

Corporate Control, Board Independence and International Diversification: Evidence from Italian Firms

Antonio Majocchi and Roger Strange

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ABSTRACT

The objective of this paper is to model the determinants of international diversification, using data for a panel of 78 Italian manufacturing firms quoted on the local stock exchange over the period 2005 - 2007. We first outline a novel framework for identifying the firm's optimal degree of international diversification, based upon a consideration of the perceived benefits and costs. The extant literature has shown that various firm-specific attributes (e.g. industry, firm size, leverage) are associated with the degree of international diversification, but we draw upon agency theory and the resource-based view to introduce as potential determinants: (a) the ownership structure of the firm, (b) the market for corporate control and (c) the independence of the Board of Directors. Our empirical analysis confirms that firms' corporate governance mechanisms have an impact on their degree of international diversification. In particular, our findings show that high levels of family and State ownership have a negative effect on international diversification, as does the presence of a CEO or a President from the controlling family. But an inactive market for corporate control negates the impact of family ownership. Finally, international diversification is promoted by a high proportion of independent directors on the Board.

1 INTRODUCTION

The process of international diversification brings many potential benefits to firms, notably the possibility of efficiency gains due to economies of scale, enhanced capabilities due to experiential learning, greater market power, and risk diversification. However, the expansion of the firms' strategic scope also adds complexity to the management of the firm, due not only to the greater information-processing demands and costs of internal governance but also to the difficulties of coordinating activities across national boundaries, and increased firm risk due to the increased exposure to uncertain environments (Hitt, et al. 2006). It is perhaps unsurprising therefore that empirical studies of the relationship between the degree of firm multinationality and firm performance show mixed results (Ruigrok/Wagner, 2003; Contractor et al., 2003; Lu/Beamish, 2004). This indeterminacy suggests, at the very least, that international diversification is not necessarily a value-enhancing strategy. It is possible that international diversification may be *ex post* value-reducing simply because of poor implementation, but agency theory also suggests that managers and various groups of shareholders may well favour expansion strategies that are not *ex ante* value-maximising for the firm.

The objective of this paper is to model the determinants of international diversification, using data for a panel of Italian firms. Much of the previous literature on international diversification has used data on US firms, though there have been several studies using data for emerging and newly-industrialised economies (e.g. Filatotchev et al, 2007). We draw upon this literature to include various firm-specific attributes (e.g. industry, firm size, leverage) that have been shown to be associated with international diversification. But the main contributions of this paper are twofold. First, we outline a novel framework for identifying the firm's optimal degree of international diversification, based upon a consideration of the perceived benefits and costs. Second we introduce several potential

determinants of international diversification that have not been fully considered in the literature, namely: (a) the ownership structure of the firm, (b) the market for corporate control, (c) the independence of the Board of Directors. Although there have been several studies of the effects of ownership structure on firm strategy (see, for example, Denis et al, 1999; Lane et al, 1999; Denis et al, 2002; Tihanyi et al, 2003; Filatotchev et al, 2007; Strange et al, 2009), none have looked at the impact of the market for corporate control and of Board independence on international diversification.

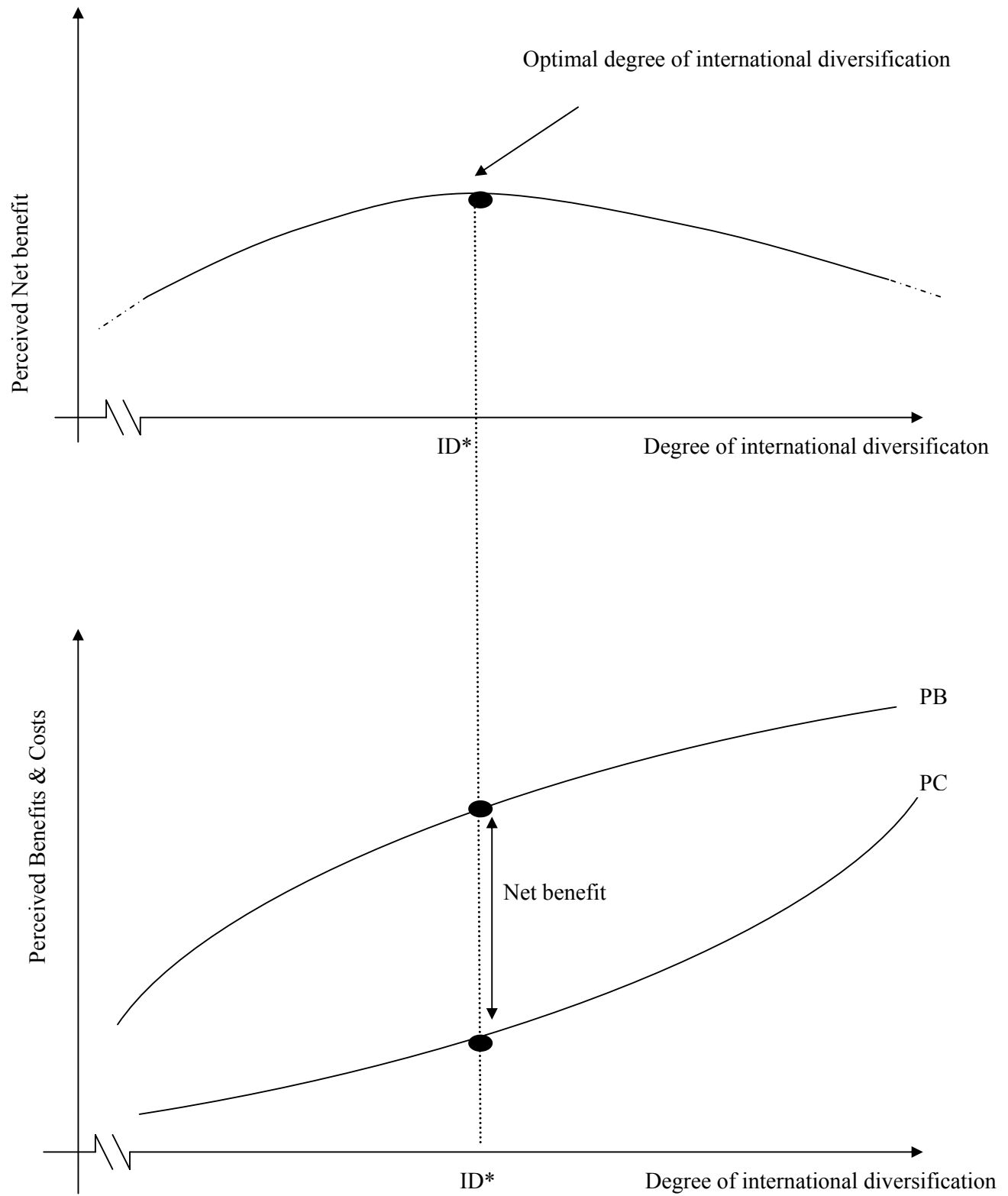
The Italian context is particularly appropriate for this study for two main reasons. First, Italy is a developed economy with a distinctive corporate governance system involving *inter alia* appreciable degrees of family and/or public ownership in many firms, and also widespread firm-specific restrictions on the transfer of shares and independent voting. Moreover, the Italian regulatory authorities have, within the last decade, increased the level of disclosure required of listed firms to a high level of detail. For example, all shareholders with holdings of 2% or more must be separately identified: this is the greatest level of detail required in any European country, and allows us to establish a very clear picture of the ownership structure of listed firms. Second, Italian industry demonstrates a high level of internationalisation. Italy was the sixth largest exporter of manufactured goods in the world in 2008, and accounts for significant shares of the world market in many industrial sectors (e.g. footwear, furniture, non-metallic mineral products).

The structure of the paper is as follows. In the next section we develop our theoretical framework, review the extant literature on international diversification, and formulate our research hypotheses. In section 3, we briefly describe the Italian corporate governance system and highlight some of its distinctive features, explain how we have operationalised the variables used in the model and detail the data sources, present descriptive statistics on these variables, and outline the estimation methodology and the statistical tests used. We present

and discuss the regression results in section 4: these confirm that all our hypothesised determinants have statistically significant effects upon international diversification. The final section concludes, and suggests avenues for further research.

2 REVIEW OF THE LITERATURE AND RESEARCH HYPOTHESES

As noted in the Introduction, international diversification brings both benefits and costs to the firm. We would argue that the perceived benefits (PB) increase with the degree of international diversification but are subject to diminishing returns, as the opportunities for economies of scale and experiential learning are gradually exhausted and the incremental advantages of further risk diversification lessen. We would also argue that the perceived costs (PC) also rise with the degree of international diversification, but at an increasing rate as the increased geographic scope of the firm adds disproportionately to the difficulties of coordinating activities across national boundaries and to greater exposure. We would thus suggest that, for a given firm and at a given point in time, there is an optimal level of international diversification (ID*) at which the difference between the perceived benefits and costs is maximised – see Figure 1. Three points should be emphasised. First, we stress that it is the *ex ante* perceived benefits and costs that determine the optimal degree of international diversification, rather than the *ex post* realised benefits and costs. Second, the key assumptions in the figure are that, although perceived benefits and costs both increase with international diversification, they do so in a non-linear fashion and at different marginal rates. There is thus an optimal level of international diversification for each firm that may change as the perceived benefits and costs change: this may partially explain the inconclusive empirical results from the multinationality-performance literature. Third, we focus in the figure on firms that have already diversified to some degree, and do not consider those firms that are considering their initial forays overseas.

Figure 1: The Optimal Degree of International Diversification

Two theoretical approaches dominate the academic literature on international diversification: internalisation theory and the resource-based view (RBV). From the RBV perspective (Wernerfelt, 1984; Barney, 1986), international diversification is viewed as a means by which the firm can both exploit and augment its heterogeneous resources (Luo, 2002), and a key driver is the existence of excess capacity either of physical assets or human expertise (Mahoney/Pandian, 1992). In contrast, internalisation theory (Buckley/Casson 1976; Hennart, 1982) focuses more on whether the firm opts to effect this exploitation internally or through arm's length transactions. Hitt et al. (2006) provide an excellent and concise summary of the empirical research published on international diversification since 1995. They report that variables such as firm size, organisational age, product diversification, and R&D intensity are positively associated with international diversification. Kochhar (1996) further suggests that the capital structure of the firm influences diversification strategy. If all shareholders are risk-neutral and are primarily concerned with maximising the value of the firm, and it can be assumed that managers act in accordance with the shareholders' wishes, then the ownership structure of the firm should have no impact upon firm strategy – the degree of international diversification will then be determined by these firm-specific attributes alone.

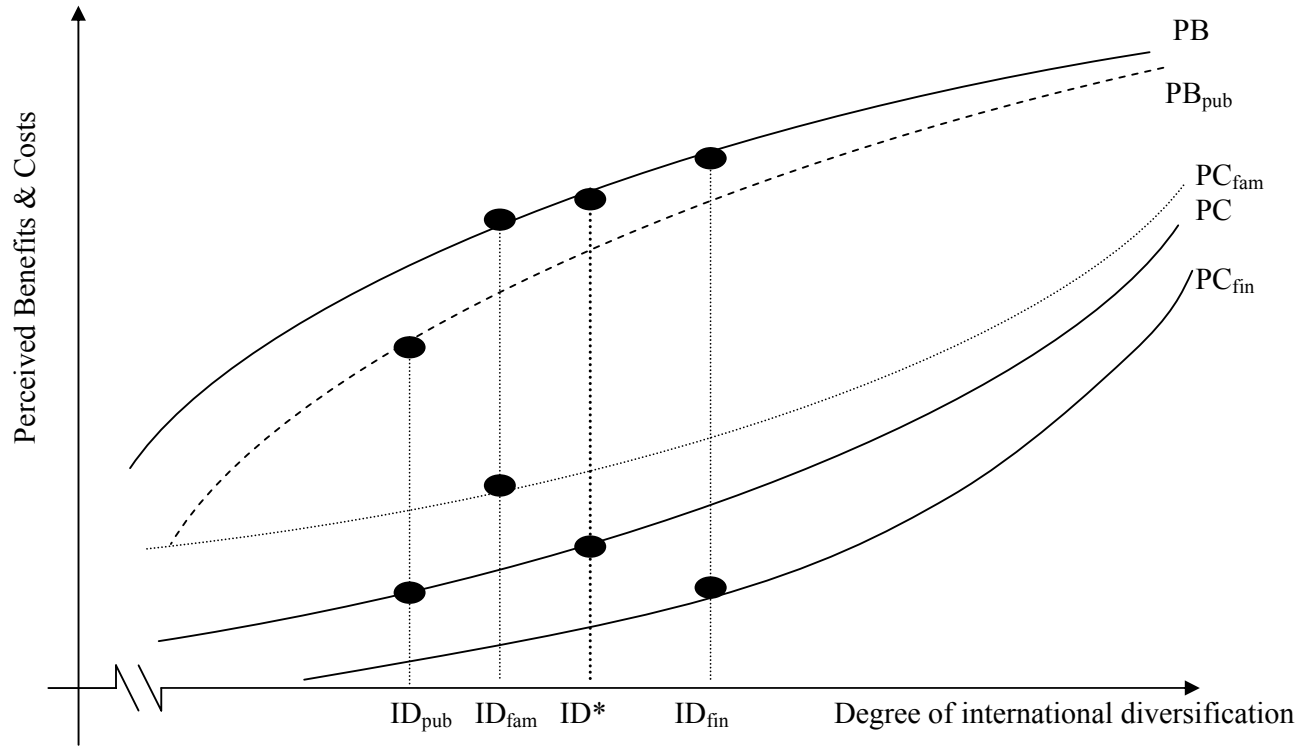
However, agency theory (Jensen/Meckling, 1976; Denis et al., 1999) suggests that the interests of managers and shareholders are not necessarily aligned, and may well conflict. Furthermore, different types of shareholders will typically have different decision-making time horizons and different attitudes towards risk, in which case the ownership structure of the firm is likely to have an impact upon the formulation of firm strategy. The situation depicted in Figure 1 should thus be seen as that associated with a firm with a widely-dispersed ownership structure, and a management team which is committed to maximising shareholder value.

2.1 The Ownership Structure of the Firm

In contrast, family shareholders typically hold relatively undiversified investment portfolios and their equity holdings show limited liquidity. Furthermore, because the owners in the current generation have an obligation to preserve wealth for the next generation, family firms often possess longer time horizons compared to non-family firms (Chrisman, et al., 2005; Bruton, et al., 2008). In an emerging economy, international diversification might provide an opportunity for long-term growth and a reduction in cash flow volatility (Lien *et al*, 2005). But in a developed economy setting, such considerations might not be as important as the fact that family shareholders are likely to be more risk-averse as they typically have most of their wealth tied up in the business, and are thus less likely to pursue high-risk strategies such as international diversification (Storey, 1994). In other words, family shareholders are likely to perceive significantly higher costs associated with international diversification, particularly in the initial stages of diversification. This is illustrated in Figure 2 by the line depicting the costs perceived by family shareholders (PC_{fam}) lying above that depicting the costs perceived by dispersed shareholders (PC). The net result is that the optimal level of international diversification falls from ID^* to ID_{fam} . Our first hypothesis is thus:

Hypothesis 1a: A high level of family shareholding will be associated with a lower degree of international diversification.

Figure 2: The Effects of Ownership Structure on the Optimal Degree of Internationalisation



Financial institutions are another important ownership constituency. Such institutions will typically have the financial interest, the independence, and the expertise to monitor the firm's management and its policies. There is some evidence (Hoskisson, et al., 1994; Young et al., 2008) that institutional shareholders promote good governance, with a resultant improvement in firm performance. The equity participation of such financial institutions may well provide firms not only with additional financial resources but also with access to the institutions' networks in overseas markets, and thus promote internationalisation (Filatotchev et al. 2008). Frequently, financial blockholders are part of large international networks that are shared with the firm. For example, Allen and Phillips (2000) show that financial

institution ownership facilitates access not only to financial resources but also to technological and commercial resources and capabilities that in turn lead to higher level of international involvement. This knowledge often takes also the form of better skilled managers with deep market and technological knowledge and with significant previous international experience. In other words, institutional shareholders are likely to perceive significantly lower costs associated with international diversification, not just because of the financial and organisational resources they can provide but also because they would not perceive the same degree of financial risk as their portfolios are already diversified. This is illustrated in Figure 2 by the line depicting the costs perceived by institutional shareholders (PC_{fin}) lying below that depicting the costs perceived by dispersed shareholders (PC). The net result is that the optimal level of international diversification increases from ID^* to ID_{fin} . Our second hypothesis is thus:

Hypothesis 1b: A high level of financial institution shareholding will be associated with a higher degree of international diversification.

A third ownership constituency, particularly important in the Italian context but also elsewhere in Continental Europe, is the public sector. Since the large wave of privatisations that took place in the UK in the 1980s and in Continental Europe in the 1990s, the role of State-owned enterprises in developed economies has received little attention. However, public ownership of important manufacturing firms (e.g. Renault in France; Volkswagen in Germany; ENI in Italy) still remains important (La Porta et al., 1999), especially in the wake of the 2008 financial crisis. Yet studies on the effects of public ownership on internationalisation strategies have been limited. Vernon (1979) showed that government-owned enterprises tended to be more vulnerable to the domestic political process than privately-owned enterprises, and adopted more inward-looking strategies that favoured domestic investment at the expense of foreign expansion. Public sector officials are sensitive

to political considerations, and investments may be made for objectives (e.g. the preservation of local employment) other than value-maximisation for the firm. In practice, such political considerations are likely to weigh rather more heavily than the risk preferences. This is illustrated in Figure 2 by the line depicting the benefits perceived by public shareholders (PB_{pub}) lying below that depicting the benefits perceived by dispersed shareholders (PB). The net result is that the optimal level of international diversification falls from ID^* to ID_{pub} . Our third hypothesis is thus:

Hypothesis 1c: A high level of public shareholding will be associated with a lower degree of international diversification.

2.2 The Market for Corporate Control

Various authors, building on agency theory and noting the separation of control and ownership between managers and shareholders, affirm that managers may pursue strategies that maximise their wealth even if these strategies generate costs for the shareholders. Most of the empirical evidence has been developed with reference to product diversification strategies, but similar reasoning has been recently applied to international diversification strategies (Denis et al., 2002). The ‘agency cost hypothesis’ suggests that managers derive various private benefits from international diversification, and that these benefits may exceed their private costs. Managers may have an incentive to promote the international diversification of their firms because their compensation is linked to firm size (Baker et al., 1988), because they derive power and prestige from being associated with a larger firm (Jensen, 1986), because their job security is enhanced (Shleifer/Vishny, 1989), or because firm diversification reduces the risks attached to their undiversified personal portfolios (Amihud/Lev, 1981). Thus it is argued that managers may opt for a strategy of international diversification, even if it is expected to lead to a reduction in shareholder wealth. Furthermore managerial proclivity for

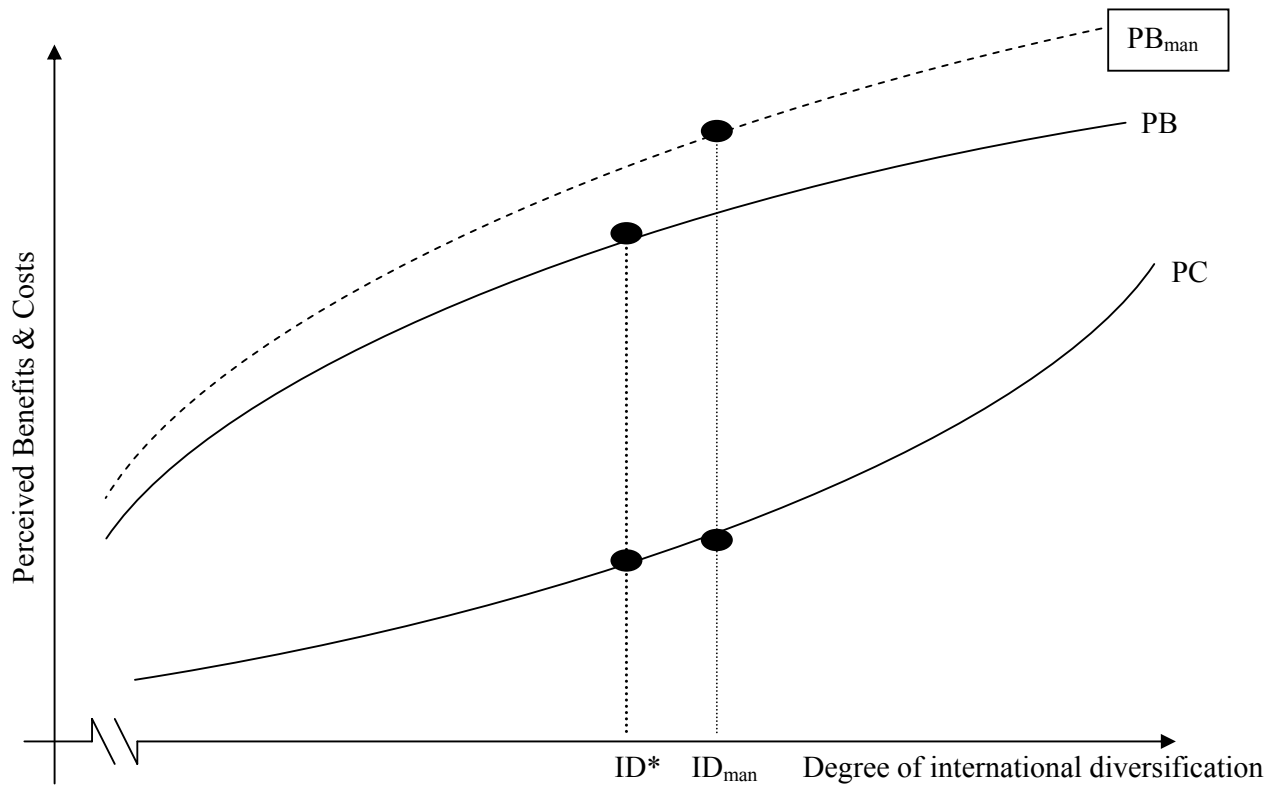
non-profitable strategies may be exacerbated by the presence of free cash flow in firms, which is assumed to breed inefficiencies and poor managerial decision-making (Jensen 1986).

But if the management of the firm does not implement strategies that maximise the value of a publicly-traded firm then outside parties may well perceive a profitable opportunity and launch a takeover bid. A constraint on managerial discretion is thus provided by the external market for corporate control, with an active market providing management with the incentive not to stray too far from profit-maximising behaviour. Denis et al (1997) for example have provided strong empirical evidence that disciplinary forces such as acquisition attempts have led to an overall decrease of the level of diversification. In contrast, if the market for corporate control does not function effectively, either because not all the shares are tradeable or because certain shareholders have concluded agreements to vote together, then there will be more leeway for management to exercise their discretion and pursue strategies that promote their own interests even if these are at the expense of firm value maximisation. This is illustrated in Figure 3 by the line depicting the benefits perceived by the managers (PB_{man}) lying above that depicting the benefits perceived by dispersed shareholders (PB). The net result is that the optimal (from the point of view of the managers) level of international diversification rises from ID^* to ID_{man} . Furthermore, the influence of individual shareholder constituencies on firm strategy will be reduced. We thus hypothesise that:

Hypothesis 2a: An inactive market for corporate control will be associated with a higher degree of international diversification.

Hypothesis 2b: An inactive market for corporate control will reduce the impact of the various shareholder constituencies on the degree of international diversification.

Figure 3: The Effects of the Market for Corporate Control on the Optimal Degree of International Diversification



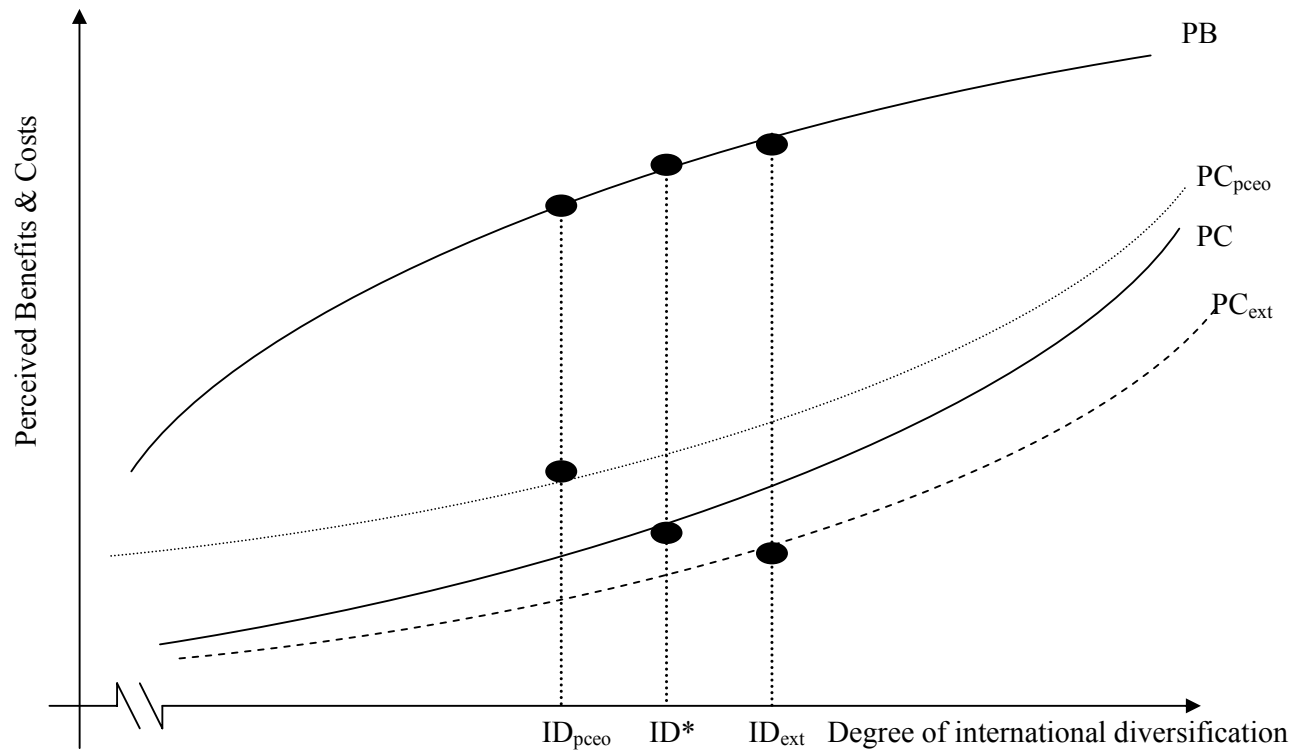
2.3 The Independence of the Board of Directors

From the agency theory perspective, the monitoring of management is not only effected by the market for corporate control but may also be undertaken by the Board of Directors on behalf of shareholders (Finkelstein/Hambrick, 1996). In principle, the Board provides an internal control mechanism which complements the external mechanism provided by the market, and together should guard against managerial strategies that may reduce the value of the firm (Jensen, 1993). But in many countries (e.g. Italy), families often maintain control of firms by appointing executives with family links rather than on the basis of proven managerial experience and expertise (Carpenter/Westphal, 2001). Enriques/Volpin (2007) note that the Boards of family-controlled firms often do not represent the shareholders'

interests but pay obeisance to the controlling families that have the power to appoint and remove them. In particular, the firm is more likely to pursue the objectives of the controlling family if either the Chief Executive Officer (CEO) or the President of the Board are family members. This is illustrated in Figure 4 by the line depicting the costs perceived by the President/CEO (PC_{pceo}) lying above that depicting the costs perceived by dispersed shareholders (PC). The net result is that the optimal level of international diversification falls from ID^* to ID_{pceo} . We thus hypothesise that:

Hypothesis 3a: If the CEO or the President is a member of a controlling family, then the firm will have a lower degree of international diversification.

Figure 4: The Effects of Board Independence on the Optimal Degree of International Diversification

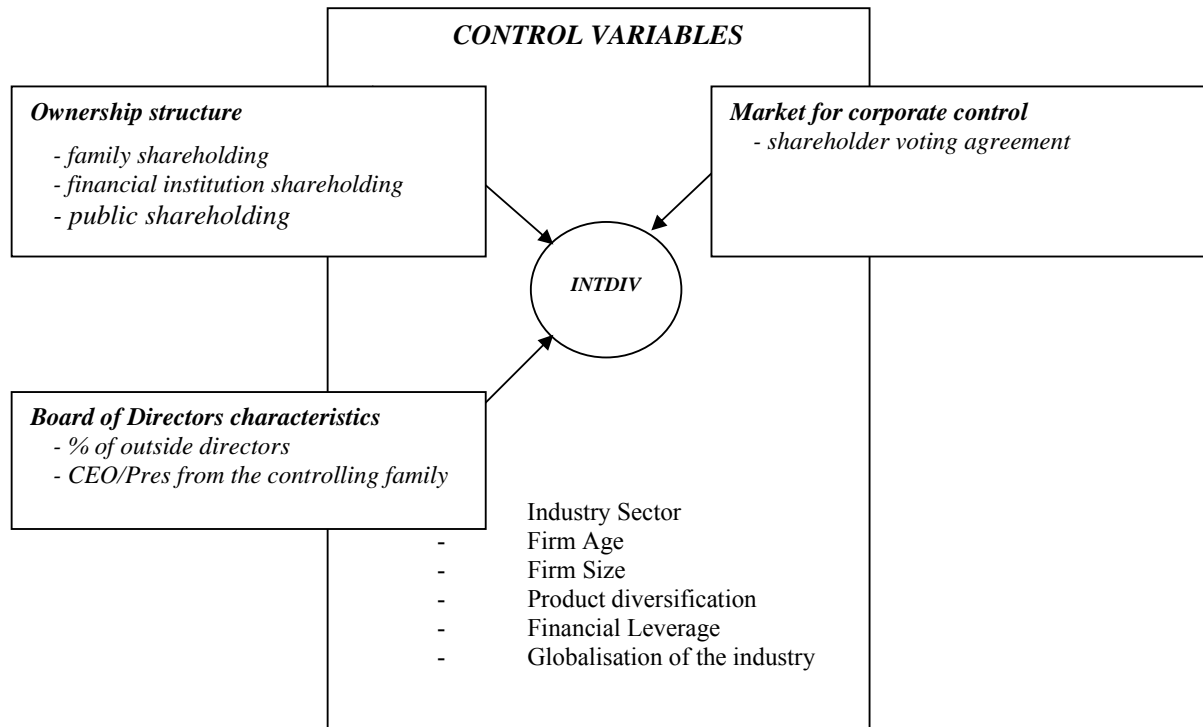


A counterbalancing influence may be provided by the presence of outside directors (i.e. those directors who do not work directly within or with the firm) to guarantee the independence of the Board. In principle, outside directors have the impartiality to oversee the managers in the strategy implementation process, and to ensure that the firm pursues strategies that are in the best interests of all the shareholders. This seems especially true in countries characterised by weak institutional contexts where, as Peng (2004: 453) claims, “outside directors do make a difference”. Furthermore, the Board of Directors is not only an institutional mechanism to protect the interests of the shareholders but, drawing upon the resource-based view of the firm, is also a source of valuable expertise and competencies that can facilitate the internationalisation process (Hillman/Dalmzier, 2003). This is particularly true of the outside directors (Kor/Misangyi, 2008), in that such directors can provide the firm

with crucial managerial competencies such as reputation, contacts to external suppliers and clients, and knowledge of new and distant markets that are essential not only to improve firm performance but also to promote effective internationalisation strategies. Various studies have investigated the effects of board composition on sundry dimensions of firm strategy, but only a few have investigated the influence of board composition on firm internationalisation and the findings have been mixed. Sherman et al (1998) found that Board composition had no impact on firm internationalisation in the US telecommunications industry. In contrast, other authors (e.g. Ellestrand et al, 2002; Tihanyi et al., 2003) have found that higher proportions of outside directors tend to promote internationalisation since outside directors supply greater understanding of foreign markets. This is illustrated in Figure 4 by the line depicting the costs perceived by a Board with outside directors (PC_{ext}) lying below that depicting the costs perceived by a Board lacking such directors (PC). The net result is that the optimal level of international diversification increases from ID^* to ID_{ext} . We thus hypothesise that:

Hypothesis 3b: A high proportion of outside to inside Directors on the Board will be associated with a higher degree of international diversification.

The general framework of our analysis is depicted in Figure 5. Our model hypothesises that the firm's degree of international diversification is a function of industry characteristics (degree of globalisation, dummies), some firm-specific characteristics (size, age, product diversification, and financial leverage), and the hypothesised corporate governance variables. We enter the industry and firm-specific characteristics as control variables, and focus primarily on the effects on international diversification of the three broad categories of corporate governance variables: i.e. ownership structure, the market for corporate control, and the independence of the Board of Directors.

Figure 5: The Model of International Diversification

3 DATA AND METHODOLOGY

3.1 The Italian Corporate Governance System

There is a plurality of corporate governance systems around the world, but much of the academic literature focuses on two models. The first model is generally referred to as the Anglo-Saxon model, and is mainly identified with the United Kingdom and the United States. The second is the German model, which is mainly identified with the countries of Continental Europe and Japan. In the Anglo-Saxon model, financial markets play a crucial role in monitoring and disciplining managerial behaviour, whilst banks limit their role to the supply of short-term finance and do not have direct interest in the firm. In this system, firms have a broad shareholder base with both private and financial institutional owners (De Jong, 1997)

and the top management team is typically made of autonomous figures. If managers do not perform well, a takeover bid for the firm is likely. This threat provides a strong incentive for managers to behave in the interests of the shareholders. In contrast, the monitoring role in the German system is typically played by the banks and insurance companies, which hold important stakes in the company. In this model, the banks not only supply short-term finance but also long-term capital, also in the form of equity, and play a crucial role also in shaping company policies and in selecting and influencing the top management team.

Both models are subject to change, and a huge amount of literature (see, for example, De Jong, 1997; La Porta et al. 1999) has discussed the strengths and weaknesses of the two approaches. Nevertheless, these models provide the standard reference when assessing any national corporate governance system. For instance, most of the literature (Cescon, 2002) agrees that the set of formal and informal rules that guide business in Italy is more similar to the German system than to the Anglo-Saxon system. However, in the last decade a new set of rules has been introduced, mainly thanks to the implementation of European directives, which progressively align Italy with other countries of Continental Europe but also to the best practice of the Anglo-Saxon model. A new Banking Law was passed in 1993 allowing banks to have direct holdings in business firms, the stock market and the all banking system have been privatised, disclosure regulations have been tightened, and a new set of regulations have been introduced to strengthen shareholders protection and transparency. Notwithstanding these changes that have improved and upgraded the Italian institutional and regulatory framework, a recent study by the Bank of Italy shows that, even if the mode of control has shown some signs of evolution, many of the peculiar traits that distinguish the Italian system still remain in place.

One important characteristic of the Italian system is the limited contestability of control (Banca d'Italia, 2008). This feature is the result of a series of market characteristics

and of control-enhancing mechanisms typical of the Italian market. Among the market characteristics, the limited role of the equity markets and the marginal role of financial intermediaries (both credit institutions and institutional investors) are well documented (Bajo et al. 1998). As a consequence, ownership and control are mainly concentrated in the hands either of the State (which is still present in some strategic sectors such as energy, defence and public utilities) or in the hands of individuals and families. According to recent data (Banca d'Italia, 2008), the State (the central government or through governmental agencies or local authorities) still plays a dominant role on the Italian Stock Exchange, with almost 30% of the listed companies directly or indirectly controlled by public authorities. These results from the listing, and partial privatisation, of very large utilities that more than offset the significant privatisation process realised during the 1990s.

Another important characteristic of the Italian corporate governance system is the pivotal role played by individuals and families in the control of firms. The strong presence of families has been guaranteed through a widespread series of control-enhancing mechanisms, such as pyramidal group structures, dual-class shares, and cross-ownership and voting agreements. In its review of the ownership and control structure in Italy in the last fifteen years, the Bank of Italy (Banca d'Italia, 2008) found evidence of a slowly decreasing role of families. This process is mainly due to a series of bankruptcies that has driven some large family groups out the market: one well-known example is the case of Parmalat and the Tanzi family. Notwithstanding this evolution, the data clearly show that individuals and family coalitions are still the prevailing control group in the Italian system.

3.2 Data Sources

The data used in this paper were extracted from the balance sheets of a sample of manufacturing firms quoted on the Italian Stock Exchange, and from official documents

regarding the corporate governance of these firms supplied by the Italian Stock Exchange and by the supervisory authority of the Italian securities market (CONSOB). The sample for this study consists of a panel of Italian manufacturing firms quoted on the local stock exchange over the period 2005 - 2007. We choose 2005 as the first year of our analysis, even though balance sheet data were available for previous years, since this is the year that Italian firms were first obliged to adopt IAAS/IFRS accounting standards. These standards introduced new accounting principles for Italian firms, and consequently the data gathered before and after 2005 are not easily comparable. Moreover, the data from 2005 onwards allow a more refined analysis of internationalisation strategies. Among the new requirements of the IAAS/IFRS standards, firms are required to disclose the geographical distribution of their sales. Since we were interested in analysing the degree of internationalisation of the Italian firm, we use these data to develop an index of international diversification (INTDIV).

We have decided to concentrate on manufacturing firms, and thus to omit the numerous service firms quoted on the Italian Stock Exchange, because the significance of exports, as a measure of internationalisation, is very limited in the service sector. We consider only the manufacturing firms continuously quoted over the period 2005 - 2007. 88 firms were quoted on the Stock Exchange at the end of 2005, but 10 firms were dropped either because they were de-listed, or acquired by other firms, over the period. We thus end up with a balanced panel of 78 firms over three years, and a total of 234 observations.

3.3 Operationalisation of the Variables

The first step was to define a measure of international diversification as the dependent variable. We do not use a uni-dimensional measure such as the ratio of foreign sales on total sales (Majocchi et al. 2005), since such a measure does not take account of the distribution of sales and whether or not they are geographically well-balanced in the main world markets

(Rugman/Verbeke, 2004). Two firms would have identical ratios of foreign to total sales even if one was exporting only to one country whilst the other had a global presence in all the main world markets. We thus follow the advice of Rugman/Verbeke (2004. p. 15) who suggest that ‘future research.....should study explicitly the regional patterns and scope of MNE sales.’ It is clear that, when data are available, a more comprehensive measure of international diversification should be preferred. In our case, the requirements of the IAAS/IFRS standards oblige firms quoted on the Stock Exchange to supply precise information on the geographical distribution of their sales, though the data do not allow us to distinguish whether foreign sales have been realised through export or through domestic sales by foreign subsidiaries. We classify (export plus overseas) sales according to six main geographical areas. The first area is the local national market (i.e. Italy). Then there are the Triad regions: North America, the expanded European Union, and Asia (Rugman/Verbeke, 2004). We add a fifth region following Ohmae's (1985) suggestion that, in order to become global players, firms should identify an additional region to the Triad where it is relatively easy for them to expand sales. The additional region we identify is Latin America because of the historical/cultural ties and the large Italian community. The sixth and final area is a residual region called the ‘Rest of the World’. Using this classification, we develop a fine-grained measure of international diversification (INTDIV) based on the Kim entropy index (1989) that has been extensively used in recent studies on international diversification (Hitt et al, 1997, 2006; Wiersema and Bowen (2008).

$$\text{International Diversification Index} = \sum_{j=1}^6 x_j \ln \left(\frac{1}{x_j} \right)$$

The subscript j defines one of the six geographical areas, and x_j is the percentage of sales realised in the market j . The natural logarithm of the inverse of the sales realised in every

market is the weight given to each geographical segment. The entropy measure will equal zero for firms that have all their sales concentrated in one country, and will reach a maximum value of 1.79 for firms with exactly the same share of sales in each of the six defined areas. In our sample the average value of INTDIV is 0.95, with a minimum value of zero and a maximum value of 1.74.

The explanatory variables in the model may be categorised to one of four groups: i.e. those variables related to ownership structure, the market for corporate control, or Board independence, and the control variables.

In order to measure the ownership structure of the quoted firms we rely on the information published every year by the Italian supervisory authority (CONSOB). The transparency regulation of the Italian securities markets, following the European Transparency Directive of 1988 (Large Holdings Directive, 88/627/EEC), forces disclosure of shareholdings larger than 2% for all the companies listed on the Stock Exchange. The stakes and the identity of the shareholders are reported by the authorities on their website. The 2% threshold is, according to international standard, very low. The corresponding rates in other European markets vary from 5% for France, Germany and Spain, to 3% in the United Kingdom (Faccio/Lang, 2002). This low rate allows a very detailed mapping of the distribution of the voting rights of the Italian quoted firms. For every firm we compute the stake held by the following constituencies: private families, financial institutions (investments funds, banks and insurance companies) and public bodies (the government, a local authority or a government agency). We named these variables respectively FAM, FIN and PUB. We did not consider in our analysis the stakes held by other kind of constituencies such as financial holdings and industrial firms. This choice is justified by the fact that financial holdings and industrial firms are often used in Italy as tools for building pyramid structures

(Bigelli/Mengoli 2004) in which a firm is controlled through another corporation which the owner does not wholly control.

Our data confirm the pivotal role played by private families in the corporate governance of Italian firms. The average percentage of shares controlled by private families in our sample is 35%, with a maximum value of 86%. Out of 234 observations, there are only 15 cases with a family shareholding smaller than 10% whilst more than 55% of the firms have a percentage of family stake larger than 30%. The role of financial institutions is more limited. The average percentage is only 8%, with this rate ranging from 0 to 70%. There were only 12 cases where the percentage possessed by financial institutions is larger than 30%. The role that the State plays in the manufacturing sector is also limited, with only five firms (for all the three years) that have a public ownership larger than 2%. However, in most of these cases, the State has a large and controlling share of ownership. In two cases (*Finmeccanica* and *ENI*) in the defence and energy sectors, the State has, over the three years, a share larger than 30%. In one case (*Saipem*) in the infrastructure sector, the State ownership is larger than 40%. And in the case of *Bonifiche Ferraresi* in the food sector, the State percentage has been stable at 62.3%.

On the basis of the disclosure requirements reported by CONSOB, we defined a dummy variable (VOTE) which takes the value of 1 when the main shareholders have any kind of formal agreement between them to form a coalition. Such coalitions among shareholders are, as mentioned above, a common device adopted by Italian shareholders to tighten their control. Our data show that this practice is common in the Italian market with almost half of the firms in our sample (111 observations, or 47% of the sample) having some kind of agreement. Most of these firms (82 observations) had a financial institution shareholding, but very few (2 observations) had a State shareholding. The presence of such a voting agreement is taken to indicate the lack of an active market for corporate control.

We analyse the independence of the Board of Directors using the Corporate Governance Report that every quoted firm is obliged to deliver yearly to the supervisory authority. We compute two variables. The first variable (PCEO) is a dummy variable which takes the value of unity if either the President or the Chief Executive Officer (CEO) is a member of the controlling family. In order to infer this information we check if the executives and the controlling family have a common surname. In our sample, this happened in 36% of the cases: this shows that family influence is an important feature of the governance of Italian manufacturing firms, not only in terms of ownership but also in terms of the composition of the Board. The second variable (EXT) provides an alternative measure of the independence of the Board, as given by the number of outside directors as a proportion of the total Board size. The insider directors are defined as those persons who have either significant direct or indirect links with the firm or with persons within the firm, and is a rather wider definition than the usual ‘non-management members of the Board’ adopted in the literature (Johnson et al. 1996). The average percentage of outside directors in the Board in our sample is 37%, with five firms with no external members. The maximum value of EXT in the sample was 88%, in the case of a company with large public shareholdings.

Finally, we include controls for several variables found to be determinants of international diversification in previous empirical studies. First we define a series of industry dummies. Each of the firms in the sample was classified to one of eight industry sectors – see Table 1 - using the official classification used by the Italian Stock Exchange.

Table 1: Sample Descriptive Statistics

Characteristic	Number of firms	% number of firms
Food Industry	7	9%
Car Industry	6	8%
Chemical Industry	14	18%
Construction Industry	9	12%
Electrical Industry	16	20%
Metals Industry	5	6%

Plant Industry	8	10%
Fashion Industry	13	17%
<i>Total firms</i>	78	100%
VOTE = 1	37	47%
PCEO = 1	28	36%

Notes: (1) All figures are averages for 2005 – 2007.

In the empirical analysis, we use the food sector as the base category and include just seven industry dummy variables – see Table 2. In addition, we include control variables for firm size, age, leverage, product diversification, and the degree of industry globalisation. Many studies (Hitt et al 2006; Majocchi et al 2005) have shown that size and age are crucial variables in determining international diversification. Large firms find it easier to grow internationally because their economies of scale generate larger organisational capabilities (Leonidou, 1998) that can be leveraged to expand international activities. Many authors (Davidson, 1980;) have underlined that international growth requires specific knowledge and experience. Consequently we introduce in the model the logarithm of the number of employees as a measure of the firm size (SIZE), and the years from foundation as a measure of experience (AGE). Financial leverage has been argued to have a negative impact upon firm internationalisation (Clark et al 1996). We compute the debt-to-equity ratio for each firm by dividing the book value of liabilities to the value of equity (DEQ). Moreover, some studies (Hitt et al, 1997) have argued that product and international diversification are interdependent and complementary strategies, hence we also insert a measure of product diversification in the analysis. We measure product diversification (PDIV) using an entropy measure (Geringer et al 2000). The formula for PDIV is similar to that used to define international diversification, but with product market shares used in place of the geographical market shares. This entropy variable is now the standard measure of diversification in strategic management research and has been widely used in various papers (e.g. Baysinger/Hoskisson 1989; Geringer et al 2000).

Finally, we have inserted a measure of the globalisation of the industry sector. Firms' internationalisation strategies are clearly affected by the competitive nature of the industries within which they operate (Wiersma and Bowen, 2008). On the one hand, more globalised markets offer better opportunities for firms thanks to the increasing standardisation of consumer tastes and the development of international value chains that link markets together. On the other hand, greater competition from foreign firms in the home market forces firms to adopt more internationally-oriented strategies. In short, a more competitive international market should be associated with a higher level of international diversification. We follow Wiersema and Bowen (2008) and develop an index of industry globalisation (GLOB) measured by the ratio of the volume of world trade relative to world sales for each industrial sector. We base our index on data for 2004 (Nicita and Olarreaga, 2006), and extrapolate to the following years using World Bank figures on the relative growth of sales and trade for the period 2005 - 2007.

The definitions and sources of data for all the explanatory variables are reported in the Table 2. Table 3 presents the correlation matrix for the continuous explanatory variables. The modest correlations between the variables suggest that multicollinearity will not be an issue in the regression analysis.

Table 2: Definitions of Variables

Variable	Definition	Data Source
INTDIV	Entropy measure of international diversification (dependent variable)	Borsaitaliana
FAM	Family shareholding (%)	Consob
FIN	Financial institution shareholding (%)	Consob
PUB	Public sector shareholding (%)	Consob
VOTE	Dummy variable = 1 if there is a voting agreement between the major shareholders	Consob
PCEO	Dummy variable = 1 if either the President or the CEO is a member of the controlling family	Borsaitaliana
EXT	Number of independent directors as proportion of Board (%)	Borsaitaliana
GLOB	Ratio of the volume of world trade relative to world sales per industry sector	World Bank Economic Review

PDIV	Entropy measure of product diversification	Borsaitaliana
SIZE	Natural logarithm of the number of employees	Borsaitaliana
AGE	Age of the firm (years)	Borsaitaliana
DEQ	Debt/equity ratio	Borsaitaliana
DFOOD	Dummy variable = 1 if firm is in the food industry	Borsaitaliana
DCARS	Dummy variable = 1 if firm is in the car industry	Borsaitaliana
DCHEM	Dummy variable = 1 if firm is in the chemical industry	Borsaitaliana
DCONS	Dummy variable = 1 if firm is in the construction industry	Borsaitaliana
DELEC	Dummy variable = 1 if firm is in the electrical industry	Borsaitaliana
DMET	Dummy variable = 1 if firm is in the metals industry	Borsaitaliana
DPLAN	Dummy variable = 1 if firm is in the plant industry	Borsaitaliana
DFASH	Dummy variable = 1 if firm is in the fashion industry	Borsaitaliana

Note: See text for further details of sources.

Table 3: Correlation Matrix of the Continuous Explanatory Variables

	Mean	s.d	FAM	FIN	PUB	EXT	GLOB	PDIV	SIZE	AGE	DEQ
FAM	0.35	0.30	1								
FIN	0.08	0.11	- 0.205***	1							
PUB	0.02	0.099	- 0.266***	- 0.044	1						
EXT	0.37	0.17	- 0.075*	-0.097	+0.432***	1					
GLOB	0.90	0.46	-0.236***	-0.0118	-0.076	0.0605	1				
PDIV	0.71	0.46	+0.048	- 0.023	+0.062	+0.275***	-0.062	1			
SIZE	7.77	23.07	- 0.110*	+0.157**	+0.137**	+0.282***	-0.022	+0.377***	1		
AGE	65.5	45.5	+0.093	- 0.011	+0.066	+0.176***	-0.028	+0.022	- 0.045	1	
DEQ	2.63	3.77	- 0.138 **	+0.003	- 0.039	+0.139**	0.097	- 0.011	+0.053	- 0.042	1

Notes: *** denotes a significant correlation at the 1% level; ** at the 5% level; and * at the 10% level.

3.4 Methodology

We have a balanced panel of data for 78 firms over a three-year period, hence we choose an econometric methodology based on a GLS regression in the context of a random effects panel data model – the calculations are undertaken using Release 9 of the Stata package. The choice of the random effects rather than the fixed effects model is typically a matter of discretion. We estimate both the random and fixed-effects models and run a Hausman misspecification test (Baltagi 2005) to verify if the coefficients estimated with the efficient random-effects estimator are the same as the ones estimated by the consistent fixed-effects estimator. The statistics, with degrees of freedom and related p-values, are reported for all models. The insignificant p-values suggest that it is appropriate to use the random-effects estimator. Moreover, the use of a random-effects approach is advisable since there are reasons to believe that not all the relevant variables have been included in our model: some excluded potential explanatory variables may be constant over time but vary between firms (such as the distribution of subsidiaries) whilst others may be constant over firms but vary over time (such as macroeconomic conditions). The explanatory power of all the models may be assessed by reference to the coefficient of determination (R^2) and the adjusted R^2 . The significance of each estimated model may be assessed by reference to the Wald χ^2 statistic.

4 EMPIRICAL RESULTS

The regression results are presented in Table 4. The first column - Model 1 – shows the estimated coefficients for a model containing the five control variables (PDIV, SIZE, AGE, DEQ, GLOB) and the seven industry dummies. The explanatory power of the model is very reasonable ($R^2 = 0.37$, $\text{Adj-}R^2 = 0.39$, $\text{Wald } \chi^2 = 59.31$, $p < 0.01$). All the industry

dummies have positive coefficients, suggesting that firms in the food industry are *ceteris paribus* less diversified internationally than those in the other seven industrial sectors. The car (DCARS), electrical (DELEC), metals (DMET) and fashion (DFASH) sectors have similar average levels of international diversification, but the most diversified firms appear to be those in the plant sector (DPLAN). Firm size (SIZE) has a positive and highly significant effect upon international diversification, as expected. The debt/equity ratio (DEQ) has a negative and highly significant impact upon international diversification. This too is in line with previous empirical work (Kochhar 1996) and the predictions of agency theory. A high level of leverage imposes a fixed financial commitment on the firm, and reduces the free cash flow available to management (Jensen 1986). There is thus less incentive for management to engage in international diversification. Both the organisational age (AGE) and the product diversification (PDIV) variables are positive, but both are statistically very insignificant.

Table 4: Regression Results

Variable	Model 1	Model 2	Model 3	Model 4	Model 5
FAM		- 0.246 ** (0.110)	- 0.199 * (0.108)	- 0.350 *** (0.131)	- 0.343 *** (0.127)
FIN		0.081 (0.220)	- 0.097 (0.223)	- 0.328 (0.505)	- 0.566 (0.488)
PUB		- 0.770 * (0.401)	- 0.508* (0.390)	- 0.604 (0.397)	- 1.239*** (0.424)
VOTE			0.211*** (0.075)	0.094 (0.113)	0.087 (0.110)
FAM*VOTE				0.402* (0.213)	0.525** (0.209)
FIN*VOTE				-0.439 (.565)	-.710 (.547)
PCEO					- 0.260*** (0.078)
EXT					0.747*** (0.246)
<i>Industry Dummies</i>					
DCARS	0.542 ** (0.229)	0.446 * (0.232)	0.535** (0.226)	0.6022*** (0.229)	0.606*** (0.223)
DCHEM	0.490** (0.276)	0.356 (0.278)	0.395** (0.274)	0.442 (0.274)	0.401 (0.265)
DCONS	0.237 (0.166)	0.097 (0.173)	0.186 (0.167)	0.249 (0.172)	0.384** (0.173)
DELEC	0.526*** (0.241)	0.423* (0.242)	0.491** (0.239)	0.542** (0.239)	0.515*** (0.232)
DMET	0.475** (0.198)	0.381* (0.200)	0.438** (0.190)	0.461** (0.192)	0.596*** (0.190)
DPLAN	0.788*** (0.256)	0.691*** (0.256)	0.759 *** (0.251)	0.803*** (0.252)	0.773*** (0.244)
DFASH	0.489** (0.161)	0.440*** (0.164)	0.453*** (0.155)	0.461*** (0.157)	0.627*** (0.160)
<i>Control Variables</i>					
PDIV	0.014 (0.044)	0.022 (0.044)	0.021 (0.043)	0.026 (0.043)	0.011 (0.041)
SIZE	0.085 *** (0.018)	0.087*** (0.019)	0.090*** (0.018)	0.090*** (0.018)	0.075*** (0.018)
AGE	0.0001 (0.0008)	0.0005 (0.0008)	0.0006 (0.0008)	0.0004 (0.0008)	-0.00007 (0.0008)
DEQ	- 0.010 ** (0.004)	- 0.010 *** (0.004)	-0.011*** (0.004)	- 0.011*** (0.004)	- 0.012*** (0.004)
GLOB	-.0966 (.190)	-.0980 (.188)	-.101 (.189)	-.107 (.187)	-.048 (.180)
CONSTANT	0.541 *** (0.148)	0.703*** (0.161)	0.540 *** (0.164)	0.532*** (0.160)	0.334** (0.185)
<i>Diagnostic statistics</i>					
R ²	0.3728	0.4024	0.4667	0.4703	0.5191
Adj- R ²	0.3930	0.4300	.5011	.5096	.5679
Wald χ^2	59.31	67.80	82.01	85.13	109.05
dof / p-value	12/ p < 0.01	15/ p < 0.01	16/ p < 0.01	18/ p < 0.01	20/ p < 0.01
Hausman/dof/p	4.02(5) p=.547	6.43(8) p=.599	9.29(8) p=.3186	10.07(10) p=.434	9.27(10) p=.5067

Notes: (1) All estimates are generated using the random effects model, with international diversification (INTDIV) as the dependent variable. (2) A balanced panel of data for 78 firms were used for 2005-07: i.e. there are 234 observations in total. (3) *** denotes significance at the 1% level; ** at the 5% level; * at the 10% level.

Model 2 contains all the variables included in Model 1, and also the three variables (FAM, FIN, PUB) related to the ownership structure of the firms. The inclusion of these three variables leads to a significant increase in the overall explanatory power of the model ($R^2 = 0.40$, $\text{Adj-}R^2 = 0.43$, $\text{Wald } \chi^2 = 67.80$, $p < 0.01$). In line with Hypothesis 1a, increased family ownership (FAM) has a significant negative impact upon international diversification, suggesting that family shareholders may indeed be more risk-averse. In contrast, share ownership by financial institutions (FIN) has a statistically insignificant effect upon international diversification, and Hypothesis 1b is thus not supported. This suggests that these institutions already have well-diversified portfolios. Consistently with finance theory financial investors seems not concerned by the degree of international diversification. On the contrary the negative and statistically significant coefficient of public ownership (PUB) variable, confirm Hypothesis 1c. This suggests that the public sector does have a marked impact upon the strategies of firms in which it invests, and that the officials are motivated less by value maximisation for the firm as a whole, than by maintaining a local manufacturing capability at the expense of international diversification.

In Model 3, we explore the effects of the external market for corporate control on international diversification. The VOTE variable is a dummy variable that takes the value of unity if there is a voting agreement between the shareholders of a particular firm, in which case the shares can be assumed to be not freely traded and there to be an inactive market for corporate control. In the presence of such an agreement, we would expect the managers to have more discretion about strategic decisions and to pursue international diversification to secure personal benefits. This appears to be the case the VOTE variable has a positive and very significant coefficient ($\beta = + 0.211$, $p < 0.01$). Furthermore the inclusion of the VOTE variable leads to a very appreciable increase in the explanatory power of the model ($R^2 = 0.47$:

Adj- $R^2 = 0.50$, Wald $\chi^2 = 82.01$, $p < 0.01$). These results appear to support Hypothesis 2a, though see the comments below.

In Model 4, we consider whether the external market for corporate control might affect the influence of the different shareholder constituencies on firm strategy regarding international diversification. We have thus included two interaction terms: one (FAM*VOTE) between the VOTE dummy variable and the family shareholding variable and the other (FIN*VOTE) between the VOTE dummy variable and the financial shareholding variable. We do not include an interaction term with the State shareholding variable, since very few of the firms with voting agreements also had some degree of State shareholding. The inclusion of these two interaction terms adds modestly to the explanatory power of the model ($R^2 = 0.47$: Adj- $R^2 = 0.51$, Wald $\chi^2 = 85.13$, $p < 0.01$). Interestingly, the size of the coefficient of the VOTE variable falls substantially, and the variable loses its statistical significance. Moreover, only the (FAM*VOTE) term is statistically significant while the interaction term (FIN*VOTE) involving financial institutions is not statistically significant. These results suggest that, in firms where there is an active market for corporate control (i.e. when VOTE = 0), that the family shareholders (FAM) have a negative influence of international diversification whilst that of the financial institutions is not significant. But, in firms where the market is inactive (i.e. when VOTE = 1), the firm managers have greater influence over corporate strategy and the influence of the family shareholders is negated whilst that of the financial institutions remains insignificant. These results support our hypothesis 2b, though admittedly only for family shareholders, and suggest that an inactive market for corporate control does provide management with more discretion to pursue internationalisation strategies that promote their own interests.

The importance of internal control mechanisms is assessed in Model 5, wherein are included the dummy variable (PCEO) which takes the value of unity if either the President or

the CEO is a member of the controlling family, and the proportion of outside directors on the Board (EXT). The inclusion of these two variables once again adds significantly to the explanatory power of the model ($R^2 = 0.52$, $\text{Adj-}R^2 = 0.57$, $\text{Wald } \chi^2 = 109.1$, $p < 0.01$), and both variables individually are statistically very significant and have the expected signs. The coefficient of the PCEO variable is negative ($\beta = -0.260$, $p < 0.01$) as suggested by Hypothesis 3a. Interestingly, the absolute size and significance of the public ownership (PUB) variable are restored. The coefficient of the EXT variable is positive ($\beta = +0.747$, $p < 0.01$) as suggested by Hypothesis 3b suggesting that the greater is the independence of the Board, the better the provision of critical resources and information, and the greater the degree of international diversification.

Overall, our preferred model is this last model which demonstrates significant effects on international diversification due to most of the seven industry dummies, firm size (SIZE), leverage (DEQ), family ownership (FAM), public ownership (PUB), Board independence (EXT), family influence through the CEO or the President (PCEO), and the interaction term involving the external market for corporate control (FAM*VOTE). Several control variables (PDIV, AGE, GLOB) are statistically insignificant. This combination of explanatory variables accounts for over 50% of the variance in the level of international diversification across the firms in the sample. It should be stressed that, even controlling for industry effects through the dummy variables and the globalisation variable, the explanatory power of the model is improved very significantly by the addition of the various hypothesised governance variables.

5 DISCUSSION AND CONCLUSIONS

This paper addresses some new issues regarding the determinants of international diversification, and makes a contribution on the debate on the effects of corporate ownership structure on firm strategy. We use, for the first time in the context of corporate governance

analysis, a measure of international diversification which takes into account the geographic distribution of sales. Furthermore, we analyse an interesting context (Italy) which is characterised by some idiosyncrasies in terms of corporate governance rules, but which in recent years has been through a process of profound innovation in terms of regulations and whose firms tend to be characterised by a very high level of international diversification. Our analysis confirms that the corporate governance structure of firms has an impact on their level of international diversification. The Italian experience, which is typically characterised by very high degrees of family and State ownership, empirically validates the hypotheses that firms wherein these two constituencies have high degrees of ownership tend to lower their level of international commitment and focus on fewer markets. The findings on the effects of family ownership are reinforced by our results concerning the effects of the CEO or the President coming from a controlling family. This result is extremely important in a context, such as Italy, where families have introduced a series of mechanisms, such as pyramid structures, in order to enhance their control of the family business. Notwithstanding the idiosyncrasies of the Italian corporate governance system, many of its essential characteristics (a high degree of family ownership, a prominent role for the State in specific sectors, pyramidal shareholding structures etc.) are also typical features not only of several other Continental European countries (Faccio/Lang 2002) but also of many newly industrialising and emerging economies such as India, Russia and China where family and State ownership are very common and widespread (Luo/Chang 2005; Luo et al. 2009). This suggests that the findings of this paper may well have more general applicability.

Our analysis, given the limitations on data, could not fully take into account the existence of pyramid structures as a result of which the registered shareholders (as reported to the supervisory authorities) might be different from the 'real' owners of the voting rights. Our analysis shows that a more open composition of the Board of Directors to outside members

improves the international diversification of the firms. These results, taken together, show that the choice of the top management team (i.e. the President, the CEO, and the Board members) affects the strategy and the degree of international diversification of the firms.

The findings on the effects of the shareholdings held by financial institutions are not significant and do not accord with the findings of previous studies. This may be the effect of passive strategies by investors, which is a peculiar feature of the Italian system where financial intermediaries have typically a limited role in the governance of manufacturing firms. However, in a recent study (Banca d'Italia 2008), the Italian Central Bank shows that, while the share of ownership of Italian financial institutions is low and have been decreasing in the last decade, the opposite holds for foreign institutions which have increasingly invested in Italian listed companies. The insignificant results of our analysis may thus be due to our lack of distinction between domestic and foreign institutional investors, and to our inability to discriminate between different kind of financial institutions. Filatochev (2008) and Lien et al (2005) for example have shown that foreign institutional ownership promotes international expansion. This issue requires further analysis. The limited role of financial intermediaries in the Italian market reflects the limited role played by the market for corporate control. Our data on shareholders' voting agreements testify to the importance of coalitions among shareholders in the Italian market. We found that, whilst family shareholders had a negative impact on international diversification when there was an active market for corporate control, this impact was removed when there was a voting agreement in place. We hypothesised that similar effects would be apparent for other (e.g. public) shareholders, but we were not able to test these hypotheses due to data limitations. This issue too merits further analysis.

Overall the paper makes a contribution to the debate on the determinants of firms' international diversification showing that the ownership structure does affect the level on international involvement of firms. These findings are consistent with those reported in

previous studies (Filatochev et al 2008; Tihanyi et al, 2003) but also, at a more general level, confirm the view, grounded in agency theory, which maintains that ownership structure is an important determinant of firm diversification. But while most of the previous studies have analysed product diversification, we have confirmed a relationship with international diversification.

These results, together with the findings regarding the disciplinary role played by external markets, confirm that agency theory is an effective theoretical framework that helps to explain firms' degree of international diversification. But the RBV approach provides a fruitful complement to agency theory, not only with regard to the role played by outside directors but also in explaining the negative impact of family ownership on international diversification. Family-owned firms are often short not only of financial resources but also of intangibles such as professional competencies that are crucial for international diversification. This paper shows that an integrated approach considering both agency and resource-based perspectives may better explain such a complex process as international diversification.

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