

Risk and wealth effects of U.S. firm joint venture activity

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Abstract

Using a sample of US firms engaged in joint venture activity primarily in the 1990s, we test the hypothesis that joint venture activity is motivated by a desire for efficient risk sharing. We find that approximately ninety-six percent of our sample experiences a risk change in response to joint venture activity. A significant proportion of these experience a reduction in beta. No market price response is evident in conjunction with this reduction. In addition, the average parent firm experiences a significant increase in firm risk, which we attribute to taking on the risky joint venture. This increase in risk is particularly pronounced for firms engaged in international joint ventures and is accompanied by a positive market response. Investment stake, pre-venture firm profitability, size and private risk increasing characteristics appear to influence the wealth character of the joint venture. We interpret that there may be a positive market premium for international diversification effects and/or for the flexibility that the real option joint venture opportunity provides.

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1. Introduction

Joint ventures are corporate combinations that involve capital investment and financial structure decision-making on the part of the participating firms. [McConnell and Nantell \(1985\)](#) differentiate joint

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ventures from other types of corporate combinations by defining joint ventures as events that join together the resources of two or more companies to accomplish some objective under the combined management of the parent companies, with the original parent companies' management remaining intact.¹ For example, in November of 1996, AlliedSignal Inc, Knorr-Bremse Ag, and Fenghua Automotive Air Compressor Factory formed a joint venture to manufacture air compressors in China. In March of 1989, Johnson and Johnson and Merck and Co, Inc., entered into a 50/50 joint venture to develop and market new over-the-counter medicines in the U.S.

Ample literature suggests various motivations that might exist for joint venture activity. Many of the motivations suggested in the literature are related to synergistic benefits. As is discussed by [McConnell and Nantell \(1985\)](#), synergies can arise through acquisition of human or financial capital, horizontal or vertical integration, R&D efforts for new products or processes, and exploitation of existing products or licensed processes, among others.²

[Johnson and Houston \(2000\)](#) discuss yet another motivation for joint venture activity, that of efficient risk sharing. The authors explore the risk sharing motive as it relates to vertical joint ventures only, and suggest that joint ventures might allow suppliers to share risks with buyers, in that, "joint ventures reduce the size of the investment a supplier makes to fill an order, which puts less of its resources at risk and allows it to invest in a greater number of projects for a given amount of capital." The authors' measure of risk is the volatility of operating income, scaled by asset size.

We extend the analysis of the risk sharing motivation for joint ventures. Specifically, we investigate whether firms engaged in joint venture activity experience any changes in risk (either systematic or private), what the nature of these risk changes might be, and how the market reacts to these changes. Our paper provides a significant contribution to the literature, as it is the first of its kind to thoroughly address and test the risk sharing motive for joint ventures. We evaluate changes in both systematic risk and private risk, with the notion that the market might very well react differently to changes in different types of risk. Theory is our guide here. The capital asset pricing model (CAPM) suggests that the market will reward investors for taking on systematic risk only, but option pricing theory suggests otherwise. Option pricing theory suggests that the market will reward investors for taking on private risk (or total variability), as well.³

We also recognize that diversification is a possible side effect of risk sharing and that size plays an important role. We hypothesize that the larger the parent firm, and the larger the relative size of the joint venture to the parent firm, and the larger the percentage investment by the parent firm, the greater the impact of the joint venture announcement on the parent firm's stock price. We also assert that if the size of the joint venture relative to the size of the parent firm is large, and if the nature and/or location (domestic versus international) of its business activity is distinct, then the by-product of the joint venture will be diversification for the parent firm. This diversification may produce a positive or negative wealth effect. According to [Lins and Servaes \(1999\)](#), possible benefits of diversification at the firm level include the creation of internal capital markets void of information asymmetries, the improved ability to take advantage of the tax benefits of debt financing, and economies of scope. For

¹ See [Glaister and Tatoglu \(1997\)](#) for a review of differing definitions of joint venture activity.

² See also [Asquith, Brunner, and Mullins \(1983\)](#), [McConnell and Nantell \(1985\)](#), [Denis and McConnell \(1986\)](#), [Root \(1988\)](#), [Hennart \(1988\)](#), [Berkovitch and Narayann \(1993\)](#), [Balakrishnan and Koza \(1993\)](#), [Gomes-Casseres \(1996\)](#), [Allen and Philips \(2000\)](#), and [Chen \(2000\)](#).

³ See [Pape and Schmidt-Tank \(2004\)](#) for an elaboration of option pricing methodologies to value joint ventures.

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