Research in International Business and Finance 38 (2016) 494–508

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length article

Euphoria in financial markets: How Indian companies generate value in their cross-border acquisitions

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ARTICLE INFO

Article history:
Received 21 December 2015
Received in revised form 21 May 2016
Accepted 8 July 2016
Available online 14 July 2016

Keywords:
Cognitive legitimacy
Euphoria effect
India
Cross-border acquisitions

ABSTRACT

In this paper, we investigate the effect of euphoria on returns derived by Indian companies in their cross-border acquisitions. Cognitive legitimacy generated at the country level facilitated firms in deriving higher value from internationalization. In addition, overoptimism after the legitimacy-building event led to euphoria in financial markets and short-term abnormal returns. Hence we argue that the springboard effect created by legitimacy is short-lived, as euphoria fades away over time. Using cross-border and domestic acquisitions by Indian companies during 1999–2009, and controlling for fundamental factors, both financial and non-financial, we find support for our euphoria hypothesis. Because of overoptimism, Indian companies experienced short-term abnormal returns in their cross-border acquisitions in the few years following the legitimation process, but not in later years.

1. Introduction

The last decade has seen a rapid internationalization of emerging-market (EM) firms (UNCTAD, 2011). In the global business environment, these EM firms face several issues in the nascent internationalization stage due to their linkages with their home country (Stillman, 1974). One of the critical issues faced by multinational enterprises, often underscored in the literature, involves the establishment and maintenance of legitimacy in foreign markets (Klossek et al., 2012; Kostova and Zaheer, 1999; Liao and Yu, 2012). Legitimacy is central in the milieu of institutions that define the rules of the game in international markets (Ahlstrom et al., 2008; Davis et al., 2000), and firms need to achieve *taken-for-grantedness* in these foreign markets (Guillén and García-Canal, 2009; Luo and Tung, 2007). However, authors in international business research have struggled to explain why legitimacy created in the business environment has no discernible impact after the initial observation of the legitimacy-creating phenomenon. This paper addresses this issue by linking the observed negligible effect of legitimacy to the euphoria effect widely studied in other areas (Helwege and Liang, 2004; Mian and Sankaraguruswamy, 2008; Steib and Mohan, 1997). More specifically, we investigate this euphoria effect in the context of internationalization of Indian firms; i.e., how euphoria created in financial markets can generate abnormal returns for Indian companies in their foreign acquisitions and how this euphoria effect is short-lived.

The lack of legitimacy in the host country has been identified as one of the costs of doing business abroad, referred to as liabilities of foreignness (Kostova and Zaheer, 1999 Zaheer, 1995). Since authors have emphasized the role of location in Dunning's OLI paradigm (Asmussen et al., 2011; Dunning, 2009), liability of foreignness is considered to be both a country-

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http://dx.doi.org/10.1016/j.ribaf.2016.07.022
0275-5319/

level and firm-level construct (Beugelsdijk, 2011; Dunning and Lundan, 2008). Indeed companies can overcome this liability of foreignness through both firm-specific (or ownership-specific) advantages and location-specific advantages. Moreover, this liability of foreignness impacts the returns of these companies. Thus, EM companies are required to cultivate legitimacy that will help them surmount drawbacks coupled with their country-of-origin and liability of foreignness (Bell et al., 2008; Klossek et al., 2012; Rugman and Verbeke, 2004). Similarly, authors have looked at the legitimization process of Indian companies in foreign markets (Pant and Ramachandran, 2012).

From the domestic country perspective, there are good grounds for believing that legitimacy generated in emerging markets will influence the tradeoffs between domestic and overseas investments. This has implications at a macroeconomic level as companies need to choose whether they will invest within their country or engage in outward investment (Gubbi et al., 2010). Hence, it is important to examine the returns that these companies derive abroad vis-à-vis their domestic investments.

Our paper focuses on the following unanswered questions: Do Indian firms accrue value for their shareholders if they internationalize after the legitimation process? Do these returns hold over a period of time, i.e., is there a degree of persistence in the legitimacy-generated abnormal value or is it mainly driven by euphoria in financial markets? The legitimacy that we discuss in this paper is not grounded in firms but rather is *in the air*. Legitimacy is created in the global business environment and Indian companies leverage it. However such cognitive legitimacy brought about overoptimism, or euphoria, in financial markets and, like fragrance, it fades away after initial exuberance as Indian companies are unable to leverage it anymore.

We contribute to the narrative on organizational legitimacy and internationalization in two ways. First, our study shows that legitimacy created in the global business environment can impel organizations from EM to create value for their shareholders via cross-border acquisitions. Second, we use the euphoria effect to explain the temporal limitations on the leverage of legitimacy in these cross-border acquisitions.

Cross-border and domestic acquisitions by Indian companies form the empirical context of our study. In their internationalization process, Indian companies traditionally entered foreign markets through greenfield investments. However, a growing number of Indian companies alter their mode of entry into foreign markets, now adopting inorganic growth through overseas acquisitions (Gubbi et al., 2010; Hattari and Rajan, 2010; Kumar, 2008).[1] We use the time period 1999–2009 to undertake our empirical analysis. This period has seen a built-up of internationalization process by Indian firms. As seen on Fig. 1 (Panel A), the number and value of cross-border acquisitions have grown considerably since 2000. Half way through the period, a Goldman Sachs report (Goldman Sachs, 2003) was published, which we argue creates a window of opportunity through legitimacy for Indian firms in their overseas acquisitions. The fact that this report acted as a legitimacy-building event for Indian companies is justified by the literature, both academic and professional (Armijo, 2007; Bloomberg, 2003; Hult, 2009; Wansleben, 2013), and motivated by informal discussions with Indian businesses.[2] Fig. 1 (Panel B) shows the surge in cross-border deal announcements – and value – right after the publication of the report in October 2003. Thus, our choice of country and time window provides an excellent setting to investigate our hypotheses. While the contribution of this paper will be specific to the particular context of Indian companies, it represents a progression towards a better understanding of the process by which EM firms are able to overcome the liability of foreignness in international markets and how legitimacy that is grounded in the external environment generates positive effects for companies only in period of euphoria.

In the next section of the paper we formally develop our hypotheses using theory and empirical evidence on legitimacy and euphoria and follow it with details on data and methodology. Results of our analysis are presented in the subsequent part, and finally, we conclude with discussion of our results and avenues for future research.

2. Theory and hypotheses

In this paper, we focus on a legitimacy-creating event at the country-level and see how its impact trickles down to firm-level. This is consistent with the institutional approach of organizational legitimacy, i.e., the existence of an exogenous legitimacy-building event that can affect how people understand and evaluate organizations (Suchman, 1995). The idea is that Indian companies are able to gain credibility and comprehensibility in the global environment, in line with the cognitive definition of legitimacy (Palazzo and Scherer, 2006; Suchman, 1995). Pant and Ramachandran (2012) also argue that Indian firms are able to achieve cognitive legitimacy in their cross-border operations through what they call *empirical credibility*. Focusing on the software services industry, they show that empirical credibility was enhanced by the industry's focus on "compilation and dissemination of extensive statistics on software services firms that enabled stakeholders to develop credible images of the Indian software industry". Moreover, they emphasize the importance of industry studies published by consulting firms such as McKinsey and Boston Consulting Group that have substantial referent power in the host country's institutional environment.

[1] The number of foreign acquisitions by Indian companies has risen from only three in 1992 to 2,195 in 2001 UNCTAD (2011).

[2] Between January 2009 and December 2013, we conducted several interviews with stakeholders of two Indian companies, as well as one acquisitions consultant in India. Both companies had limited foreign investment activity before 2003, and there was an overall consensus among respondents that the Goldman Sachs report had a great impact on the perception of Indian companies in foreign markets, and hence the firms' cross-border investment strategy.