



How firm internationalization is recognized by outsiders: The response of financial analysts

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ABSTRACT

Although prior research has studied the strategic value of internationalization for firm performance, how such value is recognized and assessed by outsiders such as analysts is less well understood. Analysts' recommendations can serve as a reasonable proxy for the external response of internationalization strategy. In this study, we investigate how analysts evaluate the strategy of firm internationalization and interpret the value of internationalization in their reports. In the analyses of 326 large publicly traded firms over a 13-year period, we hypothesize and find support for the view that firm internationalization shares a curvilinear relationship with analysts' recommendations, as well as the moderating role of industry uncertainty and competition. Overall, this study contributes to the literature by investigating how financial analysts respond to a firm's internationalization strategy.

1. Introduction

The strategic value of internationalization for firm performance has received considerable scholarly attention (Kotabe, Srinivasan, & Aulakh, 2002). It is regarded as a research topic of paramount importance that dictates firms' ongoing development and future returns (Goerzen & Beamish, 2003; Melin, 1992). A significant number of previous studies have analyzed the influence of internationalization on corporate financial performance (e.g., Hitt, Tihanyi, Miller, & Connelly, 2006; Lu & Beamish, 2001). Due to market imperfection, firms adopt international strategies to capitalize on unique capabilities or monopolistic advantages in foreign countries (Hymer, 1976; Jonsson & Foss, 2011). Internationalization also endows firms with better access to cheap raw materials, skilled labor, capital markets, and advanced technology (Collis, 1991). Hence, many studies suggest that internationalization makes a positive contribution to firm performance (Collis, 1991; Jonsson & Foss, 2011; Kogut, 1985; Patel, Fernhaber, McDougall-Covin, & van der Have, 2014).

Meanwhile, internationalization is complex and entails risks and costs, which might offset its advantages and damage a firm's future returns (Geringer, Tallman, & Olsen, 2000). Owing to environmental complexities and cultural differences, firms may lack sufficient managerial capacity to cope with the risk of miscommunication and trust, which engenders high transaction costs (Geringer et al., 2000). Firms operating in diversified countries will also encounter political

uncertainty and exchange-rate fluctuations, which may offset their monopolistic advantages (Reeb, Kwok, & Baek, 1998). International expansion is thus regarded as detrimental to firm performance (Ruigrok & Wagner, 2003).

Given that firm internationalization is a continuous process of adapting firm operations (strategy, structure, or resources) to international environments (Calof & Beamish, 1995; Prange & Verdier, 2011; Zhou & Wu, 2014), more studies find that the effect of international expansion on firm performance may not be monotonic. The nonlinear relationship between internationalization and performance indicates that firms might overexpand internationally beyond a desirable optimum level (Sullivan, 1994). Two or three stages on the performance versus internationalization graph have been discussed and analyzed (Contractor, Kumar, & Kundu, 2007; Lu & Beamish, 2004). For example, Hitt, Hoskisson, and Kim (1997) propose that firm internationalization shares an inverted-U relationship with performance. Firms can enjoy the benefit of initial internationalization, whereas overexpanded internationalization will incur greater costs and lead to decreased financial outcomes for firms (Gomes & Ramaswamy, 1999).

Previous studies contain extensive discussion on the internal link between internationalization and performance. Despite these efforts, there remain ongoing debates and controversial arguments regarding how the strategic value of internationalization might be recognized and assessed by firm outsiders (Chari, Devaraj, & David, 2007). Since firm internationalization is an important strategy, outsiders such as investors

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and analysts may also pay great attention to its quality and value. Accordingly, there is a high need to investigate the external response of firm internationalization and to gain a better understanding of its underlying relationship.

In this study, we introduce analysts' recommendations as a reasonable proxy for the external understanding of internationalization strategy. Due to information asymmetries, it is difficult for firm outsiders to obtain complete information and assess a firm's financial performance (D'Aveni & Macmillan, 1990; Schmid & Dauth, 2014). In particular, internationalization information is too intricate to be directly understood and priced by general investors who are not certified experts and who are thus often constrained by time and resources. Considering the uncertain and ambiguous internationalization information for general investors, analysts may serve as external professionals, engaged as they are in interpreting the quality of an internationalization strategy and its potential contribution to firm stock returns.

Meanwhile, stock analysts are certified industry experts (Howe, Unlu, & Yan, 2009; Womack, 1996) who identify and analyze valuable information about the firm and provide recommendations for investors (Chen & Matsumoto, 2006). It is widely acknowledged that stock analysts play a crucial role in financial markets because their recommendations provide influential assessments of firm profitability (Luo, Homburg, & Wieseke, 2010). Unlike those well-used market-based performance indices such as Tobin's Q and ROA, analysts' recommendations provide forward-looking information and insights for investors. Analysts' recommendations can thus be regarded as a reasonable indicator for the external recognition of the internationalization strategy. Analysts are also important because their evaluations significantly affect investors' decisions and firm stock performance (Nagy & Obenberger, 1994; Womack, 1996). Analysts' recommendations may even impact the board's decisions. Research has found that, among other effects, negative stock recommendations result in a higher probability of CEO dismissal (Wiersema & Zhang, 2011). Therefore, the role of analysts is evident, and their recommendations may serve as a representative of outsiders' responses.

If internationalization is indeed an important strategy for publicly traded firms, it should have a considerable influence on analysts' recommendations. Financial analysts may be interested in the level of internationalization and find the threshold point to see how the firm performance effects may be anticipated (Contractor et al., 2007). In other words, security analysts heed firm internationalization information and factor it into their recommendations. Therefore, placing the spotlight on analysts' recommendations helps us to understand the attitude of firm internationalization from the perspective of outsiders.

In this study, we aim to investigate how analysts respond to the information of firm internationalization and how they interpret the value of internationalization for a firm's future returns. By addressing this research question, we present the theoretical background of the study and develop our hypotheses in the next section. Furthermore, because firm internationalization is a complex, dynamic process that may be affected considerably by peer competitors, we also examine the moderating effects of industry uncertainty and competition. In the analyses of 326 large firms over a 13-year period, we quantify that firm internationalization shares an inverted-U relationship with analysts' recommendations. Finally, our paper concludes with a discussion and outline of the limitations of the study.

2. Theoretical background and hypotheses

2.1. The role of analysts in firm internationalization

Financial analysts are information intermediaries who reduce information asymmetries between firms and investors (Luo et al., 2010; Womack, 1996). Such professionals mainly focus on evaluating the financial implications of corporate activities. Based on firm- and

industry-related information, analysts regularly publish reports that contain predictions, such as earnings-per-share forecasts and target stock prices. Accordingly, stock recommendation is a forward-looking measure of firm performance from the perspective of professional analysts.

Analysts generally issue five levels of recommendations (strong buy, buy, hold, sell, strong sell) about stocks regarding whether a given stock is worth buying or selling (Bradshaw, 2004; Ivkovic & Jegadeesh, 2004). When investors trade based on recommendations, stock prices and trading volumes will fluctuate sequentially (Bjerring, Lakonishok, & Vermaelen, 1983). Prior research has addressed the significant influence of analyst recommendations on firm stock values (Womack, 1996). Many studies have found that analysts' buy recommendations have a positive effect on firm valuation with positive abnormal returns on stock values and that there are negative abnormal returns around sell recommendations. For example, Davies and Canes (1978) investigate buy and sell recommendations from the "Heard on the Street" column in *The Wall Street Journal* from 1970 and 1971. They observe the positive abnormal returns associated with buy recommendations. Using 16,957 analyst recommendations for 1988–1991, Stickel (1995) finds that the "buy" recommendations lead to an average 1.16% increase in firm stock value whereas the "sell" recommendations lead to an average 1.28% decrease in firm value.

In our study, analysts adopt the role of representing outsiders to recognize and value firm internationalization. First, given the professional expertise of analysts, they have the capability of assessing the value and relevance of firm internationalization. Apart from financial information, many studies suggest that key non-financial information, such as internationalization strategy and company trends, are also important information that analysts will address in their earnings forecasts and recommendations (Orens & Lybaert, 2007; Vanstraelen, Zarzeski, & Robb, 2003). Prior research further shows a high awareness among security analysts of the relevance of firms' international operations, along with investors' attention to analysts' coverage of firm internationalization. A content analysis of 1126 analyst reports for 1997–1999 reveals that 19.5% of those with a "Strong Buy" recommendation contain "positive international operations," while 33.3% of those with a "Sell" recommendation contain "negative international operations" (Asquitha, Mikhail, & Au, 2005). With the increasing importance of firm internationalization, an increasing number of analysts are taking such information into account when furnishing recommendations.

Analysts may encounter higher uncertainty in their earnings forecasts when they fail to fully appreciate the value of a firm's international expansion. Hence, information on internationalization, such as international operation and geographic segment disclosure, is very useful and relevant for analysts (Hope, Kang, Thomas, & Vasvari, 2009). Duru and Reeb (2002:418) suggest that "income from non-U.S. operations could still be more difficult to predict if analysts' unfamiliarity with the international operations prevents them from appreciating this persistence." Fortunately, as one of the most important business strategies that will affect financial outcomes, firm internationalization is now tracked in most financial data service providers' databases, which also provide profound indicators and models that help analysts perceive the value of corporate information. Therefore, analysts pay attention to firm internationalization and have the capability of assessing its value from the perspective of outsiders.

Second, the importance of analysts' recommendations does not indicate that analysts' activities substantially generate value for a firm.¹ Analysts' recommendations mainly serve as a proxy for the external assessment of internationalization and may possibly affect the performance of a firm's stock. Prior research suggests significant market reaction to revisions in analysts' earnings forecasts and recommendations

¹ We acknowledge the review team for suggesting this insight.

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