

THE VALUE OF FOREIGN OWNERSHIP¹

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ABSTRACT: We use firm level data on cross-border mergers and acquisitions and share prices to explore the extent to which foreign ownership increases the profitability of firms in emerging markets. We find that cross-border acquisitions add value to target firms. However, there is only weak evidence that such acquisitions add more value than purely domestic acquisitions. Further, most of this latter effect occurs when the target firm's country is in a crisis.

Key words: foreign ownership, emerging markets, firm value

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1. INTRODUCTION

A growing literature studies the effect of foreign direct investment on firms in emerging markets. We take up the question of whether foreign investment in emerging markets is special because it transfers better technology, managerial skills, or other valuable attributes as compared to what is locally available. We employ event-study methodology on international databases of mergers and acquisitions and share prices to investigate whether foreign direct investment (FDI) into emerging markets raises the profitability of acquired firms in these markets. Secondly, we examine if acquisitions by firms from more developed economies adds more value to the target firm as compared to acquisitions by other local firms in the emerging market. We find that foreign acquisitions do indeed increase the profitability of the acquired firm. There is some evidence that such acquisitions add more value than purely domestic acquisitions, although most of this effect comes when the target firm's country is in a crisis period. It is only during a crisis that the effect on the stock market value of the target firm is positively related to the acquirer country's level of income and institutional quality. This effect is negligible outside of crisis times.

Most empirical literature has sought to address the issue of the value of foreign ownership by estimating the productivity effects of FDI.³ This approach, while valuable, has

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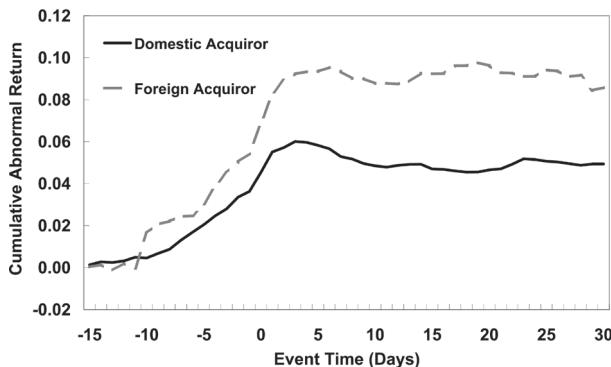
³ See, Aitken et. al. (1997), Aitken and Harrison (1999), Caves (1996), Haddad and Harrison (1993), Sinha (1993) and Tybout (1999).

some limitations. Firstly, Katayama et. al. (2003) point out that data on physical quantities of inputs and outputs are usually unavailable, so researchers use proxies that generate productivity estimates that may bear little relationship to technical efficiency. Moreover, FDI may transfer something useful beyond mere technical efficiency, such as logistical or marketing technology, better access to foreign markets or better access to capital, all of which can raise the profitability of firms. In both these regards analyzing share price responses is a useful alternative approach to examining this question. Share prices provide a convenient market-based summary of whether an acquisition is expected to add some value to the target firm, helping to sidestep difficult issues in estimating productivity from available plant-level data. They incorporate the effect of various channels through which FDI transfers value to domestic firms without restricting attention to productivity transfers alone. Secondly, share prices are a forward looking measure and therefore summarize the present discounted value of net future benefits of foreign ownership. Further, the high frequency (daily) data allows us to precisely ascertain if the acquisition is the event driving the change in valuation.

To explore the effect on share prices we construct a database linking acquired firms to their share prices. For information on mergers and acquisition we use Thompson Financial Securities Data Company's (SDC) mergers and acquisition database, which contains dates and details of cross-border and domestic mergers and acquisitions. For share price information we use Datastream. Merging the two databases we obtain a total of 608 unique matches involving target firms in 19 countries, with daily share price data during the period 1986-2002. This sample is reduced to 409 unique matches when we restrict the sample to firms for which we have information on the size of the firm, the book to market value of the firm, and country-level measures of development and institutional quality. 94 of these firms were targeted by foreign firms and the remainder by domestic firms.

We find strong evidence that foreign acquisitions increase the value of the target firm in emerging markets. The cumulative abnormal return over an event window that starts 15 days prior to and ends 3 after the date of the announcement is 9.2 %. The acquisition premium also holds its value 30 days following the acquisition (Figure 1). The premium is notably larger for smaller targets as measured by market equity. There is some evidence that the premium is greater than for a purely domestic acquisition. The difference in the premium is found to be 3.2% in favor of foreign acquisitions, but this is only marginally significantly different from zero.

We then examine the value of a foreign acquisition when the emerging market is going through a crisis-either a balance of payments crisis or a banking crisis. In most cases the economy experiences both types of crisis at the same time, a phenomenon referred to as 'twin crisis' and detailed in Kaminsky and Reinhart (2002). During a crisis, the cumulative abnormal return is higher for a firm that is acquired by a higher income country. We then test this specification by using different measures of relative institutional quality reported in La Porta et al (1998), between the target and acquirer. For some measures of institutional quality we find that crisis period acquisitions are marked by a higher premium for targets acquired by countries with better institutions.

Figure 1: Target Acquisition Premium

The event study methodology has been extensively used to analyze the effect of mergers and acquisitions on the valuation of the acquiring and target firm in the domestic corporate finance literature. For an excellent survey of this literature refer to the article by Andrade, Mitchell and Stafford (2001). The effect of foreign expansions on the stock market valuation of the acquiring U.S. multinational firm has also been explored in the literature. Fatemi (1984) finds small positive cumulative abnormal return of the acquiring firm around the date of expansion. Doukas and Travlos (1988) use an event study methodology to examine the effect on U.S. based acquiring firms of foreign acquisitions. They find a differential impact on the acquiring firm depending on the acquirers prior experience with foreign expansion.

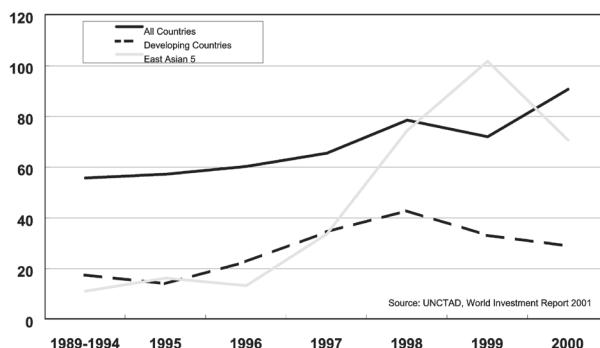
Morck and Yeung (1992) find that acquiring firms with information based assets experience a significantly positive stock price reaction. These studies however do not examine the effect on the target firm of a foreign acquisition. To this extent they cannot examine the benefits to economies of foreign acquisitions, the crucial question for emerging economies, which is what we explore here.

There have been a number of papers that have not used event study methodology to address the question of the value of foreign ownership. The evidence on spillovers to the acquired firms is mixed. Early studies surveyed in Caves (1996) suggests that foreign-owned firms in relatively advanced developing countries enjoy little productivity advantage over domestic firms. More recent literature suggests that Foreign Direct Investment does bring relatively efficient technologies to developing countries, but that diffusion to domestic firms is uncertain (Tybout, 1999). In a cross-sectional study of 164 large Indian manufacturing companies, Sinha (1993) finds that foreign equity participation is associated with higher productivity. Haddad and Harrison (1993) using a panel of 3,933 Moroccan manufacturing firms find that although foreign-owned firms had higher productivity levels, they did not have faster rates of productivity growth.⁴ Aitken and Harrison (1999) use a panel of over 4,000 Venezuelan firms to find that individual plants benefit from foreign investment, at least when those plants are small, but that there is a negative

⁴ The point estimate suggested slower growth, but was insignificant.

spillover since the productivity of domestically owned plants decreases. Most of these studies have been country specific. Since we rely on stock price data, we are able to group several different countries in our analysis. However, we can only analyze acquisitions of listed companies and it is not possible to analyze "greenfield" investments. While most FDI into developing countries has historically been through greenfield investments, Figure 2 shows that the proportion that has involved acquisitions of existing companies has increased sharply in recent years.

Figure 2: Merger and Acquisitions as % of Inward FDI



2. DATA

Our dataset for mergers and acquisitions is Thompson Financial Securities Data Company's (SDC) mergers and acquisition database, which contains dates and details of cross-border and domestic mergers and acquisitions. Primary source material includes news sources, SEC filings and their international counterparts, trade publications, wires and proprietary surveys of investment banks, law firms and other advisors. The database includes all corporate transactions involving at least 5% of the ownership of a company where the transaction was valued at \$1 million or more (after 1992, deals of any value are covered) or where the value of the transaction was undisclosed. Public and private transactions are covered. SDC also reports numerous details about the target and acquiring firm, including income and balance sheet items, industry, and ownership. For each firm acquired, SDC reports the announcement date of the acquisition and five years of historical data.

We begin our sample in 1986 (the first year for which data is available) and include all mergers and acquisitions through the end of 2002. Forty-five percent of deals involve a private target, with public firms and subsidiaries accounting for a quarter each. The remainder consists of government firms (1%) and joint-ventures (4%). The regressions below require share price data that are unavailable for privately held firms. Therefore, the regression samples only include publicly traded firms. The mean purchase involves 25% of the firm.

The SDC database provides information on the acquiring and merged firm only prior to the date of acquisition. Since we are interested in the market valuation of the firm

in an interval around the date of the announcement we merge the SDC database with data reports of the firm in Datastream. This is a non-trivial merge, since firm names are not reported identically in both databases and there is no common identifier for a firm. We searched for matches based on common name, country, currency, share price 4 weeks prior to announcement and total number of shares outstanding 4 weeks prior to announcement. We obtained a total of 608 unique matches involving target firms in 19 countries. This sample is reduced to 409 unique matches when we restrict the sample to firms for which we have information on the size, book to market value, PPP adjusted GDP and crisis information. 94 of these firms were targeted by foreign firms and the remainder by domestic firms. In the crisis sample we have 69 observations, 22 of which are acquisitions by foreign firms and the remainder 47 by domestic firms.

Our categorization of a country as an emerging market follows the definition used by Standard & Poor in constructing their Emerging Market Bonds index. The classification of emerging markets into low income and high income emerging markets follows the World Bank definition based on PPP adjusted GDP per capita. See Table 1 and Table 2 for the list of target and acquiring countries respectively. Table 1 also lists the years that are defined as crisis years for each country. We use the dates listed in Kaminsky and Re-

Table 1: Target Countries – Number of First Acquisitions

	<i>Foreign Acquisitions</i>	<i>Domestic Acquisitions</i>	<i>BOP Crisis</i>	<i>Banking Crisis</i>
Argentina	1	1	1986, 1989, 1990, 2002	1985, 1994
Brazil	0	1	1986, 1989, 1990, 1991, 1999	1985, 1994
Chile	2	5		
China	1	0		
Columbia	0	4	1985, 1995, 1997, 1998, 1999	
Greece	0	7		
India	16	28	1991	
Malaysia	12	122	1997	1985, 1997
Mexico	0	3	1994	1992
Pakistan	2	0		
Peru	2	0	1987, 1988	
Philippines	13	26	1986, 1997	1997
South Africa	2	17		
South Korea	8	46	1997	1997
Sri Lanka	0	5		
Taiwan	2	10		
Thailand	28	35	1997	1996
Turkey	3	3	1994, 2001	1991
Venezuela	2	2	1986, 1989, 1994, 1995	1993
TOTAL	94	315		

inhart (2002) and Kaminsky (2003). We define the crisis dummy to take a value of 1 in a particular year if the country experiences a balance of payments or a banking crisis or is a year immediately following either type of crisis. For instance, the crisis dummy takes a value of 1 for South Korea in the year 1997 and 1998, where 1997 is the year the crisis originated in South Korea.

Table 3 lists the number of acquisitions in our final sample by year. The first acquisition in our sample was announced in 1991, but most of the acquisitions take place post 1994. Table 4 lists some characteristic of target firms grouped by type of acquirer and between crisis and non-crisis periods.

Table 2: Acquiring Countries – Number of Acquisitions

	<i>Number of Foreign Acquisitions</i>
Australia	3
British Virgin Islands	1
France	5
Germany	6
Hong Kong	10
India	1
Italy	1
Japan	7
Malaysia	4
Mauritius	2
Netherlands	3
Singapore	14
South Africa	1
Spain	1
Sweden	1
Switzerland	4
Taiwan	1
Thailand	1
United Kingdom	9
United States	19
TOTAL	94

Table 3: Number of Acquisitions by Year

	<i>Foreign Acquisitions</i>	<i>Domestic Acquisitions</i>
1987	0	0
1988	0	0
1989	0	0
1990	0	0
1991	1	0
1992	1	9
1993	4	13
1994	4	11
1995	6	26
1996	5	45
1997	9	25
1998	18	27
1999	15	29
2000	11	45
2001	18	46
2002	2	39

3. EMPIRICAL ANALYSIS

Our event-study methodology is derived from Campbell et. al. (1997). Our event at event-time T is when a firm from any country makes an announcement that it is to acquire, or increase its holdings by, at least 5 percent of a firm domiciled in one of a selection of emerging markets. If there is more than one announcement for the same target firm,

Table 4: Descriptive Statistics of the Target Firm

	Foreign Acquisitions		Domestic Acquisitions	
	Non-Crisis	Crisis	Non-Crisis	Crisis
Observations	67	27	267	48
Market Equity				
Mean	4.52	4.39	4.49	4.47
Median	4.29	4.65	4.37	4.70
Std. Deviation	1.56	1.46	1.59	1.56
Book Equity/Market Equity				
Mean	3.12	0.49	3.42	2.06
Median	1.46	1.19	1.24	1.5
Std. Deviation	4.15	9.08	20.68	2.15

Note: All variables are in log millions of dollars.

we study the first of these announcements. In the first stage, we assume that the normal return of a firms stock is a linear function of the market return:

$$R_{ict} = \alpha_i + \beta_i R_{ct} + \varepsilon_{ict}, \quad (1)$$

where the market return R_{ct} is the Datastream Total Market Index for country c and R_{ict} is the actual return. We estimate (1) using daily data that includes one year of observations that ends 30 days prior to the announcement date.

In the second stage, we estimate the abnormal returns for each selected target firm and examine these abnormal returns for an event window that starts 15 days prior to and ends 3 days after the announcement. The abnormal return ω_{ict} at event-time t for firm i in country c is defined by Equation (2).

$$\epsilon_{ict} = R_{ict} - E[R_{ict}|R_{ct}], \quad (2)$$

where $E[R_{ict}]$ is the normal return. We then calculate the cumulative abnormal return for each stock i in country c at time t over the 19 day event window.

$$CAR_{ict} = \sum_{s=t-15}^{t+3} \epsilon_{ics} \quad (3)$$

where t is the announcement date. The reason we start the event window 15 days prior to the announcement is because we expect that there will be some leakage of information regarding the acquisition prior to the actual announcement that will cause the share price to respond.

In the third stage, we analyze the relation between the cumulated excess returns and the characteristics of the acquiring and target firm during and outside of crisis years.

$$CAR_{ict} = \alpha + \beta_0 X_{1,c} + \beta_1 (C_t * X_{1,c}) + \beta_2 X_{2,ict} + \gamma_1 D_c + \gamma_2 D_Y + \varepsilon_{ict}$$

where $X_{1,c}$ includes variables that measure the relative development of the acquirer's country to the target country. This includes differences in income, institutions and financial development. This is indexed by country only as this measure doesn't change over time. C_t is a dummy variable that takes a value of 1 if the announcement date coincides with a crisis period. $X_{2,ict}$ includes measures that control for target firm characteristics. D_c and D_Y are country and year of announcement fixed effects.

The results of this inquiry are reported in Table 5, Table 6 and Table 7. In Table 5, column (1) we report that acquisitions from any source increase the value of the target by 6.7% and this estimate is highly significant. The results in column (2) distinguish between acquisitions by foreign firms and those by domestic acquirers. A foreign acquisition raises the value of the target by 9.2%, while a domestic acquisition raises value by 6.0%. This provides some modest evidence that foreign acquirers add more value than domestic acquirers.

Since foreignness does not guarantee acquisition by a more developed nation, in column (3) we report the effect of acquisitions by high income foreign acquirers. This follows the World Bank's definition of a High Income country.⁵ The acquisition premium for a high-income foreign acquirer is 8.2%, insignificantly different from the 6.5 % average for other acquisitions. In column (4) we find that relative income differences between the acquirer and target country have an effect on the acquisition premium for the target in our sample -the greater is the relative income in the acquirer country the higher is the acquisition premium. The reconciliation of the results in columns (3) and (4) is that acquisitions from high-income emerging markets to low-income emerging markets carry a substantial premium. In columns (5) and (6) we repeat the regressions in (3) and (4) while controlling for country and year fixed effects, firm size and book to market value. We again find some evidence that acquisitions from higher-income countries increases premiums.

Since we find mixed evidence on the value to a developing country firm of being acquired by a developed country firm, our results are similar to the evidence from non-event-study approaches to measuring the value of FDI (see Aitken and Harrison (1999)). To the extent that data limitations prevent us from controlling for all differences in firm characteristics between targets acquired by domestic firms and those by foreign firms, our approach has some limitations. However, it is interesting to note that there isn't overwhelming evidence that developed country acquirers add substantially more value.

⁵ Since South Korea is an emerging market, despite being defined as a high income country we exclude it from the group of developed countries.

Table 5: Cumulative Abnormal Return: First Acquisitions

	(1)	(2)	(3)	(4)	(5)	(6)
Constant	0.067*** (0.009)	0.060*** (0.010)	0.065*** (0.010)	0.061*** (0.009)	0.055* (0.040)	0.218*** (0.055)
Foreign Acquiror		0.032* (0.019)				
High Income Acquiror			0.017 (0.017)		0.051* (0.027)	
Relative GDP				0.022** (0.011)		0.028 (0.018)
ME					-0.033*** (0.008)	-0.034*** (0.007)
BEME					0.0005 (0.0004)	0.0005 (0.0004)
Target Country Fixed Effect	N	N	N	N	Y	Y
Year Fixed Effect	N	N	N	N	Y	Y
No. of Observations	661	608	608	605	443	440
R2	0.00	0.00	0.00	0.00	0.13	0.13

Note: Robust standard errors clustered for target country*year reported. ***, **, * represent significance at the 1%, 5% and 10% level respectively. ME and BEME represent market equity and book to market equity of the target firm, respectively.

Table 6: Cumulative Abnormal Return: First Acquisitions, Crisis Vs. Non Crisis

	(1)	(2)	(3)	(4)
Constant	0.203*** (0.039)	0.017 (0.020)	0.216*** (0.039)	0.221*** (0.055)
Relative GDP	0.019 (0.017)	0.019 (0.017)	0.013 (0.019)	0.011 (0.020)
* Crisis Dummy	0.056* (0.030)	0.057* (0.032)	0.061* (0.037)	0.067* (0.037)
ME	-0.029*** (0.007)	-0.029*** (0.007)	-0.032*** (0.007)	-0.033*** (0.008)
BEME	0.0006 (0.0005)	0.0008 (0.0005)	0.0003 (0.0004)	0.0005 (0.0004)
Crisis Dummy	-0.045** (0.017)	-0.092** (0.039)	-0.042** (0.021)	-0.073* (0.041)
Target Country fixed effect	N	N	Y	Y
Year fixed effect	N	Y	N	Y
No. of Observations	409	409	409	409
R2	0.07	0.09	0.10	0.14

Note: Robust standard errors clustered for target country*year reported. ***, **, * represent significance at the 1%, 5% and 10% level respectively. ME and BEME represent market equity and book to market equity of the target firm, respectively. The third row is the coefficient for the interaction term between relative GDP and the crisis dummy.

We next examine how the differential effect varies between crisis and non-crisis years. This is reported in Table 6. Across different specifications we find that relative income has an effect on the premium for the target during a crisis period but not in non-crisis

Table 7: Role of Institutions: Crisis Vs. Non-Crisis

	(1)	(2)	(3)	(4)
Constant	0.214*** (0.055)	0.217*** (0.053)	0.099** (0.035)	0.109*** (0.031)
Relative Expropriation Risk	0.047 (0.113)			
* Crisis Dummy	0.29 (0.20)			
Relative Judicial Effectiveness		-0.011 (0.043)		
* Crisis Dummy		0.137*** (0.052)		
Relative Bribery			-0.024 (0.035)	
* Crisis Dummy			0.104* (0.059)	
Relative Marketcap/GDP				0.012 (0.023)
* Crisis Dummy				0.059 (0.039)
ME	-0.032*** (0.008)	-0.032*** (0.008)	-0.033*** (0.008)	-0.033*** (0.008)
BEME	0.0003 (0.0003)	0.0003 (0.0003)	0.0005 (0.0003)	0.0003 (0.0003)
Crisis Dummy	-0.072* (0.043)	-0.071* (0.042)	-0.073* (0.043)	-0.070 (0.045)
No. of Observations	407	407	410	397
R2	0.12	0.13	0.13	0.13

Note: All regressions include a country and year fixed effect. Robust standard errors clustered by target country*year reported in parenthesis. ***, **, * represent significance at the 1%, 5% and 10% level respectively. ME and BEME represent market equity and book to market equity of the target firm, respectively. X*crisis dummy represents the interaction between the variable X and the crisis dummy.

periods. The market more greatly values acquisitions by firms from relatively higher income countries during a crisis, while this effect is insignificantly different from zero in non-crisis periods. In Table 7 we continue this analysis using indicators that capture different levels of quality of domestic institutions such as expropriation risk, bribery, judicial effectiveness, and financial development proxied by the ratio of market capitalization to GDP. We use these measures one at a time because they turn out to be highly correlated. We find some evidence that being acquired by a country with better institutions has a positive effect on the premium for the target relative to a purely domestic acquisition, but again only in crisis periods.

One possible inference of the results in Tables 6 and 7 is that one of the main ingredients that more developed country firms can transfer to local firms is liquidity. Outside of

crisis periods this liquidity effect is less important as compared to a crisis period when emerging market countries find themselves in financial distress. This is consistent with Aguiar and Gopinath (2004) who find evidence of liquidity driven sales during the crisis in East Asia.

Table 8 examines the effect on the acquirer firms located in the United States following acquisition announcements in emerging markets. The average cumulative abnormal return for the acquiring firm is 1.6%. The acquirers gain most when they acquire more than 50% of the shares outstanding of the target firm. There is little significant evidence that the acquirer premium is systematically related to market equity, book to market equity of the target firm or the crisis dummy.

Table 8: Cumulative Abnormal Return: Acquirer

	(1)	(2)	(3)	(4)
Constant	0.016*** (0.005)	-0.002 (0.007)	0.015 (0.022)	0.021 (0.023)
Majority Acquisitions		0.021* (0.012)	0.015 (0.012)	0.010 (0.010)
ME			-0.001 (0.001)	-0.001 (0.002)
BEME			-0.003 (0.005)	-0.004 (0.004)
Year Fixed Effect	N	N	N	Y
No. of Observations	812	527	473	473
R2	0.00	0.00	0.00	0.03

Note: Robust standard errors clustered by year reported (there is only one acquiring nation, the US). To avoid the effect of outliers we delete observations in the top 1% and bottom 1% of the cumulative abnormal return distribution. This reduces the sample size from 830 to 812. ***, **, * represent significance at the 1%, 5% and 10% level respectively. ME and BEME represent market equity and book to market equity of the target firm, respectively.

4. CONCLUSION

In this paper we adopt an event-study approach using share price data to estimate the value of foreign ownership. Share prices are a convenient forward-looking market based summary of whether an acquisition is expected to add value. The high frequency of this data also allows us to ascertain if the acquisition is the event driving the change in valuation. Using this approach, we find that cross-border acquisitions add significant value to target firms. There is weaker evidence that such acquisitions on average add more value than purely domestic acquisitions in emerging markets. In crisis years there is evidence of a higher premium for target firms acquired by a firm headquartered in a more developed economy.

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