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Does internationalization make a difference? Stock market reaction to announcements of international top executive appointments

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ABSTRACT

In recent years, there has been an increasing scholarly and practical interest in the internationalization of top management teams. It is argued that international firms need international top managers to meet the challenges arising from operating across borders. However, the few existing studies that focus on the link between top managers' internationalization and firm performance yield inconclusive results. Thus, it is an open question if and to what extent international firms can benefit from international top managers. Drawing on upper-echelons theory, resource-dependence theory, and signaling theory, this paper examines how the stock market reacts to the appointment of an international top manager. Our empirical study of German firms employs an event study to analyze the direct impact of internationalization on a firm's stock price. Piecewise regression analysis reveals that a top manager's internationalization needs to exceed a certain threshold before investors incorporate this individual characteristic into their investment decisions. Furthermore, our analysis shows an inverted U-shaped relationship between internationalization and abnormal returns, suggesting that internationalization may have both positive and negative effects on a firm's stock price. We present several explanations for our empirical findings and discuss future research directions.

1. Introduction

A firm's competitiveness is affected by its ability to anticipate and respond to internal and external opportunities and to pressures for change (Nielsen, 2009). In particular, this argument applies to multinational enterprises (MNEs). These firms are regularly confronted with complex environments (Adler & Gundersen, 2008; Cuervo-Cazurra, Maloney, & Manrakhan, 2007). For example, MNEs must address the differing needs of foreign customers and suppliers, reduce uncertainty regarding local legal systems, and bridge knowledge gaps related to foreign management styles (Greve, Nielsen, & Ruigrok, 2009; Oxelheim & Randøy, 2005). In this context, scholars claim that MNEs increasingly need top managers who understand global markets and diverse business practices and who are aware of opportunities to compete on an international level (Finkelstein, Hambrick, & Cannella, 2009; Luo, 2005).

The composition of a firm's top management team (TMT) is one of the most important governance issues – not only for scholars but also for managers. Institutional investors and private shareholders strongly defend their arguments for governance reforms and increase the pressure on firms to search for TMT members with differing backgrounds and expertise (Carter, Simkins, & Simpson, 2003; Dalton, Daily, Ellstrand, & Johnson, 1998; Grosvold, Brammer, & Rayton, 2007). These claims are accompanied by political efforts to intensify internationalization among top managers. For example, the U.S. Securities and Exchange Commission denounces the lack of diversity in boards of U.S. firms (Aguilar, 2010), the UK Corporate Governance Code proposes that board appointments should be made "with due regard for the benefits of diversity" (Financial Reporting Council, 2010), and the German Corporate Governance Code recommends that firms' international activities should be reflected by an international composition of the management board and the supervisory board (Lutter, 2009a).

Although existing literature acknowledges the increasing importance of having one or more international top managers on the TMT (Carpenter, Sanders, & Gregersen, 2000; Nielsen, 2010b; Ruigrok, Peck, & Tacheva, 2007; Santen & Donker, 2009), it remains unclear if and how firms can actually benefit from international top managers. Studies that investigate the relationship between international top managers and firm performance mostly examine the influences of individual characteristics (such as age, gender, or functional background) on different (and frequently lagged) financial indicators, such as

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Tobin's Q,[2] market-to-book value, and return on assets (for reviews, see Carpenter, Geletkanycz, & Sanders, 2004; Dauth, 2012; Finkelstein et al., 2009). The question of how shareholders and ultimately stock prices react to the appointment of an international top manager remains unanswered. Moreover, existing research dealing with international top managers is mostly based on U.S. samples (Hambrick, 2007; Sambharya, 1996; Tacheva, 2007). Therefore, it is arguable whether the findings of these studies are valid and transferable to firms headquartered in countries with different corporate governance systems.

In the present paper, we ask one central research question: How does the appointment of an international top manager affect the stock price of an MNE? By addressing this question, we contribute to IB literature and TMT research in several ways. First, our paper provides theoretical reasoning for the relationship between top managers' internationalization and firm performance by combining upper-echelons theory, resource-dependence theory, and signaling theory. We move beyond a mere replication of existing studies that state "top managers do matter" (Carpenter et al., 2004, p. 770) since we integrate the three theoretical strands. This contribution enables us to derive refined hypotheses that argue *how* international top managers influence firm-level outcomes. Second, our research presumes that the relationship between the appointment of an international top executive and firm performance is more complex than previous models have suggested. Thus, we extend prior analyses and go beyond simple linear effects by investigating curvilinear and moderated relationships. In the process, we are able to reconcile existing inconclusive findings by demonstrating that there are specific relationships between top managers' internationalization and stock returns depending on the level of top managers' internationalization. Third, unlike most other work in the field, we use event-study methodology, which is increasingly being employed in strategy and international business research (Lubatkin & Shrieves, 1986; McWilliams & Siegel, 1997). This methodology helps us to investigate the direct effect of an international top manager's appointment on a firm-specific performance measure (its stock price). Fourth, we provide a new perspective on the impact of top managers' internationalization by investigating a sample of MNEs headquartered in one of the most international coordinated market economies (CMEs), namely, that of Germany.

In accordance with existing literature we expect that top managers' internationalization is a highly relevant subject for German firms (Adler & Gundersen, 2008; Magnusson & Boggs, 2006; Schmid & Dauth, 2012). Recent years have shown important economic, legal, and social changes in Germany (Bathelt & Gertler, 2005), leading to a more transparent corporate governance structure that enables firms to gain access to international financial markets (Chizema, 2010; Chizema & Buck, 2006). Oxelheim and Randøy (2003) argue that appointing international top executives can help firms to further improve corporate monitoring and transparency standards. These steps may attract new foreign investors and thus increase firm value. To test this presumption, we investigate the abnormal stock returns that can be observed when international top managers are appointed to the TMTs of German MNEs.

2. Theory and literature review

2.1. Top managers do matter – an upper-echelons perspective

During the last decades, business literature has witnessed increasing interest in top managers. For many scholars, a central trigger was the 1984 publication of Hambrick and Mason's work, "Upper Echelons: The Organization as a Reflection of Its Top Managers". The authors present a theory in which top managers play a pivotal role in shaping organizational outcomes (Carpenter et al., 2004; Hambrick & Mason, 1984; Loane, Bell, & McNoughton, 2007). As Hambrick (2007, p. 334) states: "If we want to understand why organizations do the things they do, or why they perform the way they do, we must consider the biases and dispositions of their most powerful actors – their top executives".

At its core, upper-echelons theory is based on the assumption of bounded rationality (Aharoni, Tihanyi, & Connelly, 2011; Cyert & March, 1963; March & Simon, 1958). The underlying concept hypothesizes that complex and uncertain situations are not objectively knowable but, rather, only interpretable (Carpenter et al., 2004). Consequently, top managers base their actions on their individual perceptions of the situations they face. According to upper-echelons theory, these interpretations are influenced by managers' experiences, values, and personalities (Hambrick, 2007).

Early upper-echelons research investigated the effects of TMT diversity in managers' characteristics (e.g., age, education, functional track, and other career experiences) on several organizational outcomes, such as the firm's competitive behavior (Hambrick, Cho, & Chen, 1996; Nielsen, 2010a). In a conceptual paper, Carpenter et al. (2000) argue that top managers' internationalization can also have a positive impact on the financial performance of a firm. According to their view, shareholders will benefit from the appointment of international TMT members. This finding has been reinforced empirically: for example, Carpenter, Sanders, and Gregersen (2001) and Daily, Certo, and Dalton (2000) confirmed that U.S. Fortune 500 firms headed by international CEOs realize better financial performance than firms whose CEOs have limited or no experience on an international level. In addition to the potential financial impact of international top managers, executives' internationalization can determine their preferences for certain strategic actions (Caligiuri, Lazarova, & Zehetbauer, 2004; Geletkanycz, 1997; Tihanyi, Ellstrand, Daily, & Dalton, 2000). Herrmann and Datta (2006) discovered that top managers with an international background are inclined to favor foreign direct investments as their degree of perceived risk associated with foreign expansion is lower compared to that of managers with different backgrounds and experiences. In this context, Berry (2006) states that shareholders may value a firm's international investment positively if the firm is perceived to have international top managers who possess the skills and expertise to effectively manage foreign operations.

Although upper-echelons theory provides a well-accepted framework to explore the consequences of top managers' internationalization (Carpenter et al., 2004), critics argue that the upper-echelons perspective alone cannot serve as a solid theoretical basis for investigating any linkage between managers' characteristics and firm-level outcomes (McIntyre, Murphy, & Mitchell, 2007; Pettigrew, 1992). In other words, while upper-echelons theory postulates that top managers and their characteristics *do matter* (Carpenter et al., 2004; Nadkarni & Herrmann, 2010), it does not fully explain *how* those characteristics relate to a firm's performance (Nielsen, 2010a; Pettigrew, 1992). To shed more light on the influence of top managers' characteristics, this study combines the upper-echelons perspective with resource-dependence theory. Resource-dependence theory elaborates on the specific functions of top managers within a firm, enabling scholars to develop research designs that test whether international top managers can better fulfill these functions and to illustrate *how* they add value to the firm (Hillmann, Withers, & Collins, 2009; Johnson, Ellstrand, & Daily, 1996; Pfeffer & Salancik, 1978).

[2] Tobin's Q denotes the ratio of the market value of firm assets to their replacement cost (Tobin, 1969).