COUNTRY RISK AND VALUATION OF U.S.-LISTED FOREIGN FIRMS

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Country Risk Measures

Laws vary a lot across countries, partly due to differences in legal origin. Based on previous studies, each country is assigned to one of four legal traditions:
(1) English common law
(2) French civil law
(3) German civil law
(4) Scandinavian civil law.

In general, common law countries give both shareholders and creditors the strongest, and French civil law countries the weakest, protection. German civil law and Scandinavian countries generally fall between the other two.

Measure 2: Economic Freedom

The Index of Economic Freedom is created by the Heritage Foundation along with the Wall Street Journal. Since 1995 this index has tracked the march of economic freedom of more than 180 countries around the world. The economic freedom is described as the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself.

Measure 3: Freedom from Corruption

Corruption index is from Transparency International, which includes firm size, high tech dummy, global offer dummy, IPO first-day return and the number of underwriting managers. Y represents a number of country risk variables.

Empirical Results

Regression analyses are used to examine the effect of country risk variables on the valuation of foreign IPOs listed in the U.S.

The results indicate that IPO valuation is not only affected by its offer- and firm-specific characteristics such as firm size, whether or not it is in the high-tech sector and the number of underwriters, but also affected by the home country’s economic freedom and freedom from corruption. The magnitude of the coefficient of the economic freedom index implies that for each 10-point increase in a nation’s economic freedom index, the average q ratio can increase by 0.70.

Testable Hypothesis

In general, countries with weak legal institutions or less economic freedom are associated with weak investor protection and shaky corporate governance. Hence, the main hypothesis of the paper is as follows:

The valuation of foreign IPOs is inversely related to country risk. In other words, firms domiciled in countries with higher country risk are worth less, other things equal, at their IPO debuts in the United States.