Applied theory on geographical diversification economics essay

Economics

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Geographic diversification was defined as an expansion of a firm beyond its border. Capar and Kotabe (2003, p. 345) believed that geographic diversification was a kind of an expansion of a company " beyond the borders of its home country across different geographical regions and countries". They also claimed that many people often interchangeably usedthe terms, international diversification, multi-nationality, and international diversity, in the geographic diversification literature (Capar and Kotabe, 2003). According to Qian (1997), international market diversification referred to companies which are integrated horizontally or vertically across different national sub-markets. In the geographic diversification literature, the consensus point of view that exploitation of market imperfections wasthe main reason for geographic expansion (Rugman, 1979) has led to extensive empirical testing of the linear and positive relationship between geographic diversification and company performance. These researches have created different results about the influences of diversification of geography and the results have been inconclusive and contradictory (Geringer, Tallman and Olsen, 2000). Some empirical evidence (Annvarajula, Beldona and Sadrieh, 2005) showed a positive linear effect and supported a positive relationship between geographic diversification and company performance. Errunza and Senbet (1984), using multinational enterprises only, found some evidence to support that there is a positive relation between excess company value and the company’s extent of geographic diversity. Focusing on international acquisitions, Doukas (1995) documented the fact that US bidders gain from international diversification. Similarly, Morck and Yeung (1991) found a positive relation between international diversification and company value.

Others confirmed a negative relationship (Michel and Shaked, 1986). More recently, taking into account the transaction and coordination costs involved in internationalization, some multinational researchers advanced the possibility of a curvilinear relationship between geographic diversification and company performance. Capar and Kotabe (2003) suggested an inverted-U relationship between the extent of geographic spread and company performance, while othersproposed a U-shaped curve between the two (Lu and Beamish, 2001). There was even an S-curve hypothesis advanced to reconcile the alternative explanations (Lu and Beamish, 2004). Kumar (1984)as well as Yoshihara (1985) even found no significant relationship between the extent of geographic spread and company performance. The inconsistencies in reported findings may be attributed to differences in sampling, methodologies, measures of geographic diversification and company performance, and the analytical methods used. An inverted U-shaped effect is usually shown in researches that relied on large, well-internationalized firms, on the other hand, a U-shaped effect is frequently found in researches of small and medium-sized companies (Lu and Beamish, 2004).

Impacts of Geographical Diversification on Company Performance

Over the last decade, some geographic diversification literatures have investigated how companies undertake global presence. Reasons for the existence of the multinational firm are concluded and summarized by Ethier and Markusen (1996) as location, ownership, and internalization advantages. All of the three factors are related to geographic diversification strategy, with

the location rationale being the most relevant (Ethier and Markusen, 1996). Multinational companies have a number of advantages from geographic diversification. For example, Buhner (1987) claimed that geographic diversification creates prospective market opportunities, which offers company the opportunity for greater growth. Kim, Hwang, and Burgers (1989) and Qian (1997) argued that an increased geographic scope of business could increase the ability of a company to co-ordinate or share its international activities. These benefits contain economies of scale, scope, and experience. In addition, Qian (1997) pointed out that diversification across geographic boundaries are supposed to improve a company's risk-return opportunities. He also argued that although international investment may be more risky than a similar investment in a home country, the risk of international activities in total may be lower than the risk of domestic investment (Qian, 1997). Thus, companies that are more heavily engaged in foreign activities may have a more stable stream of profits than corresponding companies that are not internationally diversified (Qian, 1997). According to the Resource-Based View of multinational enterprises, geographic expansion by investing internationally could help a company to protect themselves from compromise while better exploiting its profitable capabilities (Buckley, 1988). Researchers that supporting a learning perspective argue that geographic expansion through establishing foreign subsidiaries can improve a company's capabilities, knowledge base, and competitiveness (Zahra, Ireland and Hitt, 2000). Therefore, Kim, Hwang, and Burgers (1989) argued that the more multinational a company is, the more its possibility to manage strategic resources and develop by experiential

learning, which could improve company performance. Ramaswamy (1993) also stated that interactions between different measures of geographical diversification had more important effects on multinational enterprises' performance. It is widely believed that diversification across regions incurs much higher costs than diversification across countries within a region (Ramaswamy, 1993). Given the need for most companies to expand markets overseas in Asia, the concept of geographic diversification might be more important. Hitt, Hoskisson, and Kim (1997) classified companies that are integrated vertically or horizontally across different national markets as companies with international market diversification and suggested that companies usually become internationalized in a step-by-step process and in this process, investment opportunities in the least psychically distant foreign locations are developed first. Geographical diversification could improve company performance by reducing the risk of economic downturn in the home market, increasing sales in foreign markets, lowering costs through economies of scale in manufacturing, researching, developing, marketing and distribution system (Sarathy, Terpstra and Russow, 2006). Doukas and Lang (2003) examined whether the benefits of internalization arise from the geographic diversification of non-core or core of the company by addressing the long-term and short-term influences of direct international and corporate diversification of American companies. Afterwards, they concluded that geographic expansion of the core business is good for shareholder value. Doukas and Lang (2003) also examined whether the activities of international corporate diversification itself reduces shareholder value. Furthermore, they found that geographic expansion of the company's non-

core business harms company value and performance. Martin and Sayrak (2003) discovered three waves of research during the 1990s, categorized by methodological refinements that provide a basic shift in the evidence. At first, some research supported the hypothesis of diversification discount (Berger and Ofek, 1995). This research found that the heavy operational costs as the firms expand is the reason for the reduction of company value. These costs contain incentive degradation, coordination costs and bureaucratic distortions (Nayyar, 1992). Besides, top managers of highly diversified companies may find it quite expensive and difficult to appropriately control different kinds of business operations (Jones and Hill, 1988). More recently, Click and Harrison (2000) found that multinational enterprises run their business at a discount compared to domestic firms. Denis, Denis, and Yost (2002), based on aggregate data and value measure from the Berger and Ofek (1995), showed that international diversification destroys shareholder value by 18%. However, Martin and Sayrak (2003) went on to point out that the subsequent research argued that the factors other than diversification contributed to value destruction. A main premise for some of these researches is that focused companies are different from conglomerate companies even before diversification procedures are applied and that this factor is not explained clearly in the earlier analyses (Graham, Lemmon and Wolf, 2002).

Empirical evidence on geographic diversification

3. 1 Real estate Investors

Geographic diversification was viewed as an important portfolio strategy by many real estate investors. In an early survey that related to the investment

practice of real estate investment trusts, Webb and McIntosh (1986) documented that over 90 percent of the real estate investment trusts considered diversifying the geographic locations of properties as the most common method of diversification among investors who attempt to diversify their holdings. In a more recent survey among pension fund real estate holdings, Worzala and Bajtesmit (1997) reported that 73 percent of the managers consider geographic diversification at the regional levels, and 23. 9 percent of these managers consider diversification at the metropolitan area level in their asset allocation process. While the evidence seems compelling that investors make efforts to diversify across geographic locations, their choices seem to be limited to a few so-called core locations (Worzala and Bajtesmit, 1997). Shilton and Stainley (1995) researched the National Council of Real Estate Investment Fiduciaries property database and found that institutional real estate investments are highly focused on metropolitan areas and large counties. Their findings showed that approximately 30 percent of the National Council of Real Estate Investment Fiduciaries properties are located in the seven largest counties, 45 percent in the largest fifteen counties, and roughly 60 percent of all investments are in the largest thirty counties, which represent twenty-six distinct metropolitan areas (Shilton and Stainley, 1995). Given there are more than 3, 000 counties and over 320 metropolitan areas inAmerica, such high concentration of institutional real estate holdings raises questions thatrelated to the appropriateness and effectiveness of institutional investment strategies (Wit, 2010). Moreover, Wit (2010) argued that achieving diversification by investing internationally has not been viewed as

attractive for direct real estate because there are higher risks and costs involvedand real estate markets are less transparent. This might be a disadvantage for the international real estate investor compared to the domestic investor (Wit, 2010). Therefore, a survey conducted by Eichholtz, Koedijk and Schweitzer (2001) found that multinational enterprises underperform domestic companies and that this underperformance is not the result of leverage, transaction costsand currency. Size seemed to be the only factor that improved the performance of multinational enterprises (Eichholtz, Koedijk and Schweitzer 2001).

3. 2 Bank Mergers

If the economic environments are not correlated perfectly, a bank with branches spread over a wide geographic area benefits from geographic diversification (Emmons and Yeager, 2004). Recent mergers among community banks are consistent with the notion that the perceived benefits from geographic diversification are quite small (Emmons and Yeager, 2004). Two issues that relate to potential reductions in risk from geographic diversification are especially vital for small banks (Emmons and Yeager, 2004). In the first place, given that risk reduction from increasing scale may not be exhausted for these banks, geographic-diversification benefits may turn out to be relatively unimportant and small in comparison (Emmons and Yeager, 2004). In the second place, greater geographic dispersion of a small bank's operations may create significant operational inefficiencies, detracting from the potential benefits of geographic diversification (Emmons and Yeager, 2004). Informal discussions with experienced bank supervisors indicated that over-reaching by small banks diversifying out of their local

markets can raise the failure risk of a bank (Emmons and Yeager, 2004). In a study of 7000 banks, Berger and DeYoung (2001) presented the evidence that is consistent with the conclusion that geographic expansion may be quite costly for small banks. They found that the ability of a banking organization to impose its standard for efficient operation diminishes as the distance increases between the headquarters of the banking organization and a bank affiliate (Berger and DeYoung, 2001). In contrast, Berger and DeYoung (2002) focused on the dynamic effects of distance and found that the ability of banks to manage the operations of their more-distant offices has been increasing during recent years.