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Financial sector diversification and MNC valuation

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ABSTRACT

We extend the literature on MNC performance by examining the relationship between market valuation of MNCs and intangibles associated with financial expertise. We identify firms as having financial expertise if they have diversified their business in the financial sector. We argue that financial expertise enhances the ability of MNCs to internalize financial transactions and take advantage of financing and investment opportunities around the world. Therefore, it is a potentially significant source of market power. Our test results demonstrate that as the degree of multinationality increases market valuation is positively related with financial expertise even after we account for several other control factors. Our findings imply that MNCs with financial expertise can be viewed as possessing an additional intangible, which essentially is the financial equivalent of the traditionally examined intangible assets, such as technological "know-how," goodwill, and managerial expertise.

1. Introduction

Internalization theory implies that geographic diversification is valuable when the benefits from the creation of intra-firm markets for the transfer of firm-specific intangible assets related advantages across borders, that bypass incomplete or non-existent external markets, exceed the organizational and agency costs associated with doing business in foreign countries. In support of this notion, Morck and Yeung (1991), followed by many others, found that intangibles associated with consumer goodwill

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and technical expertise increase the value of multinational firms (Morck and Yeung, 1992; Allen and Pantzalis, 1996; Pantzalis, 2001). Others (Buckley and Casson, 1998; Kogut and Zander, 1993) have argued that MNCs derive benefits from operating a geographically dispersed network of subsidiaries that enable them to absorb shocks and take advantage of growth opportunities not available to their local competitors in foreign countries. These networks provide MNCs with operating flexibility and are sources for an array of valuable real options (Pantzalis, 2001). An important part of the MNC network of operations is the internal financial market that links financing, investment, and risk management activities of the different affiliates. These internal financial markets span several geographic, business, and currency areas and provides MNCs with numerous advantages and strategic options (Desai et al., 2004). The ability of MNCs to internalize financial transactions and take advantage of financing and investment opportunities is a potentially significant source of market power. In essence, expertise in operating an internal capital market in an efficient manner and taking advantage of financial arbitrage across borders can be viewed as the financial intangible equivalent of technological “know-how,” goodwill, and managerial expertise.

Many of the prior studies examining the sources of MNC market power have focused on the traditional intangibles associated with technological “know-how,” marketing, and managerial expertise. To the best of our knowledge, there is no study thus far that empirically examines whether intangibles associated with financial expertise result in higher valuations for MNCs. In this study, we proxy financial expertise intangibles by an indicator variable that takes the value of one if the firm reports a business segment in the 6000 SIC range (i.e., in the financial industries domain). While it may be an imperfect measure of intangibles associated with internal capital markets and firms’ ability to conduct financial arbitrage across borders, we believe that this variable is appropriate. It largely captures a firm’s foray in the financial sector implying a higher probability that the firm possesses the expertise needed to run an internal capital market efficiently. Additionally, reporting a business segment in the financial services sector is also indicative of a greater likelihood that the firm has the ability to interact with financial markets, bypass capital market segmentation, and monitor for financial arbitrage opportunities.

The value of internal capital markets to MNCs depends upon how efficiently capital is allocated. Agency issues often arise in internal capital markets that distort the allocation (Scharfstein and Stein, 2000). Whether the “dark side” of internal capital markets prevails over the aforementioned advantages from operating a financial affiliate within a MNC is an empirical question. We argue that the ability of management to overcome the agency issues and efficiently allocate funds across the firm is a valuable intangible asset for MNCs. Having financial affiliates (our financial expertise proxy) result in a net benefit in the case of MNCs as the potential opportunities that arise within an internal capital market spanning several geographic and business areas outweighs the associated costs. Thus, we hypothesize that MNCs with financial subsidiaries should be better able to overcome the “dark side” of internal capital markets, take advantage of arbitrage opportunities by internalizing incomplete financial markets, and, consequently, display better performance on a cross-sectional basis.

Our investigation extends the literature by examining the relationship between intangibles associated with financial expertise and market valuation of MNCs. We find that, on average, in the absence of financial sector diversification, the market values (proxied by Tobin’s q, hereafter Q) of domestic firms are significantly higher than those of MNCs. However, among firms with financial expertise, the mean Q of MNCs is significantly greater than that of domestic firms. Our multivariate tests reveal that Q is positively related with financial expertise even after we account for several other factors that are associated with Q. The results are consistent with the notion that financial expertise is an important intangible asset and a source of monopolistic power for U.S. MNCs. Our findings imply that MNCs that report operations in the financial services sector possess the ability to overcome internal capital market agency issues and create value as this intangible asset is leveraged across foreign markets.

2. Financial sector diversification and MNC intangibles

The ability of internal capital markets to efficiently allocate funds across divisions of diversified firms has received considerable attention in the literature. Early studies (Williamson, 1975; Myers and Majluf, 1984; Shleifer and Vishny, 1992) argued that diversified firms create internal capital markets