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The Effects of International Operations on the Market Value of the Firm: Theory and Evidence: Discussion
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4. R. M. Rodriguez and E. E. Carter, *International Financial Management*, 2nd edition. Prentice-Hall, Inc. Englewood Cliffs, New Jersey, 1979.

DISCUSSION

D. E. LOGUE*: Professors Errunza and Senbet hypothesize that multinational corporations' market values should reflect the capitalized value of either market power, owing to imperfections in foreign products and factor markets, or the capitalized savings on transactions by investors who rationally desire some form of international diversification in their portfolios. In brief, the shares of U.S. based multinational firms should sell at a premium relative to purely domestic firms after adjusting for risk.

Their phrasing of the question in this way leads them to conclude that the appropriate test for the rationale underlying the development of MNCs should be a valuation based test, rather than a standard abnormal performance test on security returns. In my view, this way of asking the question has moved the analysis of MNC's forward. Their actual theoretical and empirical work, alas, has not done us so much good.

Theoretically, they argue that MNC's shares could sell at a premium because product/factor market imperfections will lead to higher than normal cash flow; or alternatively, their shares could sell at a premium because investors bid up their prices to reflect the fact that direct diversification through purchases of shares in foreign companies operating abroad is very costly.

The obvious question anyone would ask at this point is: if MNC shares sell at a premium, then why don't more MNC's start up, sell shares, and capture the valuation premiums for the promoters? Errunza and Senbet address this issue by arguing that supply adjustments become increasingly costly—given a fixed stock of international investment opportunities—so there are no more rents to capture. This seems a contrivance to tighten their valuation theory. Nonetheless, more work on this issue is likely to be illuminating. The authors have outlined a research topic with their conjecture that is worth pursuit.

A second problem that exists in their analysis is its implied suggestion that MNCs' direct investment flows are uni-directional. Either cash flow or investor international diversification rationales suggest that MNC investments will go from countries with more to countries with less efficient product/factor markets or from countries where security transaction costs are low to those where transaction costs are high. This does not explain, for example, how General Motors can make value maximizing decisions to invest in Germany while Volkswagen can almost simultaneously make value maximizing decisions to invest in the U.S. Transportation costs and tariffs alone cannot account for these flows. Some other factors must be operative.

Turning to the empirical work, at best it must be viewed as preliminary. Unfortunately, my knowledge of the available data sources suggests it may be as good as possible, but it still is not entirely satisfactory.

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First, the dependent variable is market value of equity less book value divided by sales, or, as the authors term it "excess market valuation." They find that this is highly correlated with foreign activity, implying that the more foreign activity the higher will be excess valuation. However, there are incredible comparability problems which arise as the accountants aggregate foreign and domestic book values. What tax rules allow to be capitalized rather than expensed, differences in depreciation allowances, etc. all must be accounted for. Indeed, if foreign depreciation rules are more liberal than domestic rules, then foreign book values will be low relative to domestic book value, other things the same. Accordingly, for any sales to assets ratio, more foreign sales, implying more foreign assets, will simply yield greater "understatements" of foreign net worth. So the correlation between excess market valuation and foreign sales could be a result of the way the books are kept, nothing more.

Second, the results do not allow easy distinction of the competing hypotheses. To the authors' credit, a "controls" period and a "non-controls" period are used; this separation is intended to suggest whether it is product/factor market imperfection or financial market impediments which yield excess valuations. It does not do the job, however. Other things that are not held constant changed sufficiently between the two periods to undermine the revelation. Moreover, the "controls" period was one in which controls on both portfolio capital and direct investment capital applied. The noncontrol period had neither, so we do not know whether excess valuation declined in the latter period because investors could buy more foreign shares or because more U.S. firms could invest abroad—supply adjustment in the authors' analysis—thus reducing product/factor market imperfections.

Third, all foreign investment is treated the same. However, the motivations and consequent excess valuation for U.S. based MNC's investing in the Common Market countries may not be the same for investment in developing countries.

There are other problems with the empirical work, but there is no need to move to smaller issues. The aforementioned problems are sufficient to cause one to consider the findings as quite preliminary. These deficiencies do not really so much reflect the authors' shortcomings as they do the deficiencies in the data that have been organized on MNCs. Nonetheless they exist.

In closing, I emphasize again that despite some questionable analysis, the authors have opened quite interesting and potentially very productive research paths. This is far more than we get from most papers, so they deserve at least our muffled applause.

DISCUSSION

J. H. MAKIN*: The Eaker paper is aptly titled the numeraire *problem* and exchange risk. The problem of preserving purchasing power over commodities with nominal assets measured in terms of some money has not generally been addressed by portfolio theorists and my analysis in Makin (1978), as Eaker observes, is no exception.

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