
Policy hazards, opportunism and the stock market reaction to the international expansion of telecom firms

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Abstract: This paper analyses the extent to which policy hazards may affect the stock market reaction to internationalisation decisions made by telecommunication firms. Building on transaction cost economics, we predict that the stock market should react negatively to increases in the policy instability in the host country, and that the entry mode should moderate the relationship between policy instability and the stock market reaction to international projects. To test these predictions, we first use the event study methodology to estimate the abnormal returns obtained by firms expanding abroad, and then run several multiple linear regression models to estimate the effects of the policy risk and the mode of entry chosen on these abnormal returns. Our results show that the stock market has not reacted negatively to those international projects carried out in conditions of policy instability. Investors only value policy instability negatively when the entry mode is a total acquisition.

Keywords: policy hazards; internationalisation; strategic alliances and joint ventures; mergers and acquisitions; telecommunications industry; international management; Europe.

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1 Introduction

The consequences of Foreign Direct Investment (FDI) in company performance are a widely studied research topic (Contractor et al., 2003; Lu and Beamish, 2004; Kirca et al., 2011). Most of this literature analyses the performance consequences of FDI in the aggregate, without distinguishing international mergers and acquisitions from other forms of FDI, although there are several studies focused only on specific entry modes such as acquisitions (see King et al., 2004; Haleblan et al., 2009; Weber et al., 2009; for a review) or joint ventures (see, for instance, Merchant and Schendel, 2000; Hanvanich et al., 2005). In their recent review of the literature, Haleblan et al. (2009) argue that the impact of macrolevel factors on the performance of mergers and acquisitions is an underdeveloped area. The most studied macrolevel factor is perhaps national culture, which has been analysed as a determining factor in the performance of FDI (Weber et al., 2009) and other operations such as joint ventures (Hanvanich et al., 2005). However, other macrolevel factors such as policy instability in the host country have typically received less attention, even though previous research shows how policy instability influences the choice of entry mode (Henisz, 2000; Delios and Henisz, 2003). Two exceptions are the works of Henisz and Delios (2004) and Gaur et al. (2007): both analyse the impact of the institutional environment on the performance of subsidiaries, yet do not separately delve into mergers and acquisitions from other international operations.

This paper tries to fill this gap in the literature by analysing the impact of policy instability on the stock market reaction to international acquisitions and alliances made by telecom firms, as, to the best of our knowledge, no empirical papers have yet delved into this issue. The telecommunications industry is an excellent research setting for the study of policy instability, as the international expansion and international strategy of telecom firms are affected by host governments (Sarkar et al., 1999). Not only can these factors make or break the entrance in a new country, they can also change the rules of the game through regulatory or political processes once a firm has entered said country. We will analyse the most common forms of international expansion in this industry: strategic alliances and acquisitions. We argue that the stock market should not react to these phenomena in the same way, as each has different features that the stock market should take into account. Whilst acquisitions imply an equity position (100% or less) on the whole set of assets of the target firm, alliances only imply selected assets of the partner. In addition to this, not all alliances work in the same way. When the alliance is a joint venture, partners are better protected against opportunism, according to previous research (Pisano, 1989; García-Canal, 1996; Oxley, 1997; Colombo, 2003; Sampson, 2004). We build our analysis on Transaction Cost Economics (TCE) (Williamson, 1975;

Williamson, 1996). According to this paradigm, the most efficient entry mode for international expansion is that which minimises the costs associated with contractual and policy hazards (Henisz and Williamson, 1999).

2 Theory and hypotheses

TCE deals with the economic logic surrounding organisation decisions, analysing how governance forms must fit with the attributes of each transaction in order to minimise the costs that this transaction entails (Williamson, 1975; Williamson, 1996). Specifically, the choice between hierarchical modes and market or quasi-market forms of organisation is the most frequently analysed problem, the contractual hazards of the latter forms of organisation being the key variable when it comes to explain the choice of governance form (Williamson, 1996). These contractual hazards usually stem from changes in the incentives of the partners involved in the transaction just after specific investments have been made. Obviously, the value of a firm that minimises such transaction costs should increase, since it is better governed. Thus, the stock market should prefer the firms that apply each governance mode properly to those that do not. In fact, some empirical evidence exists regarding how the stock market values the use of hierarchical governance modes more positively when they contribute to economise on transaction costs (Morck and Yeung, 1992). In the field of international business, one of the most commonly analysed organisational issues is the choice of entry mode. Many papers have studied this problem, the protection of idiosyncratic assets (for instance, knowledge and reputation) being the key factor in explaining entry mode and performance (Anderson and Gatignon, 1986; Gomes-Casseres, 1989; Hennart, 1991). However, the relationship between the choice of entry mode and the institutional environment of the foreign country has not been sufficiently explored. Several developments within TCE have started to address this issue. For instance, Oxley (1999) showed how differences in property rights protection across countries may alter the choice of governance structures for strategies alliances. According to this result MNE should adapt its governance decisions to the institutional environment of each country. But this adaptation is not as simple as it would initially appear. This is due to the fact that the institutional environment in the host country is not a fixed parameter. In some cases, it is easy for the governments to change the rules of the game once the firms have already invested. This is what happens when policymakers in the host country are not constrained by other institutions in their decision-making (Henisz, 2000). In these cases, the firm is exposed to political hazards in the form of policy instability (Knack and Keefer, 1995). As a consequence, a transaction costs analysis on how investors should value international expansion might take into account not only policy instability but also its interaction with contractual hazards (Henisz and Williamson, 1999; Henisz, 2000). Next, we analyse how the stock market should react to the exposure to policy instability, and then how the reaction differs depending on the entry mode chosen.

2.1 The impact of policy instability

Since the work of Stephen Hymer (1960/1976), the research on FDI success is focused on the so-called 'liability of foreignness' as well as on the means used by foreign investors to overcome it. Due to their lack of knowledge of the local business

environment as well as some risks of discrimination by customers and governments, foreign firms have a liability against local ones. This latter type of risk is conditioned by the stability of the political system and the discretion that foreign governments have to change the rules of the game unilaterally (Williamson, 1996; Henisz and Williamson, 1999; Henisz, 2000). Whilst some governments cannot easily act unilaterally to worsen the position of a foreign firm, others have the feasibility of expropriating foreign firms' assets or changing regulations and tax policies that may affect the firm and reduce its profitability (Henisz, 2000). This happens when the policymakers do not have constraints on policy change in the form of independent veto points by other branches of the government or other institutions such as the legislature or the judiciary (Henisz, 2000). Whenever these constraints are either absent or easy to overcome by policymakers, the firm automatically becomes exposed to policy hazards. Given the fact that the activity of telecom firms is highly regulated, these hazards are a very important issue in this industry (Sarkar et al., 1999). As a consequence, policy instability is a factor that firms (especially telecom firms) expanding abroad should take into account during their decision-making process (Henisz and Zelner, 2001). Once a firm has invested abroad, this investment is somewhat exposed to the risk of losing its value due to discretionary decisions made by the foreign government. This is because these investments are irreversible and, as a consequence, a sunk cost. In other words, telecom firms investing abroad are exposed to hold-up problems (Henisz and Zelner, 2001). For this reason, shareholders of telecom firms should value those international operations made by firms under conditions of policy stability more positively, and those carried out under high policy instability negatively. We can thereby formulate the following hypothesis:

H1a. Policy instability due to a lack of institutional constraints on policymaking in the host country will reduce the abnormal returns in response to international operations made by telecom firms.

However, this hypothesis can be challenged by applying the insights of the most recent research on the international expansion of firms in regulated industries. García-Canal and Guillén (2008) and Holburn and Zelner (2010) show that firms in regulated industries do not always avoid investments in countries with high levels of policy risk. Building on resource-based theory and on the literature on the international expansion of regulated firms (Henisz, 2003; Bonardi, 2004; Guillén, 2005), these authors argue that firms in these industries develop over time what can be called political capabilities that can help them to deal with unconstrained policymakers in host government. As these firms are used to dealing with politicians and regulators in their home markets, they can exploit this know-how in foreign markets. Specifically, García-Canal and Guillén (2008) argue that the main advantage of entering into a country with unconstrained policymakers is that the foreign firms can negotiate a better deal. Obviously, once the company has invested into the host country, the discretion of the host governments and regulators can turn into a disadvantage, as they can substantially alter the initial conditions. However, firms can use their political capabilities to deal with these risks. On this basis, we argue that:

H1b. Policy instability due to a lack of institutional constraints on policymaking in the host country will increase the abnormal returns in response to international operations made by telecom firms.

2.2 The interaction between policy instability and entry mode

When entering into a country whose policymakers have a lot of discretion, a foreign firm has some options to safeguard itself against policy hazards (Boddewyn, 1988). The entry modes chosen in the telecom industry are usually acquisitions and strategic alliances (Joshi et al., 1998; Sarkar et al., 1999). When a firm enters through a strategic alliance, the policy hazards are reduced not only because the firm is sharing the risk with one partner but also because this partner – especially if it is local – can help the firm in its relationship with the local government (Boddewyn, 1988; Henisz, 2000). The role of local partners in FDI in less developed countries is well documented (see, for instance, Stopford and Wells, 1972; Beamish, 1988). The local partner provides local information and contacts, as well as local legitimacy, as in case of an expropriation (Henisz, 2000). A similar situation occurs when the firm acquires only a share of a target firm located in the host country. Sharing the equity with local shareholders may also prevent local governments from expropriating the investment of the foreign firm or worsening the situation of the target. Although the role of local partners seems to be important in all industries, it is especially critical in the specific case of telecom firms. Sarkar et al. (1999) show how, in this industry, the dependence of MNE on the decisions of host governments has obliged firms to turn strategic alliances into a cornerstone of their international strategy. Taking this into account, we expect that the worst-case scenario for a telecom firm in a country with high policy instability would be entering through a full acquisition. If a firm acquires all the ownership of the target, the risk assumed in a country with high policy hazards is the maximum. Besides, it would lose a political ally that could help them to deal with the local government or bring legitimacy to its expansion. In this case, the stock market should react negatively to this full acquisition. On this basis, we can formulate the following hypothesis:

H2. The impact of policy instability on the abnormal returns in response to international operations made by telecom firms will be more negative for total acquisitions than for other entry modes.

Relying on local partners, however, can also entail risks for the telecom firms that are expanding abroad. When entering into strategic alliances, firms are exposed to contractual hazards, as the literature on contractual form in strategic alliances has shown (Pisano, 1989). These contractual hazards are not independent of policy hazards, as Henisz and Williamson (1999) and Henisz (2000) have revealed. In fact, policy instability and a weak institutional environment can act as a loophole for the local partner to cheat its foreign partner. The local partner can in fact lobby the local government in order to make it difficult for the foreign partner to enforce their rights or simply to change the rules of the game in its own favour. Joint ventures protect the foreign partner better than other options. Control rights and profit sharing are implicit on the basis of the ownership structure of the joint venture (García-Canal, 1996). In the event of relying exclusively on contractual agreements, the clauses that regulate them may be more difficult to enforce due to the aforementioned lobbying practices. Joint ventures also have advantages over partial acquisitions. In joint ventures, only selected assets from the partner are incorporated into the project, which avoids what Hennart and Reddy (1997) call the digestibility problem. In addition, the partner is usually more committed to the foreign firm than the remaining shareholders in a target firm. Taking these factors into account, we formulate the following hypothesis:

H3. The impact of policy instability on the abnormal returns in response to international operations made by telecom firms will be more positive for joint ventures than for other entry modes.

3 Methods

3.1 Sample

In order to test the previously formulated hypotheses, a sample was built including the cross-border acquisitions and alliances¹ carried out by European telecommunication companies between 1986 and 2001. We built this database from Thomson SDC Platinum. This database is the most reliable source for identifying these operations, and it has been widely used in the fields of strategy, management and finance. We deliberately focused our attention on the telecommunications industry² given that these firms have faced the challenge to be able to internationalise quickly, which has compelled them to deal with different types of host governments and regulations and, consequently, to be exposed to different levels of political risk. After several processes of technological changes and deregulation, this field is not a multi-domestic isolated industry anymore. The convergence of these formerly unconnected markets did not happen suddenly but through several parallel processes of boundary expansion made by means of strategic alliances and acquisitions (Joshi et al., 1998; Trillas, 2002).

We searched in SDC for cross-border alliances and acquisitions. A total of 387 acquisitions and 530 alliances for the studied period were identified.³ Our goal was to analyse how the formation of these business combinations affected the share price of European telecom companies. In order to warrant inclusion in the final sample, each combination announcement had to meet the following criteria:

- 1 The European firm's daily stock prices should be available in the DataStream database.
- 2 The precise date of the announcement should be identifiable in the Lexis-Nexis database.
- 3 No major confounding announcement that could contaminate the effect of the studied event should have been made within a ± 5 -day period around the announcement day.

After the elimination of all events that did not fit the above criteria, the final sample consisted of 117 and 235 experiences of European telecom firms in acquisitions and strategic alliances, respectively. Tables 1 and 2 show the number of operations carried out in each country and each year, respectively.

3.2 Dependent variable and method of analysis

Standard event study methodology (McWilliams and Siegel, 1997) was used to calculate the abnormal returns generated by these cross-border alliances and acquisitions. These abnormal returns were used as a dependent variable. Specifically, we used the cumulative abnormal returns within a ± 3 -day period around the public announcement of the business combination. We used this lapse of time because it is the widest window in which we could guarantee the non-contamination of our events. A more detailed explanation of the event study methodology is included in Appendix A. Appendix A also includes the initial results of the event study.

Table 1 Number of operations by host country

<i>Host country/ region</i>	<i>Number of acquisitions</i>	<i>Number of alliances</i>	<i>Total number of operations</i>
Argentina	1	0	1
Armenia	1	0	1
Australia	2	4	6
Austria	7	1	8
Belarus	1	0	1
Belgium	2	2	4
Bermuda	0	1	1
Brazil	1	1	2
Bulgaria	0	1	1
Canada	3	3	6
Caribbean	0	1	1
Chile	4	0	4
China	1	4	5
Czech Republic	3	0	3
Czechoslovakia	0	2	2
Denmark	1	1	2
El Salvador	1	0	1
France	4	9	13
Germany	12	7	19
Hong Kong	2	3	5
Hungary	2	0	2
India	2	6	8
Indonesia	0	2	2
Ireland Republic	1	2	3
Israel	2	1	3
Italy	5	10	15
Jamaica	1	0	1
Japan	1	6	7
Lithuania	0	2	2
Mauritius	1	0	1
Mexico	0	1	1
Moldova	0	1	1
Netherlands	6	5	11
Norway	4	0	4
Panama	0	1	1
Philippines	0	1	1
Poland	1	1	2
Portugal	1	0	1

Table 1 Number of operations by host country (continued)

<i>Host country/ region</i>	<i>Number of acquisitions</i>	<i>Number of alliances</i>	<i>Total number of operations</i>
Romania	1	0	1
Russian Federation	1	8	9
Singapore	0	5	5
Slovak Rep	1	0	1
South Korea	0	1	1
Spain	4	3	7
Supranational	0	61	61
Sweden	8	4	12
Switzerland	2	0	2
Thailand	0	1	1
Trinidad & Tobago	1	0	1
Ukraine	0	2	2
UK	9	2	11
USA	14	68	82
Uzbekistan	0	1	1
Venezuela	2	0	2
Yugoslavia	1	0	1
<i>Total</i>	<i>117</i>	<i>235</i>	<i>352</i>

Table 2 Number of operations by year

<i>Year</i>	<i>Number of acquisitions</i>	<i>Number of alliances</i>	<i>Total number of operations</i>
1986	1	1	2
1987	0	7	7
1988	2	6	8
1989	4	5	9
1990	3	15	18
1991	5	18	23
1992	2	22	24
1993	3	10	13
1994	4	22	26
1995	5	28	33
1996	4	18	22
1997	8	24	32
1998	13	20	33
1999	27	19	46
2000	32	17	49
2001	4	3	7
<i>Total</i>	<i>117</i>	<i>235</i>	<i>352</i>

Table 3 shows the number of firms depending on their size, as well as the number of operations by the size of the European firm involved.

Table 3 Number of operations by size of European firm involved

<i>Firm size (total assets)</i>	<i>Number of firms</i>	<i>Number of acquisitions</i>	<i>Number of alliances</i>	<i>Total number of operations</i>
Unknown	5	3	5	8
0–1000	17	58	93	151
1001–2000	4	20	94	114
2001–3000	2	2	4	6
3001–4000	3	19	26	45
4001–	3	15	13	28
<i>Total</i>	<i>34</i>	<i>117</i>	<i>235</i>	<i>352</i>

3.3 Independent variables

In order to test our hypotheses, we used the following variables. The most important one is POLICY INSTABILITY. This variable measures policy instability in the geographical area of the alliance or in the country of the acquired company. It is based upon the index of political stability defined by Henisz (2000) – POLCON V index. This index, ranging between 0 and 1, identifies the number of independent branches of government with veto power over policy change in each country and then considers the alignment across branches of government. The higher the number of branches with veto power and the higher the alignment among them (i.e. the higher the POLCON V index), the higher the constraints local governments need to overcome in order to arbitrarily change the rules of the game. In other words, the higher the POLCON V index, the higher the political stability of the country. The POLCON V index has been used as a measure of policy stability to analyse the impact of this variable on the propensity to invest in the telecommunications industry (Henisz and Zelner, 2001), among other contexts. In order to facilitate the interpretation of our results, we constructed an index of policy instability in the following way: POLICY INSTABILITY = 1–POLCONV, which now ranges between 0 and 1 and increases along with the discretion of the government of the host country to unilaterally change the rules of the game. Whenever the international expansion was conducted through an alliance and its activities involved several countries (61 alliances in our sample), the arithmetic average of all countries' indexes was calculated. The range of the policy instability of the host countries in our sample goes from 0.1 (Belgium in 1996 and 1999) to 0.92 (Russian Federation in 1995).

We used several variables to test the influence of entry mode. First, we introduced a dummy variable labelled TOTAL ACQUISITION, valued 1 in the case of acquisitions in which more than 95% of the shares of the target firm are acquired, and 0 in the remaining cases. We used the 95% as a cut-off point, because this is the criterion used in the literature to identify a wholly owned subsidiary (see, for instance, Gomes-Casseres 1989).⁴ With this variable, we tried to identify the situations of greater exposure to policy risk. We also introduced a set of dummy variables to test Hypothesis 3 and to analyse a wider typology of entry modes:

- MAJORITY PARTIAL ACQUISITION, a dummy variable valued 1 if the focal firm is buying a stake in the target bigger than 50% but lower than 95%.
- MINORITY ACQUISITION, a dummy variable valued 1 if the focal firm is buying a stake in the target lower than or equal to 50%.

- MAJORITY JOINT VENTURE, a dummy variable valued 1 if the entry mode chosen is a joint venture in which the focal firm holds a stake bigger than 50%.
- NON-MAJORITY JOINT VENTURE, a dummy variable valued 1 if the entry mode chosen is a joint venture in which the focal firm holds a stake lower than or equal to 50%.
- CONTRACTUAL AGREEMENT, a dummy variable valued 1 if the entry mode chosen is a contractual agreement. For the purposes of this paper, we labelled as contractual agreements all of the strategic alliances in which there is not a joint venture, i.e. a new entity set up to coordinate and/or conduct the collaborative activities.

When this set of variables is introduced, total acquisitions act as the reference group to analyse the influence of these variables.

3.4 *Control variables*

To test the robustness of our results, we also included several control variables in our estimations. First, year, company and country dummies were introduced with the aim of controlling the possible influence of time and any unobserved heterogeneity inherent to each company or country on the abnormal returns. Second, we also introduced some other control variables already used in the literature on the stock market reaction to the formation of alliances and acquisitions or in the literature dealing with the international expansion of regulated firms.

- 1 DIVERSIFICATION: This is a dummy variable, valued 1 in those operations whose purpose is to carry out activities in a non-telecommunications industry. Previous results about the relatedness between the activities of the firms involved in alliances and acquisitions are somehow mixed. In alliances, this relatedness increases the abnormal returns associated with the formation of the alliance (see, for instance, Koh and Venkatraman, 1991; Merchant and Schendel, 2000). As for acquisitions, previous works (see, for instance, Seth, 1990; Balakrishnan and Koza, 1993) show mixed results.
- 2 CULTURAL DISTANCE: This variable measures the cultural distance between the firms involved in the business combination. We created this variable by means of the Kogut and Singh's (1988) index, using Hofstede's (2001) revised measures as input. In the case of multiparty alliances, for each pair of partners, we calculated the Kogut and Singh's (1988) index, and then the average between these indexes, following Kim and Park (2002).
- 3 INCUMBENT: This is a dummy variable valued 1 if the company that carries out the operation is a former national monopoly of telecom services. We included this control because, according to Hennisz (2003) and Bonardi (2004), these companies would have more advantages due to their knowledge in dealing with governments, even though they may be less dynamic than newcomer firms.
- 4 GDP GROWTH PER CAPITA: This variable measures the growth experienced by the GDP per capita of the geographical area entered through the operation in the year prior to it. The data needed to create this variable were obtained from the OECD statistics and from Eurostat, and is included as a measure of the existing opportunities in the target country. When the international expansion was conducted through an alliance and its activities involved several countries, the arithmetic average of all countries' measures was calculated.

- 5 PATENTRIGHTPROT: This variable is based on an index of the effectiveness of the patent system in the country the focal firm is entering. This index is based on the methodology developed by Ginarte and Park (1997), using 1995 data from Park (1999). The index, which ranges between 0 and 5, increases as the protection becomes higher. The lowest value is 0 (Ethiopia, Mozambique, Papua New Guinea and Burma) and the highest one is 4.86 (USA). When the international expansion was conducted through an alliance and its activities involved several countries, the arithmetic average of all countries' indexes was calculated.
- 6 FIRST ENTRY: This is a dummy variable valued 1 when the event studied is the first operation (acquisition or alliance) carried out by the focal firm in the host country.

There is a methodological issue that deserves attention. The field of strategic management is fundamentally predicated on the idea that management's decisions are endogenous to their expected performance outcomes, and endogeneity has important implications for the statistical analysis of such decisions (Hamilton and Nickerson, 2003). In this particular study, we take into account what countries firms decide to enter (country dummies). These variables could not be randomly assigned across the sample, thus rendering our analysis susceptible to self-selection bias. To identify and treat the self-selection bias in our analysis, we followed Campa and Kedia's (2002) methodology. Specifically, we created the variable OECD, which takes value 1 if the host country of the operation was a member of the OECD ($n = 278$) and 0 otherwise⁵ ($n = 74$).

We ran Heckman's (1979) two stages models, one considering the likelihood of entering into the OECD area and other considering the likelihood of entering into other emerging countries (OECD = 0). As regressors in the first-stage model, we used the following:

- 1 Company dummies.
- 2 Firm profitability, measured through the EBIT over sales ratio in the year of the operation, and one and two years before.
- 3 Firm investment, using the ratio of capital expenditures of the firm over sales in the year of the operation, and one and two years before.
- 4 Firm size, as the log of the total assets of the firm in the year of the operation and one and two years before.
- 5 Six variables that count the number of previous operations:
 - made by the studied company in the European Union
 - made by the studied company in other OECD countries outside the European Union
 - made by the studied company in countries outside the European Union and OECD
 - made by other telecommunication companies in the European Union
 - made by other telecommunication companies in other OECD countries outside the European Union
 - made by other telecommunication companies in countries outside the European Union and OECD.

Table 4 shows the correlations and descriptive statistics of these variables.

Table 4 Descriptive statistics and Pearson correlation coefficients

	Mean	SD	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
(1) DIVERSIFICATION	0.60	0.49	1.00												
(2) CULTURAL DISTANCE	1.22	1.16	-0.18	1.00											
(3) INCUMBENT	0.56	0.50	-0.02	0.03	1.00										
(4) GDP GROWTH PER CAPITA	1.94	3.01	0.01	-0.05	0.04	1.00									
(5) PATENTRIGHTPROT	4.03	0.73	0.22	-0.35	-0.12	-0.11	1.00								
(6) FIRST ENTRY	0.33	0.47	-0.13	0.17	-0.13	0.11	-0.25	1.00							
(7) TOTAL ACQUISITION	0.14	0.34	0.01	-0.05	-0.11	0.10	0.09	-0.00	1.00						
(8) MAJORITY PARTIAL ACQUISITION	0.04	0.22	0.03	0.05	-0.12	0.01	0.03	0.05	-0.10	1.00					
(9) MINORITY ACQUISITION	0.15	0.36	-0.22	0.09	0.03	0.02	-0.06	0.12	-0.19	-0.10	1.00				
(10) MAJORITY JOINT VENTURE	0.05	0.22	-0.03	0.04	-0.06	0.01	-0.09	0.08	-0.10	-0.06	-0.10	1.00			
(11) NON-MAJORITY JOINT VENTURE	0.28	0.45	-0.08	-0.02	0.03	0.04	-0.16	0.05	-0.27	-0.15	-0.247	-0.15	1.00		
(12) CONTRACTUAL AGREEMENT	0.34	0.47	0.24	-0.05	0.12	-0.15	0.16	-0.20	-0.29	-0.15	-0.28	-0.15	-0.41	1.00	
(13) POLICY INSTABILITY	0.29	0.21	-0.15	0.32	0.10	0.01	-0.46	0.15	-0.04	0.03	-0.01	0.21	-0.04	-0.03	1.00

The inverse Mills ratios of these two first-stage models were used to calculate a compound lambda ratio (FIRST STAGE LAMBDA VARIABLE). This ratio was calculated following the method used by Campa and Kedia (2002) and was considered in all second-stage models we estimated. As shown below, the FIRST STAGE LAMBDA variable always has a significant effect on the abnormal returns of the operations. This confirms that our sample is affected by a self-selection bias, although this bias is corrected following the inclusion of the lambda ratio. Estimations of the second-stage models are explained and presented in the next section.⁶

4 Results

Using the above-mentioned variables,⁷ we estimated several second-stage multiple linear regression models for our sample. Specifically, we estimated two sets of models. The first set includes only the TOTAL ACQUISITION variable to control for entry mode. The second set uses a more detailed set of variables, already defined above. All of these models are shown in Tables 5 and 6. Each table contains three models. The first one includes only control variables and is the baseline model. The second model includes the POLICY INSTABILITY variable. Finally, the third model also includes the interaction effects between POLICY INSTABILITY and the variables related to the entry mode.

Table 5 Multiple linear regression models

<i>Independent variables</i>	<i>Model 1a</i>	<i>Model 2a</i>	<i>Model 3a</i>
Intercept	33.98***	33.38***	32.77***
TOTAL ACQUISITION	-0.013	0.020	7.924*
POLICY INSTABILITY		3.026	2.932
P.I. × TOTAL ACQUISITION			-35.61*
<i>Control variables:</i>			
Year dummies	Included	Included	Included
Company dummies	Included	Included	Included
Country dummies	Included	Included	Included
DIVERSIFICATION	-0.363	-0.381	-0.360
CULTURAL DISTANCE	-0.745**	-0.714**	-0.679*
INCUMBENT	38.47***	38.74***	38.91***
GDP Growth Per Capita	-0.342	-0.335	-0.343
PATENTRIGHTPROT	-0.935	-0.957	-0.976
FIRST ENTRY	-1.139	-1.099	-1.311
FIRST STAGE LAMBDA	-3.554**	-3.554**	-3.773**
Model F	5.83***	5.62***	5.74***
Number of cases	259	259	259
Adjusted R squared	48.26%	48.47%	49.38%

Notes: The dependent variable is the Cumulative Abnormal Returns, in percentage, over the period [-3,3] (CAR [-3,3]). Abnormal returns were calculated using the Market Model. The year, company and country dummy numbers included in the models are 16, 33 and 54, respectively. The firm coefficients and year dummies are omitted in order to simplify the presentation of these results. Coefficients are robust to the heteroskedasticity.

* $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

Table 6 Multiple linear regression models

<i>Independent variables</i>	<i>Model 1b</i>	<i>Model 2b</i>	<i>Model 3b</i>
Intercept	33.89***	33.31***	45.68***
MAJORITY PARTIAL ACQUISITION	0.705	0.479	-7.563
MINORITY ACQUISITION	0.075	0.101	-7.069
MAJORITY JOINT VENTURE	0.962	1.065	-8.739*
NON-MAJORITY JOINT VENTURE	-0.403	-0.371	-9.285*
CONTRACTUAL AGREEMENT	-0.192	-0.256	-8.154
POLICY INSTABILITY		3.105	-33.42
P.I. × MAJORITY PART. ACQ.			34.71
P.I. × MINORITY ACQUISITION			31.71
P.I. × MAJORITY JV			43.78*
P.I. × NON-MAJORITY JV			41.65*
P.I. × CONTRACT AGREEMENT			36.72
<i>Control variables:</i>			
Year dummies	Included	Included	Included
Company dummies	Included	Included	Included
Country dummies	Included	Included	Included
DIVERSIFICATION	-0.266	-0.265	-0.291
CULTURAL DISTANCE	-0.723**	-0.695*	-0.655*
INCUMBENT	38.75***	39.09***	43.63***
GDP GROWTH PER CAPITA	-0.350	-0.350	-0.358
PATENTRIGHTPROT	-1.106	-1.129	-1.142
FIRST ENTRY	-1.123	-1.102	-1.210
FIRST STAGE LAMBDA	-3.399**	-3.426**	-3.875**
Model F	5.73***	5.54***	5.12***
Number of cases	259	259	259
Adjusted R squared	48.58%	48.79%	50.07%

Notes: The dependent variable is the Cumulative Abnormal Returns, in percentage, over the period [-3,3] (CAR [-3,3]). Abnormal returns were calculated using the Market Model. The year, company and country dummy numbers included in the models are 16, 33 and 54, respectively. The firm coefficients and year dummies are omitted in order to simplify the presentation of these results. Coefficients are robust to the heteroskedasticity.

* $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

In both Tables 5 and 6, each model includes the value of the coefficients of each independent variable, as well as an indication of their significance level. The explanatory power of all the models (measured via the F -statistic) is statistically significant. In all models, we corrected any problem heteroskedasticity, using White's (1980) correction, which allows obtaining robust standard errors for the coefficients. Stata has a specific option to apply this correction.

Table 7 shows the results regarding the net effect of POLICY INSTABILITY, depending on the entry mode chosen. These results only involve Models 3a and 3b and Table 7 includes the coefficients of the relevant variables, the sum of these coefficients (the net effect) and an indication of their significance level.

Table 7 Interaction effects

<i>Model</i>	<i>POLICY INST.</i>	<i>POLICY INST. X</i>	<i>Coefficient</i>	<i>Net effect</i>
3a	2.932	TOTAL ACQUISITION	-35.608*	-32.676*
		MAJORITY PARTIAL ACQ	34.707	1.289
		MINORITY ACQUISITION	31.707	-1.711
3b	-33.418	MAJORITY JV	43.778*	10.36**
		NON-MAJORITY JV	41.649*	8.231*
		CONTRACT AGREEMENT	36.721	3.303*

Notes: * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

The results regarding the prediction according to which investors either value or penalise the exposure to policy risk (H1a and H1b) show that there is not a significant influence of this variable per se in the stock market's reaction to the announcement of international operations. We interpret this result as the juxtaposition of two forces each pulling its own way: on the one hand, there is the ease of negotiating favourable entry terms; and on the other hand, the uncertainty regarding eventual future changes in these terms. We provide a more detailed explanation of this interpretation in the discussion. We find significant and robust support for the prediction that total acquisitions are less valued by investors as policy instability increases (H2); see Model 3a in Table 5. When the operation is a total acquisition, the net effect of the instability is the sum of the coefficients of the two variables (POLICY INSTABILITY and POLICY INSTABILITY X TOTAL ACQUISITION). This sum is -32.676 and is statistically different from 0 with a significance level of 90%. Similarly, the results of the TOTAL ACQUISITION variable are consistent with our second hypothesis. Although this variable has a positive and significant coefficient in the Model 3a, the interaction effect is negative. For this reason, the net effect of the TOTAL ACQUISITION variable will be dependent on the policy instability of the host country. It will be positive if the instability is lower than 0.223 (countries that are usually below this level are, among others, USA, Switzerland or Germany), and negative in countries with higher degrees of policy instability. Finally, we find significant support for the prediction that joint ventures are preferred to contractual agreements as policy instability increases (H3); see Model 3b in Table 6. When the operation is one of those in the table, the net effect of an increase in the POLICY INSTABILITY, for each kind of operation, is the sum of the coefficients of the POLICY INSTABILITY and the POLICY INSTABILITY \times ENTRY MODE variables. These effects are highest in the case of joint ventures (non-majority and majority), followed by the net effect of contractual agreements. These effects are statistically significant at all levels between 90% and 95%. In the case of acquisitions, none of the net effects is statistically different from 0. Thus, our results confirm that joint ventures are preferred to other contractual agreements as the policy instability of the host country increases.

Taken as a whole, our results do not fully confirm all of our hypotheses, since exposure to policy risk per se is not significantly valued by the stock market. However, they are consistent with recent explanations of the international expansion of regulated firms, based on the international exploitation of the ability to deal with governments and regulators. This explanation is developed in the following section.

5 Discussion and conclusion

This study has considered to what extent the stock markets take into account policy risk in the reaction to the announcements of international expansion projects carried out by telecom firms. We expected a negative valuation by the stock market of those projects carried out in conditions of policy instability. We also expected that the entry mode would play a moderating role in the relationship between policy instability and the stock market reaction to internationalisation projects. Using empirical evidence from the international projects carried out by European telecom firms, we found that, contrary to our expectations, the stock market did not react in any significant way to those international projects carried out in conditions of policy instability. However, when the interactions between policy instability and entry mode were taken into account, we only found this positive reaction to policy instability in international projects involving partners. The following discussion examines these somewhat puzzling results.

We found that policy instability per se did not affect significantly the stock price reaction. This result is not only counterintuitive, but also contrary to the conventional wisdom. Previous research suggested that firms are reluctant to invest in countries in which policy hazards are high (Henisz, 2000; Henisz and Delios, 2001; Henisz and Zelner, 2001). Although the impact of policy instability on the stock market reaction to FDI or even on FDI performance has not been analysed yet, a straightforward analysis of this problem suggests that investors would prefer countries with policy stability since the exposure to policy hazards are minimised. However, taking into account the results of recent research on the corporate expansion of regulated firms and the arguments developed in Hypothesis 1b it is possible to explain this result. Bonardi (2004), Henisz (2003) and Guillén (2005) show that the logic of the international expansion of regulated firms lies in exploiting their accumulated knowledge in dealing with governments and operating in a regulated environment in their home country. For these firms, high policy instability is not an impossible barrier to overcome. In fact, their international expansion usually lies in the exploitation of the experience accrued in coping with regulators in their home market. These firms usually do not have technological or marketing capabilities, but they know how to deal with governments and how to operate in a regulated context (Henisz, 2003). In fact, our results show that investors place more value on international expansion movements made by former national monopolists than the international expansion of newcomers, as the results of the *INCUMBENT* variable shows. According to Henisz (2003), former national monopolists have more proprietary advantages accumulated because they have more experience in dealing with regulators. We also have to take into account the fact that governments with high discretion have more chances to alter the conditions of telecom firms, but not necessarily against their interests. For instance, Digicel – an Irish mobile operator – was accused by Haiti's regulator of violating international standards, although this accusation was overruled by the Haitian government, who argued that Digicel was helping to extend the service to Haiti's poor majority (Economist, 2007). Therefore, telecom firms may see countries with high instability as a favourable context in which to exploit their accrued expertise.

Policy instability, therefore, entails high risks but also great opportunities. But why does the market not value total acquisitions when this is the entry mode that allows the firm to get hold of the whole pie of the gains obtained from operating in a foreign country? The answer lies in the fact that, once a firm invests in a country with high policy instability, it can suffer from hold-up problems if it has invested alone. Most of the

investments within the field of telecom industries are not only large but also non-redeployable (Levy and Spiller, 1994; Henisz and Zelner, 2001). Within this context, whenever a firm invests alone in a foreign country with high policy instability, its negotiation power with government may decrease substantially not only because of their greater exposure to risk, but also because of the lack of assistance from a local partner in its relations with the local government. Taking this into account, we predicted that full acquisitions would be less valued as policy instability rises. Our results confirmed this hypothesis. Analysing Models 1a, 1b, 2a and 2b, we can see that there is not a clear reaction to any entry mode. However, when we introduce the interaction between entry mode and policy instability in our estimates, we can see that investors value this instability negatively only when the telecom firm enters alone. In fact, investors see an opportunity in policy instability rather than a threat. But they only react positively to this opportunity if the firm enters in a flexible way; that is, having a partner. In Table 7, we can see that investors prefer strategic alliances to acquisitions, which means that having an explicit commitment with a partner is valued by the stock market.

Although partners are more highly valued in contexts of high policy instability, we predicted that, due to the opportunism problems that policy instability may generate, joint ventures would be preferred to strategic alliances. We expected that policy instability could be some sort of loophole that allowed the local partner to behave opportunistically and that having a joint venture (even as a minority partner) would be preferred by the stock market. As we could see in Model 3b, our results confirm this idea. The net effect of an increase in the policy instability of the host country depends on the entry mode used. This effect is the sum of the coefficients of the POLICY INSTABILITY variable and the multiplicative variable for each entry mode. The net effect is highest in majority joint ventures (10.360 at a significance level of 95%), followed by non-majority joint ventures (8.231 at 90% significance level) and contractual agreements (3.303 at 90% level). The net effects in the case of majority or minority acquisitions are not statistically different from 0. A clear implication of our results is that the optimal entry mode chosen is not independent of policy hazards. Our estimates in Models 1a, 1b, 2a and 2b do not show significant results in the variables related to entry mode. However, when we introduce the models including the interaction effects between POLICY INSTABILITY and entry mode, we see that investors have a clear preference for countries with high policy instability.

It is interesting to note that many of the operations in our sample are European-based. To test the robustness of our results, we reduced the sample excluding those operations carried out in the European Union. The results of the estimations with the new sample do not substantially differ from the ones using the whole sample, as the effect of policy instability per se is still insignificant, becoming significant once introduced its interaction with the entry mode. These results are available upon request.

One control variable that has significant results is cultural distance. The results of this variable are noteworthy. Even though cultural differences do condition the performance of international operations, these differences are never impossible obstacles to overcome. Bidding firms can handle the integration process of the acquisition to deal with cultural differences (Weber et al., 2009). In addition, previous research suggests that cultural distance can damage the performance of foreign acquisitions, which makes strategic alliances a more advisable option (Kogut and Singh, 1988). Taking this into account, it is not easy to explain the significance of this result, as our sample includes acquisitions and alliances. From our point of view, this result is consistent with our view of telecom firms.

The ability to operate in institutional contexts similar to the one of their home market is less valuable as cultural distance increases. In fact, not all governments are equal and the experience of firms is more valuable in institutional contexts similar to those of the country of origin (Henisz, 2003).

To sum it up, the main contribution of our paper is presenting a first empirical analysis of the influence of policy instability on the stock market reaction to the international expansion of regulated firms. Our results suggest that the stock market does not penalise the telecommunications firms that invest in countries with high policy instability. On the contrary, we found that investors prefer expansion moves to countries with high policy instability. However, not all expansions into such countries are valued positively. Investors value policy instability negatively when the entry mode is a total acquisition, and positively in the case of expansions through strategic alliances and, above all, through joint ventures. The main implication of our results is that policy instability does not always harm telecom firms. Although telecom firms, like all firms operating in regulated industries, are more influenced by the actions of governments and regulators, they are also more prepared to deal with them. To some extent, this is a paradox: in an industry that is more affected by policy risk, investors are more willing to be exposed to it. The explanation for this paradox is that firms can manage their relationship with governments to turn policy risks into an advantage. They can do that by profiting from their experience in dealing with governments and by making the most of the assistance their local partners can provide them with. A final implication of our results is that joint ventures provide a better protection to opportunism in contexts of policy instability.

This paper sees the emergence of some interesting insights that may be helpful for practitioners. The main insight of our paper is that policy instability is not an impossible barrier to overcome, as firms can use their political capabilities to handle their relationship with host governments and the stock market does not always penalise the exposure to policy risk. Thus, firms must develop a political strategy to deal with policy risk based on three dimensions: capabilities, local support and governance. First, previous experience dealing with unconstrained policymakers improves the capabilities of a firm so as to the exploitation of this experience in the host market, allowing them to negotiate a better deal. Second, local support entails having a local partner or partners that help in dealing with governments. The local partner provides local information and contacts, and prevents local governments from expropriating the investment of the foreign firm. Finally, governance means having a control stake in the foreign unit, which protects the foreign firm against any potential opportunism from the local partner.

Certain limitations in the study must be taken into account in the analysis of our results. First, the results may be influenced by the particular characteristics of our sample: all the acquisitions and alliances collected in the database were made by European telecom operators. Obviously, results may not apply to other industries. Haggard (1990) argued that the bargaining power between local governments and foreign investors should not be the same, either across all the industries or across all the stages of the investment process. In fact, the existing empirical evidence showing a preference for investing in countries with high policy instability come from regulated industries (García-Canal and Guillén, 2008; Holburn and Zelner, 2010). Thus, more empirical research is needed to identify the degree to which our results can be generalised. A related limitation is that we are not measuring the 'so called' political capabilities

(Henisz, 2003; García-Canal and Guillén, 2008; Holburn and Zelner, 2010). This is a concept that lies behind our hypotheses. Although some conceptualisation efforts have been made (e.g. Dahan, 2005), no empirical studies exist measuring these capabilities, and new empirical studies addressing this issue could shed more light regarding the generalisation of our findings. An additional limitation is that our analysis has only considered two entry modes – alliances and acquisitions – and not greenfield investments, which are another option (see, for instance, Barkema and Vermeulen, 1998). However, this limitation is less important to our study, as telecom operators have usually expanded their boundaries using only acquisitions and alliances (Joshi et al., 1998; Trillas, 2002).

It seems, therefore, that further research using data from other industries and other countries is needed in order to reach conclusions that can be generalised to all acquisitions and alliances, regardless of the investing firm's industry or home country. In addition to this, several interesting questions arise from our paper: the first one is the extent to which firms operating in regulated industries have a different attitude towards policy risk. Another question that deserves attention is the measurement of political capabilities. Finally, the role of cultural differences in the international expansion of telecommunications firms is also worthy of further research.

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Notes

- 1 We considered not only joint ventures, but also any kind of strategic alliance in our sample.
- 2 We considered providers of telecommunication services as those firms whose main SIC code is 4812 (Radiotelephone Communications) and/or 4813 (Telephone Communications, except Radiotelephone). Our sample also included those firms classified under the SIC 4899 (Communications Services, not elsewhere Classified) and whose 'Business Description' in the database is that of telecommunications services providers. Such was the case of British Telecom. This consideration allowed us to detect 34 providers of telecommunication services. The list of companies is available upon request.
- 3 The operations included in our sample are very heterogeneous. For instance, there are R&D, manufacturing and marketing operations, operations which encompasses technology transfer and other which not. Sometimes, the scope of the operation includes one country, while some alliance's scope includes several countries.
- 4 However, we repeated our estimations considering an acquisition to be TOTAL when it involved 100% of the shares of the target company, and the results remained similar.
- 5 Whenever the geographical destination of the operation comprised more than one country (as was the case in some alliances) we considered that OECD variable as 1 if at least one host country belonged to the OECD. We created another more restrictive variable, considering OECD = 1 only where all the host countries belonged to the OECD. The results of our estimations do not differ substantially.
- 6 First-stage results are available upon request.
- 7 In order to test the robustness of our results, we ran all our models, excluding the control variables which coefficients were not significant (as suggested by an anonymous reviewer). More specifically, we excluded the variables DIVERSIFICATION, GDP GROWTH PER CAPITA, PATENTRIGHTPROT and FIRST ENTRY, in all the regression models of the paper. These new estimations do not differ substantially from the original ones. Results are available upon request.
- 8 Expected abnormal returns were estimated using Sharpe's (1964).market model.

Appendix A

We followed Brown and Warner's (1985) procedure to determine the reaction in the stock price of the financial assets, under the announcement of certain relevant events. Abnormal returns are defined as the difference between actual returns and those returns that should be expected according to a market model.⁸ The estimation of the market model was carried out over a 180-day period beginning 200 days before the date of the announcement ($t = -200$) and finishing 21 days before this same date ($t = -21$); $t = 0$ being the announcement date. We excluded the 20 days prior to the announcement from the estimation of the market model so as to remove data that might be affected by the event.

Table A1 shows the results of the event study. We observed that, on average, the companies that carried out cross-border alliances or acquisitions obtained negative and significant returns (in the intervals of accumulation $[-3,3]$ and $[-2,2]$) the same day in which the operation was announced, which oscillated between -0.23% and -0.29% . In acquisitions, we saw how the bidders obtained positive abnormal returns on average, although these abnormal returns are not statistically significant, regardless of the interval of accumulation considered. In the case of the alliances, abnormal returns were only statistically significant for the intervals $[-3,3]$ and $[-2,2]$, in which a loss of value between -0.53% and -0.56% is shown with a significance level of 95%.

Table A1 Abnormal returns (%)

<i>Interval</i>	<i>AR whole sample</i>	<i>% Pos.</i>	<i>AR acquisitions</i>	<i>% Pos.</i>	<i>AR alliances</i>	<i>% Pos.</i>
$[-3,3]$	-0.23^*	43	0.36	40	-0.53^{**}	44
$[-2,2]$	-0.29^{**}	43	0.25	41	-0.56^{**}	44
$[-1,1]$	-0.02	48	0.45	50	-0.24	46
Day 0	-0.08	44	-0.07	44	-0.09	45

Notes: * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

As for the percentage of positive events, we observed that between 40% and 50% of firms in all samples obtained positive abnormal returns. These high percentages showed that investors considered strategic alliances and acquisitions sometimes beneficial and sometimes disadvantageous for firms.