or target country experience, investors consider the investments positive which show up as positive and statistically significant abnormal return effects. This is exactly what one might expect. The result supports earlier results by Fatemi (1984) and Hu et al. (1992). However, it is interesting to note that when comparing the means between the categories whether a firm has or has not prior FDI or target country experiences, the differences are in both cases statistically significant in favor for no prior experience. In the case of the FDI experience firms with no earlier experience had on average a 5.47% (cumulative) abnormal return versus 0.90% return for firms with prior experience. Thus, the difference is 4.57 percentage points. Although the sample size remains small for the no-FDI-firms, the empirical evidence supports the hypothesis 2 that the value creation is more pronounced in the first FDI than in later ones.

In the case of earlier target-country-experience the difference of abnormal returns is 1.27 percentage points in favor for the no earlier experience subgroup. Of course, there is a confounding effect for the no earlier target-country-experience cases with the no-earlier-FDI-experience cases, because investments with no earlier FDIs are included to the no earlier target-country-experience class. In order to eliminate this effect, we removed from the 95 investments with no earlier target-country-experience the 8 no FDI experience investments, resulting to 87 cases with earlier FDI experience but no earlier target country experience. The average CAR in this group is 1.52% with t -value of 2.36, which again is statistically significant at the 5% level. The mean difference of these CARs to those of earlier experience became 0.85 percentage points with t -value of 1.36, which is borderline statistically significant at the 10 percent level in the one sided test. Thus, in reflection to the discussion in Section 2.2, there is some evidence for the hypothesis 3 that the value creation of the first FDI to a target country is greater than later ones. This coincides with the earlier results by Doukas and Travlos (1988).

Investment specific features

Based on the R&D intensity a positive relationship between R&D intensity and value creation was expected. The results indicated that in the highest R&D intensity group

(intensity four or more) the positive value creation was only at the borderline (statistically significant at the 10 percent level in one sided test (t-distribution threshold at 10 % with 38 degrees of freedom is 1.304), which may be due to the relative small number of observations (n=38). In the medium and low R&D intensity groups the value creation effects are clearly statistically significant even in two-sided tests. Thus the hypothesis 4 does not receive support. An economic explanation of the statistically weaker signal of the value creation in the highest R&D intensity group could be that the acquiring firms may have been forced to pay a higher premium for the target than what the acquirers in medium or low R&D intensity cases have been forced to do and this entails an increased uncertainty about the potential value added of the acquisition.

Based on the relative size of the investments (total sales of the acquired company related to the total sales of the acquiring company in the year preceding the acquisition) the results indicated that larger investments provided higher value creation than smaller ones (difference significant at the 0.01 level). Thus the hypothesis 5 is supported. The more detailed analysis indicates that positive value creation was also found in the subgroup where the relative size was between 1 and 4.9 % although the value creation was lower than in bigger investments. The result gives support to the view that very small acquisitions may contain relatively more problems with integration of the acquired unit than these investments often not worth of doing as also found by Kitching (1973).

Based on the degree of ownership acquired the results indicate positive abnormal value creation in full acquisitions and positive but non-significant value creation in partial acquisitions. In this sense the results fully support the hypothesis 6. However, the difference in abnormal returns between full and partial acquisitions is not statistically significant which weakens the empirical evidence for the hypothesis 6. Thus, the end result is that there is only partial empirical support for the hypothesis and additional research is needed before conclusive inference.

The results indicated positive abnormal value creation only in cases of full acquisitions and non-significant value creation in partial acquisitions. In this sense the results support hypothesis 6. However, the difference of abnormal results between total and partial acquisitions is not statistically significant. Thus the hypothesis six is not supported. Although partial acquisitions mean usually more problems in decision-making and integration, these problems were not expected to be too big. The results by López-Duarte and Garcia-Canal (2007) also indicated that only full acquisitions by Spanish firms provided positive value creation, but she did not test the statistical significance of difference in the level of value creation.

Target country specific features

Based on the level of development in the target country a positive relationship between level of development and value creation was expected. The results indicated that value creation in terms of positive abnormal returns was statistically highly significant in acquisitions made both in developed and developing countries. And again the difference

is not statistically significant. In fact the empirical estimate of the difference (developed minus developing) is negative. Thus, there is no empirical evidence for the hypothesis 7. On the basis of the results it seems that investors see that the potential related to investments in developing countries exceeds the possible added risks due to uncertainties in these countries.

Against the initial expectation stated in the hypothesis 8 the value creation is not significantly higher in foreign acquisitions made in culturally closer than in culturally more distant countries. The mean return is almost the same. Thus, if the countries are classified into culturally close and distant countries by the mean distance (which in our sample was 1.57), there seems to be no evidence for the hypothesis 8 that investors value more investments in culturally close countries. The result coincides with the earlier results by Kallunki et al. (2001) and Gerpott and Jakopin (2007) based on the cultural distance analysis using Hofstede's dimensions and the formula developed by Kogut and Singh (1988). However, a different grouping into culturally close and medium close as one group and culturally distant (distance greater than 3 from Finland) as the other group, a positive value creation was found only in acquisitions made in culturally close and medium distant countries while for investments in culturally distant countries the mean abnormal return was clearly lower. Thus, the expected negative impact of cultural distance on value creation seems to take place first in cases of clearly higher cultural distance. This result gives some empirical support the hypothesis 8.

Significant positive value creation was found only in cases of acquisitions in countries which were grouped as low country risk countries. Thus, although the mean difference between the groups (low vs. medium and high country risk) is not statistically significant, the statistical significance of the abnormal return related to acquisitions in the low country risk target countries and the non-significance of the value creation in acquisitions made in higher country risk countries clearly supports the higher trust on investments made into the former countries. This result indicates clearly partial empirical support for the hypothesis 9.

In order to get more detailed view of the value creation depending of target country specific variables the sample was divided on four subgroups based on the target countries - acquisitions made in: 1. Nordic countries (n= 37), 2. Western European countries (n= 104), 3. Central and Eastern European countries (n= 48), and 4. other countries (n= 108). The analysis indicated positive abnormal results in acquisitions made in Western Europe (at the 0.05) and in Central and Eastern Europe (at the 0.01 level) whereas no abnormal positive returns were found in acquisitions made in Nordic countries and in non-European countries. An even more detailed analysis based on the single target countries (sample included 10 or more investments made in the country) revealed that positive abnormal returns were found only in acquisitions made in two of the nine main target countries – in Russia (at the 0.05 level) and Germany (at the 0.1 level). Thus the markets seem to have relied on the growth opportunities in the Russian markets and on the strong German economy. No abnormal returns were found in acquisitions made in the USA, Sweden, the UK, the Netherlands, Poland, China, and France. The clearly lowest return was found related to acquisitions made in Sweden, but

also returns in acquisitions made in China and Poland were very low. Sweden is culturally close to Finland. Thus the differences in the national cultures should not cause so great problems as e.g. in acquisitions made in Poland or China. Apparently the main reason for the low valuation of those acquisitions has been that they have been regarded in several cases much more problematic because they were in several cases motivated by rationalization of manufacturing operations at the Nordic level.

Finally, an analysis was made between acquisitions made in various time periods: in 1989-1996 ($n=22$), 1997-1999 ($n=85$), 2000-2003 ($n=110$), and 2004-2006 ($n=80$). Positive abnormal return was found in all other time periods (at the 0.05 level) than in the period 2000-2003. This time period was characterized by declining trend in the Helsinki stock of Exchange and this is reflected also in the returns related to foreign acquisitions. E.g. in this period the mean return related to acquisitions made in Sweden was clearly negative and also in acquisitions made in the USA only slightly positive whereas in 1997-1999 acquisitions in the USA created positive abnormal returns (at the 0.1 level). However, even in 2000-2003 acquisitions made in Germany created positive abnormal returns (at the 0.1 level). In the most recent time period (2004-2006) the 56 acquisitions made outside the three main target countries (USA, Germany, and Sweden) of acquisitions in the sample created clearly positive abnormal returns (at the 0.05 level). Several of the acquisitions made e.g. in CEE/ Russia were made just in the last time period. Thus the results clearly indicate that there has been great variation in the value creation in acquisitions made to the same areas and single target countries between analyzed time periods.

5. SUMMARY AND CONCLUSIONS

This paper has investigated shareholders' wealth creation in foreign acquisitions. In addition to main question the study analyzed the impact of selected acquiring firm, investment, and target country specific features on the value creation. The earlier results have shown that foreign acquisitions have provided positive value creation for the shareholders of the acquired firms but not necessarily to the shareholders of the acquiring firms. Furthermore, the results of the impact of various additional features on the value creation in FDI's have been mixed. The empirical part of the study was based on the event history analysis of 297 foreign acquisitions made by Finnish firms in 42 target countries in the period 1989-2006.

The results of the study indicated significant positive abnormal return for the shareholders of the acquiring firms. Thus, the result coincided with the earlier results by e.g. Markides and Ittner (1994), Markides and Oyon (1998), Kallunki et al. (2001), Merchant (2002) and López-Duarte and Garcia-Canal (2007). In an earlier study focusing on the value creation in FDI's made in 1987-1996 by Finnish firms the authors (Kallunki et al. 2001) found that the investing firm, investment, and target country specific features did not have any significant impact on the level of value creation. A similar result was also found in the study by Cakici et al. (1996). Opposite to these results this study indicated that several of the acquiring firm, investment, and target country specific features had a significant impact on the value creation. In more detail

the results indicated that the first acquisitions abroad and the first acquisitions in a specific target country provided significantly higher positive value creation than the later ones. Furthermore, as expected bigger investments based on the relative size of the investments provided higher value creation than smaller ones. R&D intensity of the field of investment and level of ownership did not indicate statistically significant differences but the level of value creation was lower in high R&D sectors and positive abnormal returns were found only in cases of full acquisitions. Furthermore, the level of development (developed vs. developing), cultural distance (culturally close vs. distant) or degree of country did not significantly influence the level of value creation: However, in culturally very distant countries the level of value creation was negative and positive abnormal returns were found only in acquisitions made in low country risk markets. Four of the nine hypotheses of the study received full support and in addition three others received partial support.

The more detailed analysis revealed that in total value creation had been greatest in acquisitions made in Russia and Germany. However, there was great variation in value creation depending on the time period when the acquisition was made. However, the value creation seemed to have been low during the whole analyzed time period in acquisitions made in Sweden. The country is culturally and geographically close to Finland and the country is a developed and politically low risk country, thus based on those facts one could expect higher value creation than the results show. It seems that several of these acquisitions have been motivated by Nordic level rationalization of the production and this kind of investments are often difficult, which explains the low value creation in those acquisitions. The above results mean also clear managerial implications for the managers in companies planning new foreign acquisitions concerning both investment strategy and target country related decisions.

This study had several limitations. The study did not include more detailed analysis of the motives for the reviewed acquisitions and/or the relationships between the acquiring and acquired firm before the acquisition. Thus the analysis of these aspects would be of interest in future. In addition, the study did not include any analysis of the joint effects of the reviewed features. Thus analysis of the joint effects would also be of interest in future. The analysis focused on the short term value creation. Of interest would be the long term analysis of the value creation effects as well as the comparisons between short term value creation and later managerial evaluation of the performance.

This study focused totally on foreign acquisitions. Thus of interest would also be an analysis of possible differences in value creation between greenfield form of investments and acquisitions, because the earlier results are mixed (see e.g. Kallunki et al. 2001, and López-Duarte and Garcia-Canal, 2007). Finally, some studies have focused totally on international joint ventures (e.g. Chen et al. 1991, Merchant 2002, Meschi 2004, and Meschi & Metais 2006) and the results in these studies have been mixed. This study included partial acquisitions. Thus, more research on value creation in international joint venture type of investments (including both greenfields and partial acquisitions) is also clearly needed.

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Table 1. Summary of the sample features and results in selected studies focusing on value

Origin of Investors	Target countries of FDIs	SAMPLE FEATURES			Timing of FDIs	Abnormal Positive Value Creation
		Number of FDIs	Number of Investing Firms			
USA	OECD & non OECD	301	202		1975-83	NO
USA	China	88	56		1979-90	YES
USA	China	42	34		1983-89	YES
USA	mainly OECD	276	NI		1975-88	YES
Sweden	OECD	30	8		1981-91	NO
USA	OECD	112	NI		1978-90	NO
Denmark	OECD	92	40		1988-92	YES
USA	OECD & non OECD	502/393	NI		1986-90	YES
OECD	USA	225	117		1979-90	YES
OECD	USA	195	NI		1983-92	YES
USA	mainly OECD	55	55		1984-89	YES
USA	OECD & non OECD	98/68	NI		1979-89	NO
USA	OECD	236	NI		1975-88	YES
Netherlands	OECD	111	NI		1990-96	YES
Finland	OECD & non OECD	79	19		1985-96	YES
USA	OECD & non OECD	351	NI		1986-90	YES
OECD	USA	111	NI		1990-96	YES
France	China	67	NI		1994-2002	NO
EU Countries	EU Countries	352	NI		1993-2002	NO
Western Europe	OECD & non OECD	4429	NI		1996-2001	NoYes *
France	USA	291	NI		1988-2004	YES
Spain	OECD & non OECD	234	NI		1990-2003	YES
OECD	OECD	148	29		1989-2004	NS

NI= no information

*= YES In cases of unlisted target

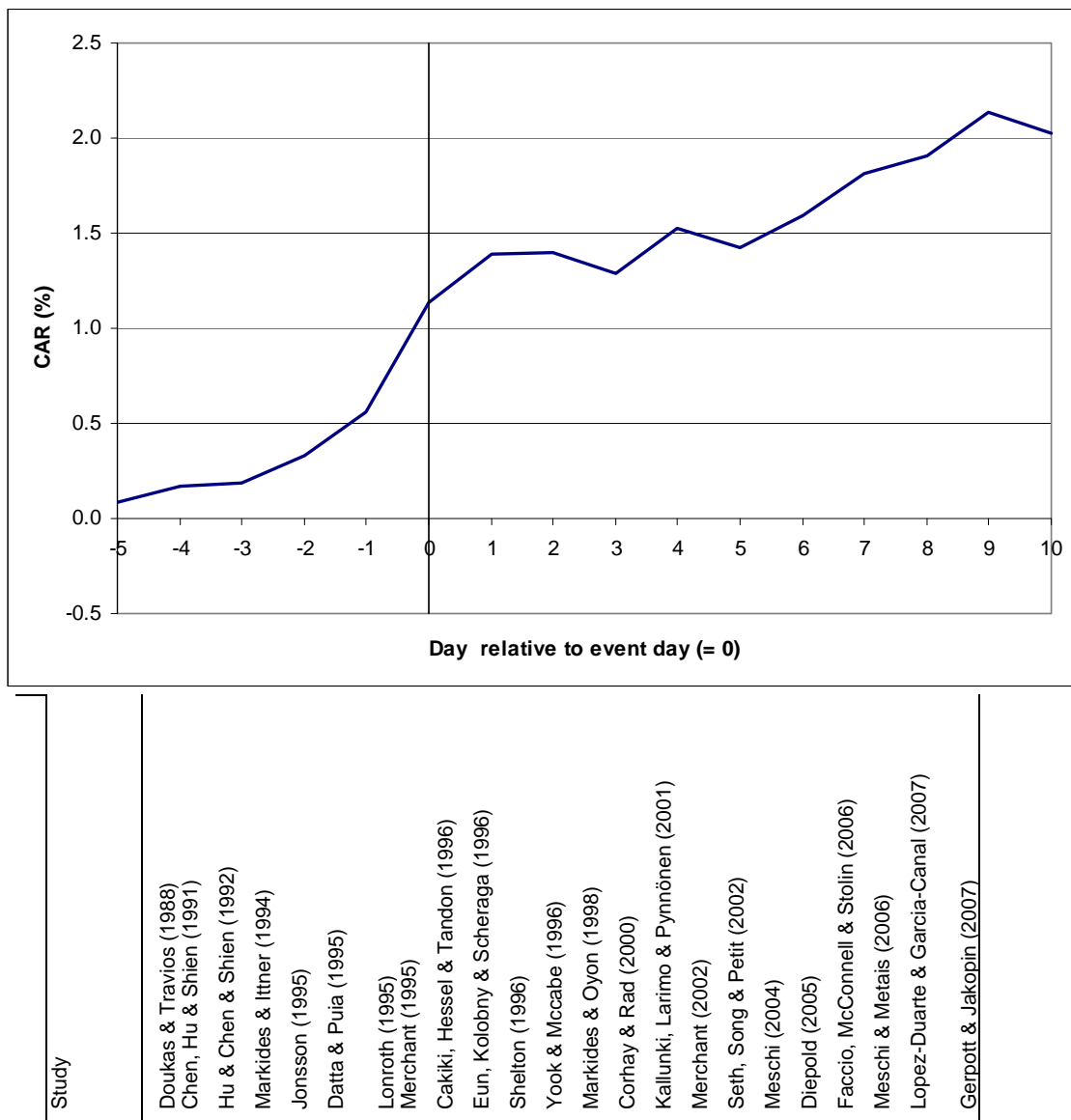


Figure 1. Cumulative unexpected returns around investment announcements.

Table 2. Daily abnormal stock returns around the foreign direct investment announcement day.

Panel A: Abnormal Returns (AR)					
Day	AR(%)	Patell's t-stat	p-val	BMP t-stat	p-val
-5	0.10	0.60	0.546	0.71	0.480
-4	0.08	0.07	0.945	0.07	0.942
-3	0.02	0.40	0.688	0.40	0.690
-2	0.15	1.25	0.210	1.10	0.272
-1	0.23	1.70	0.088	1.94	0.052
0	0.57	3.71	0.000	2.28	0.023
1	0.26	1.85	0.064	1.89	0.059
2	0.01	-0.27	0.785	-0.29	0.770
3	-0.11	-1.15	0.252	-1.17	0.243
4	0.23	1.82	0.069	1.87	0.062
5	-0.10	-0.88	0.378	-1.01	0.315
Panel B: Cumulative Abnormal Returns (CAR)					
Window	CAR(%)	Patell's t-stat	p-val	BMP t-stat	p-val
-5 ... -1	1.15	1.80	0.072	1.85	0.064
-1 ... +1	1.06	4.20	0.000	3.47	0.001
+1 ... +5	0.29	0.62	0.538	0.65	0.517
Panel C: Number of Positive and Negative Returns					
Day	Positive	Negative	> +5 %	< -5 %	Total
AR: t = -1	147	133	7	7	280
AR: t = 0	152	128	19	8	280
AR: t = +1	151	131	9	5	282
CAR(-1,+1)	183	111	35	18	294

Table 3. The impact of reviewed variables on value creation.

VARIABLE	Mean (%)	t-value	N	Positive (%)
FDI experience				
No	5.47	2.57**	8	87.5
Yes	0.90	3.20***	286	62.2
Difference (No/Yes) ⁺	4.57	2.80***	..	
- 2–5	2.89	2.74***	38	76.3
- 6–10	1.93	2.26**	24	70.8
- >10	0.45	1.78*	224	58.9
TC experience				
No	1.85	2.84***	95	66.3
Yes	0.58	2.05**	201	60.7
Difference (No/Yes) ⁺	1.27	2.04**		
- 1–5	1.31	1.66*	53	62.3
- 6–10	-0.21	0.06	37	43.2
- >10	0.50	1.55	111	65.8
R&D intensity				
Low	0.97	2.34**	120	62.5
Medium	0.56	2.09**	138	58.7
High	2.36	1.39	39	74.4
Diff (Low vs Med or High) ⁺	0.01	0.02		
Relative size				
Very Small	-0.15	0.21	84	51.2
Small	0.73	1.64*	94	63.8
Medium	1.41	2.57**	67	74.6
Large	4.47	2.16**	20	80.0
Diff (Med-Large vs Very Small/Small)	1.55	3.16**	..	
Ownership				
Joint Venture	0.60	1.23	85	56.5
Wholly-owned	1.11	3.13***	212	64.6
Diff (JV/ WO)	-0.51	-0.97		
Level of development				
Developed	0.86	2.70***	217	61.3
Developing	1.22	1.96**	80	65.0
Diff (Developed /developing)	0.36	0.58	..	
Cultural distance				
Low	0.83	2.43**	76	64.0
Medium	1.06	2.99***	201	63.2
High	0.43	-0.25	20	50.0
Diff (below mean vs above mean) ⁺⁺	-0.01	-0.01		
Country risk				
Low	0.89	2.72***	213	62.0
Medium	1.21	1.57	63	65.1
High	1.31	1.53	20	60.0
Diff (Low vs Med/High)	-0.33	-0.56	..	

Statistical significance levels: * 10 %, ** 5 %, *** 1 %

⁺ The t-value for testing the equality of mean returns is the standard two sample t-test with pooled or unequal variances depending whether the F-test of equality of the variances was significant at the 5 percent level or not.

⁺⁺ The sample mean of the cultural distance is 1.57.