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UNVEILING THE ANTECEDENTS OF INTERNATIONAL DIVERSIFICATION: AN AGENCY THEORY APPROACH

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INTRODUCTION

Managing operations in diverse geographic markets has turned into a daunting task for managers of firms of all sizes. Since international diversification may have either positive or negative effects on firm performance (Cardinal, Miller & Palich, 2011), understanding the factors that can shape the firm's ability to spread operations in foreign countries may help managers to better organize resources for international expansion, and easily or timely change the degree of international diversification if conditions dictate so. In this perspective, a critical component of international diversification research concerns its antecedents (Hitt, Bierman, Uhlenbruck & Shimizu, 2006a).

While various studies have developed hypotheses about the antecedents of international diversification drawing mainly on the resource-based view, the behavioral theory of the firm, and the transaction costs literature, we advance our understanding by investigating the explanatory power of *agency theory* (Sanders & Carpenter, 1998; Tihanyi, Johnson, Hoskisson & Hitt, 2003). Although "agency-theoretic examinations can potentially enhance prior […] explanations for international diversification" (Hitt, Tihanyi, Miller & Connelly, 2006b, p. 856), agency theory arguments have been rarely used for unveiling the *antecedents* of international diversification (Sanders & Carpenter, 1998; Tihanyi *et al.*, 2003; Kim, Hoskisson, Kim & Cannella, 2009). In fact "ownership variables have received somewhat less attention […] there are opportunities for scholars to further examine the effects of ownership on international diversification […], or the impact of the market for corporate control on this strategy" (Hitt *et al.*, 2006b, p. 856-858).

Explicitly, international diversification may be viewed as tackling an agency problem for three main reasons:

- managers may prefer the firm to increase its size by means of geographic diversification because managing a large multinational firm (Peng & Delios, 2006) leads managerial Weberian power and prestige, as well as Schumpeterian empire building strategies (Jensen & Meckling, 1976; Jensen, 1986; Eisenhardt, 1989);
- since international diversification generates a larger scale of operations and increases managerial complexity (Gomez-Mejia & Palich, 1997), it creates the conditions to cement

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the managers' position by increasing the demand for managerial skills;

- while international diversification is a way to reduce corporate risk through compensation between positive and negative performance in different geographic areas (Agmon & Lessard, 1977; Dess, Gupta, Hennart & Hill, 1995; Hisey & Caves, 1985; Levy & Sarnat, 1970; Rugman, 1976), managers, large shareholders and minority shareholders have different risk preferences (Denis *et al.*, 1997; Denis & Sarin, 1999; Jensen, 1986).

The aim of this paper is to investigate the explanatory power of *agency costs of free cash flow* (Jensen, 1986) arguments in recognizing the determinants to internationally diversify. Jensen (1986) suggested that two variables can explain the firm's decision to amplify or hamper the level of diversification according to the costs of free cash flow argument: *cash flow* (i.e., the sum of the after-tax profit of a business plus depreciation and other noncash charges) and *debt* (i.e., an obligation owed by one party, the debtor, to a second party). In addition, we assess the explanatory power of our agency arguments in firm-contexts where managers or large shareholders potential opportunism is exacerbated. Specifically, we test the effect of cash flow and debt on international diversification for: (1) firms with *low growth opportunities*, where managers may use their discretional judgment to overinvest, a condition that is not necessarily in line with the other stakeholders' expectations; (2) firms with *high level of ownership concentration*, where large shareholders may use their influence to push corporate strategy toward overinvestment in their own interest, e.g. to maximize the value of their equity stakes.

THEORY AND HYPOTHESES

Free Cash Flow

When an excess of free cash flow is available after valuable investments are carried out, managers have greater discretion to implement expansion strategies. Executives are inclined to reinvest abundant financial resources in strategies especially pursuing self-serving projects and thus compensation, power and control of their own (Jensen & Meckling, 1976). For instance, Chatterjee and Wernerfelt (1991) and Gibbs (1993) find that the abundance of financial resources encourages managers to push unrelated diversification strategy. However, excess cash flow gives executives a greater level of discretion so as to take into considerations other expansion possibilities, such as international diversification strategy (Nohria & Ghoshal, 1994; Roth & O'Donnell, 1996).

Hypothesis 1. The relationship between free cash flow and international diversification is positive.

Debt

According to Jensen's (1986) 'control hypothesis', debt can help reduce overinvestment problems by limiting managerial discretion in using resources. The use of debt can affect the pursuit of international diversification strategies intended as agency-driven decisions (Jensen, 1986). Put it simply, debt reduces the cash available that can be used to hunt for an international diversification path. This in turn limits the managerial discretion to invest in growth strategies driven by an opportunistic behavior. In fact, firms that are strongly indebted will have the

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necessity to get on the market the financial resources required to internationally diversify (Morck, Shleifer & Vishny, 1990).

Hypothesis 2. The relationship between debt and international diversification is negative.

The moderating effect of high level of ownership concentration

The effects of the presence of a large shareholder in ownership structure on the firms' value have been explored extensively, with the conflict of interests between majority shareholders and minority shareholders receiving special attention (Burkart, Gromb & Panunzi, 1997; Claessens, Djankov, Fan & Lang, 2002; Florackis, 2008; Shleifer & Vishny, 1997; Zhang, 1998). The larger the ownership concentration, the higher the power that large shareholders can exert on managerial decision making with an opportunistic aim. Large shareholders can "use their growing control rights to compel the management to conduct internationalization strategies" according to their preferences of risk reduction (Oesterle *et al.*, 2013, p. 196).

Ownership concentration and cash flow. We contend that the positive relationship between cash flow and international diversification is amplified by a high level of ownership concentration. On one hand, large shareholders like to reduce their risk by diversifying the firm's investments in geographic markets that show not to have highly correlated performance to each other (Hisey & Caves, 1985). On the other hand, the abundance of free cash flow is associated with unrestrained behavior in exercising discretionary power. As a consequence, the simultaneous presence of these two sources of agency conflicts (i.e., excess free cash flow and high level of ownership concentration) is likely to amplify the quest for international diversification.

Hypothesis 3: High level of ownership concentration positively moderates the relationship between cash flow and international diversification.

Ownership concentration and debt. As Williamson (1988) has suggested, debt affects the firm governance structure, changing the way of exercising power. Higher debt level reduces the possibilities to keep on opportunistic growth strategy that large shareholders would pursue using the abundant free cash flow available. We suggest that the negative relationship between debt and international diversification (proposed by hypothesis 2) becomes more negative in firms with high level of ownership concentration: when large dominant shareholders are present, a higher level of debt, being a source of financial constraint, alerts creditors and motivates them to hamper the likely opportunistic geographic expansion strategy desired by large shareholders.

Hypothesis 4: High level of ownership concentration negatively moderates the relationship between debt and international diversification.

The moderating effect of low level of growth opportunities

As Jensen (1986) and Stulz (1990) point out, an increase in resources that are under managerial control would allow a firm expansion likely beyond the shareholder's desirable level. However, if the firm has a prospect of limited growth opportunities, an excessive increase in firm

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size is against the shareholders' interest. In fact, the propensity towards following empire building options tends to stimulate managers to invest the free cash-flow in projects that increase firm size, but not necessarily the firm's value (Degryse & De Jong 2001). Therefore, the firm's growth opportunities are one of the determinants of agency costs of free cash flow.

Growth opportunities and cash flow .We contend that the positive relationship between cash flow and international diversification is stronger for firms with low levels of growth opportunities. On the one hand, abundance of financial resources encourages executives to expand internationally to increase their private benefits (as hypothesis 1 suggests). On the other hand, the pressure to grow abroad is amplified by low levels of growth opportunities, since managers in firms with low growth potential feel, more than the others, the need to increase their prestige and compensation (Jensen, 1986). We thus argue that, when growth opportunities are low, managers of firms that have excess free cash flows will be more likely to pursue higher levels of international diversification.

Hypothesis 5: Low level of growth opportunities positively moderates the relationship between cash and international diversification.

Growth opportunities and debt. When the level of debt is high, managers are not in the position to have an easy access to financial resources to invest in foreign markets expansion, and therefore they are likely to be discouraged by debtholders to pursue an international diversification strategy. The constraining action of debtholders will be particularly aggressive if the firm shows a low level of growth opportunities (La Rocca, 2011), since the latter represent a condition that is likely to trigger opportunistic international expansion by managers.

Hypothesis 6: Low level of growth opportunities negatively moderates the relationship between debt and international diversification.

METHODS

Sample

We used primarily Ricerche & Studi (Ric&St) Annual Directory of Mediobanca (one of Italy's most traditional and accomplished investment banks) to collect data for this paper. The database includes information on a vast and reliable sample of leading businesses based in Italy. The sample consists on a set of 167 firms that were evaluated along a comprehensive consecutive 31-year period from 1980 to 2010.

Measures

Our dependent variable, international diversification (*IntDiv*), is a count of the number of geographic areas (i.e., Middle and South America, North America, Europe, Asia, and Africa) where the firm's production is based. In fact, we believe that production-based indicators of international diversification may better seize foreign direct investment decision rather than conventional sales-based indicators, since these are investments that entail the use of larger resources and have been described as influencing particularly managerial power as well as firm

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performance in foreign countries (Lampel & Giachetti, 2013). All these conditions are particularly important to capture the effect of agency problems (Hitt *et al.*, 2006b).

As for the two independent variables *Cash Flow (CF)* and *Debt*, the former is measured as the ratio of operating cash flow minus cash dividends and capital expenditures divided by total asset (Castañer & Kavadis, 2013), the latter is measured as the ratio of financial (or interest-bearing) long-term and short-term debt (excluding trade debt) scaled by the total financial debt plus equity (Rajan & Zingales 1995).

With regard to moderators, high ownership concentration (*HighOwner*) is a binary variable equal to one for firms that have a percentage of shares held by the primary shareholder that is higher than the median ownership concentration value, and zero otherwise (Chen & Ho, 2000; Fauver, Houston & Naranjo, 2004; Lins & Servaes, 1999), while low growth opportunities (*LowGrowth*) is a binary variable equal to one for firms that have a growth opportunity value, in terms of annual percentage changes in sales, that is lower than its median value, and zero otherwise (Lang, Stulz & Walkling, 1989; McConnell & Servaes, 1995).

Finally, various control variables were used in the analysis, both at the firm- and industry-level.

Estimation methods

Together with the main effect of Cash Flow and Debt used to test Hypotheses 1 and 2, we created a set of *interaction* variables to test hypotheses 3, 4, 5, and 6. All independent variables were lagged one year.

Since our dependent variable is a count variable that contains a high proportion of zeroes and an evident overdispersion in the data, with the sample variances exceeding the sample means, a zero-inflated Poisson regression (zip model) to model count data (Lambert, 1992) seems more appropriate for our analysis.

RESULTS AND DISCUSSION

From the zip model, we found the following significant relationships (at least at $p < 0.1$) between independent variables and international diversification:

- CF (–) [*H1: not supported*]
- Debt (–) [*H2: supported*]
- HighOwner (+)
- LowGrowth (+)
- CF × HighOwner (+) [*H3: supported*]
- Debt × HighOwner (–) [*H4: supported*]
- CF × LowGrowth (+) [*H5: supported*]
- Debt × LowGrowth (–) [*H6: supported*]

As regards cash flow, our findings indicate that, contrary to our expectations, there is a negative relationship between cash flow and international diversification. Nonetheless, when we plot the significant interaction of the zip model according to standard procedures (Aiken & West, 1991), the negative relationship at hand between cash flow and international diversification turns interestingly into a positive one for firms that have high level of ownership concentration. This

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confirms that a high level of ownership concentration is a reliable factor that exacerbates the latitude of private rents by facilitating fund diversion. Thereby, large shareholders in highly owned-controlled firms boost the use of internally generated financial resources to increase international diversification that are aimed by expropriation purposes. This contention that advocates for ownership concentration by large block stockholders concurs with those who have claimed that managerial stock ownership and dividends actually raise new agency problems or aggravate certain agency problems already existing within firms. Consistent with these claims, La Porta, Lopez-de-Silanes, Shleifer and Vishny (2000) argue that the lack of protection of minority shareholders by Italian securities law generate inescapable conflicts between minority and majority shareholders that are even more relevant than those related to the separation between management and shareholders (Faccio & Lang, 2002).

In addition, we pay heed to the negative relationship between cash flow and international diversification that (when plotting the interaction according to standard procedures: Aiken & West, 1991) turns into a positive one for firms that have low level of growth opportunities. According to Jensen's (1986) agency theoretical argument, when managers make decisions that best serve their own interests, these decisions may conflict with the shareholders' interests. In management literature, a low level of growth opportunities is considered an important antecedent of diversification strategy for managerial goals (Jensen, 1986; Easterbrook, 1984). Similarly to previous considerations concerning high ownership contexts, this firm situation pushes to use internally generated financial resources to walk into new geographic markets for opportunist purposes.

Our results show that the relationship between debt and international diversification is clearly negative. Notwithstanding that, the negative sign is stronger in presence of low growth opportunities. In fact, when the level of growth opportunity is low, executives are prone to divert free cash flow to other investments, such as international diversification. Our empirical results confirm that debt plays an important "monitoring and disciplining role" in this respect, ensuring that investment decisions are not inspired by personal managerial goals.

Finally, we found support for our hypothesis that ownership concentration negatively moderates the relationship between debt and international diversification. We can make inference that, before starting to push for further international expansion, large shareholders aim to slacken the firm's debt constraints, possibly in order to reduce the external pressure to monitoring and control by creditors and debtholders.

To conclude, this paper attempts to complement the extant literature in various ways. First, we develop a set of hypotheses on the effect of cash flow and debt on the firm's decision to diversify its international operations. In this light, we contribute either to the agency theory literature and international management studies by applying an agency cost of free cash flow framework to the specific context of international diversification. Second, while most studies that explain diversification processes by relying on agency arguments have focused either on managers' or large shareholders' opportunism, in this article we develop hypotheses on the *antecedents* of international diversification by using explanatory variables taking the perspective of both stakeholders.

REFERENCES AVAILABLE FROM THE AUTHORS