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International Corporate Diversification, Market Valuation, and Size- Adjusted Evidence:
Discussion

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DISCUSSION

JAMES L. BICKSLER*: The Errunza-Senbet (hereafter E-S) paper on excess valuation and degree of international involvement (hereafter DOI) is both interesting and rigorous and there are a variety of laudatory comments that could be detailed regarding its analytics and empirics. I do, however, have some reservations and technical points about their paper.

The starting point analytics utilized by E-S is that of a Miller debt and tax framework (i.e., an upward sloping demand curve and a horizontal supply curve determining an equilibrium price having the characteristic of a zero excess value

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attributed to the firm's DOI). E-S maintain that, because of positive costs and differential firm cost efficiencies, the supply curve is downward sloping resulting in a positive relationship between DOI and excess valuation. The rationales set forth by E-S to account for this excess valuation anomaly take the form of (1) completing the market, (2) eliminating diversifiable risk, and (3) the proportional costs of international capital asset flow being less than the costs associated with the investors' access to equivalent foreign financial securities. These arguments are, strictly speaking, not conceptually equivalent and E-S structure their reasoning as if they were identical. This adds some minimal non-clarity to the paper.

Turning to substantive issues, first, fundamental to Vihang's and Lemma's spanning and market completeness argument is their presumption that all MNC capital investment constitutes unique linearly independent securities. My own perception is that the major preponderance of MNC capital investment in countries like France and Japan, etc. represents, from a market completeness standpoint, duplication of contingent securities already provided by existing traded financial securities and/or existing financial intermediaries. Ergo, most MNC capital investment does not lead to market completeness inasmuch as investors already have in their investment opportunity set future payoffs from these specific linear independent states of the world. Granted, however, some MNC capital investment, for example, in Niger, Libya, Sri Lanka, etc. may add to market completeness. This means that given the fundamental role of the market completeness argument to the E-S paper, it is necessary in their empirical work to distinguish between these polar cases—one of which enhances market completeness and the other which replicates existing security return payoffs. Specifically, E-S in their choice of sample companies must utilize only firms whose international capital investment is in countries which indeed leads to market completeness.¹ However E-S's sample design and measurement of DOI does not lead to such delineation.

Second, let us examine the two polar cases regarding the world wide product and factor markets. If the world wide product and factor markets are perfectly competitive, then it follows that MNC's would supply international diversification services or completing the market service in whatever quantity is necessary to eliminate or price out the E-S positive valuation effect. This point is analogous to the merger/acquisition literature wherein the pricing of acquired firms is competitively determined and the market price paid to the acquired firm is sufficiently high that no monopoly rents accrue to the acquirer. Indeed, Mandelker's empirical results are consistent with this view that the acquiring firm's equity shareholders do not benefit in merger transactions and likewise Asquith-Ruback's empirical results are consistent with the proposition that the market for acquisitions is competitive. In short, given competitive product and factor markets, supply side changes would result in there being no super premium being paid for diversification or completing the market services provided by MNC's.

¹ An analogous argument from portfolio theory is that absent knowledge about the covariance structure of security returns, no meaningful statement can be made about the effect on the variance of the expected portfolio return of adding additional securities or capital assets to the opportunity set.

At the opposite end of the spectrum, if the product and factor markets are characterized by disequilibrium prices due to imperfect supply and demand adjustments, then the major gains from international involvement will result from the value additivity of production-investment decisions. Indeed, my prior is that the rationale for and the existence of MNC's depends primarily on the value additivity resulting from the production-capital budgeting domain. Alternatively stated, for the disequilibrium factor market scenario, the value additivity of the production-investment decision swamps the gains from providing diversification and completing the market services. This means that the magnitude of the E-S measure of excess valuation is likely inextricably linked and primarily determined by this assumption concerning disequilibrium factor market price.²

Third, given that the paper's focus is on MNC's uniquely provided international diversification and market completeness services, it is inappropriate to use a NYSE index as a proxy of the world wide market portfolio. Indeed, use of the NYSE index will result in biased estimates of the parameters of their estimating equation 16.

Fourth, E-S indicate that the excess valuation term (i.e., their dependent variable) represents the difference between the market price of equity and the book equity normalized by annual sales. It is difficult to set forth an unambiguous interpretation of the economic meaning of a number that represents a difference between a capital market price that reflects investor assessments of future cash flows that result from the firm's vector of future financing, investment (including human capital) and factor market decisions and a book accounting figure that reflects historical acquisition prices, accounting and not tax depreciation policies, historical inflation rates, etc. In general, the E-S excess valuation ratio measure has all of the limitations of the Tobin *Q* ratio plus the additional limitations associated with the use of historical book costs rather than replacement costs.

Fifth, it is unclear that their equation 16 can be used to discriminate between value additivity due to the production opportunity hypothesis and value additivity due to providing international diversification-market completeness services. This is because no independent variable that captures the production variable, as distinct from other value additivity determinants, is included in the regression (i.e., there is a specification problem). Part of this problem may be that their test equation is based on the analytics of a single period valuation framework that does not explicitly include a "growth" variable.

Lastly, it would have been useful for E-S to have a control sample to reestimate the regression parameters using data of firms that did not provide any completing the market services.

Whatever limitations exist are likely to result in a path of future research that is going to lead to interesting results and answers to relevant questions.

² It should be noted that E-S's analysis is perfectly general in the sense that no particular factor market scenario is postulated.