

# The Effect of Foreign Ownership on Firm Performance: Evidence from Emerging Market

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## ABSTRACT

With the surge up in foreign direct investments, the percentage of foreign ownership in total has increased within the domestic firms in emerging markets and especially in Turkey. Due to the advantages of foreign ownership, firm profitability is expected to ameliorate as opposed to domestically owned firms. Empirical studies conducted on this topic demonstrate conflicting results. The main purpose of this paper is to analyze the effect of foreign ownership on firm performance for the publicly listed companies in Turkey using a panel of 256 Turkish firms over the 2009-2014 period. “Generalized Method of Moments” is used as the main methodology; which helps overcoming the endogeneity problem to a great extent. The results derived from this study indicate that foreign ownership improves firm profitability up to a certain level; however after the threshold limit, the surge up in foreign ownership starts to deteriorate firm performance.

**Keywords:** Foreign Ownership, Foreign Sales, Firm Performance, Generalized Method of Moments (Gmm), Endogeneity, ROA

## 1. INTRODUCTION

With the rise of globalization prevailing in the 21<sup>st</sup> century; Foreign Direct Investments (FDI) have surged up in the emerging markets; which has prospered not only economic growth, but also improved the corporate governance standards in the subject countries. According to Yudaeva et al. (2003); FDIs bring foreign technologies into the emerging markets; which eases the information buildup process, paving the way for the modernization of manufacturing facilities in the emerging markets, with the combination of technological improvements and increasing competition.

Similar to the other emerging markets, who have become the targets for FDI, Turkey is also one of the emerging markets who attracts great attention within this respect, as a consequence to which, Foreign Direct Investments in Turkey have also surged up tremendously, especially in the last two decades. The fact that Turkey has a very strategic position being located in between the Eastern border of the European Union and the Middle East, which is oil-rich; increases the likelihood of inward FDIs.

Given the huge impact embedded in Foreign Direct Investments, the effect of FDIs on firm performance and corporate governance has been a huge area of concern both by the academic world and by the policy makers. In the academic world, despite the fact that the role of ownership structure on firm performance is analyzed to a great extent in order to figure out the effects of different types of ownership structures; i.e. family-owned, state-owned, etc. on different kinds of performance measures; the effect of foreign ownership on corporate performance has not been analyzed to a great extent.

The main purpose of this paper is to analyze the effect of foreign ownership on firm performance. This hypothesis will be tested with three separate regressions, the details of which will be given in the following sections. This paper aims to provide a full examination of the particular nature of the relationship, as a consequence to which we aim to show its uniqueness. What differentiates this research from the rest is the fact that instead of a linear relationship, we perceive it as non-linear, as a consequence to which we also insert the square of foreign ownership into question and analyze firm performance accordingly.

In a nutshell, we would like to analyze whether or not the surge up in “foreign ownership” positively affects the “return on assets” and if there is a relationship, whether or not this relationship exists when the corporation is minority or majority owned by foreigners. Moreover, another differentiating factor about this paper is its methodology. “Generalized Method of Moments (GMM)” is used for this research; which will bring a brand new perspective at the subject matter. As a result of our findings, we are aiming to provide a guide for the corporate world in terms of figuring out the optimal level of foreign ownership.

The rest of the paper is analyzed as follows: While the literature on “the effect of foreign ownership on firm performance” will be analyzed in the next section; the methodology including the sample, data and method specification will be analyzed in the third section. The article will be finalized with the conclusion section, wherein the main results will be emphasized in addition to giving the future outlook of the research.

## 2. LITERATURE REVIEW

Many studies have been conducted to answer the question of whether firms with foreign owners perform better than domestically controlled firms. Barbosa and Louri (2005) state that “multinational corporations display superior performance and their advantage is comprised of financial advantages, product differentiation and marketing advantages, advantages arising from superior governance or from the ability to exploit economies of scale”. Given the multi-layer of advantages associated with foreign ownership; the empirical studies conducted in this area will be scrutinized in this section in order to figure out whether or not the embedded advantages have turned into actual rises in performance measures of corporate. Given the difference in intrinsic dynamics of developed countries vs. developing countries; literature on this topic should be analyzed in two sections: the effect of foreign ownership in developed countries vs. the effect of foreign ownership in developing countries, i.e. emerging markets. Following this, literature review conducted for the Turkish market will also be scrutinized.

As far as the literature on developed countries is concerned, Grant (1987) assessed the relationship between return performance and explanatory factors for UK; which demonstrated that there is a positive relationship between foreign ownership and firm profitability. Supporting the findings of Grant (1987), in their empirical studies, Caves (1996) and Boardman et al. (1997) also state that multinational corporations have superior performance in the developed countries, i.e. UK and Canada, respectively. In a study conducted for the publicly listed companies in Belgium; Goethals and Ooghe (1997) tested whether or not the performance of foreign firms outweigh the performance of domestic firms and they concluded that firms with foreign ownership have better performance measures than their domestically owned counterparts. Moreover, Qian (1998) analyzed the US industrial corporations for the period 1981-1992 and found that the return performance is different with change in foreign involvement, i.e. foreign ownership has a significant effect on the performance measures of the companies. Furthermore, Alan and Steve (2005) also analyzed the issue of foreign ownership for the firms in UK, through examining 333 overseas acquisitions for the period 1984-1995; wherein they concluded that foreign ownership have significant positive returns on firm performance.

Notwithstanding the fact that there is general consensus on foreign ownership positively effecting firm performance, there are some contradictory studies. For example, Kim and Lyn (1990) found that firms with foreign ownership in the US market perform worse than randomly selected domestically owned firms. Furthermore Clobberman et al. (1994) state that once the effects of capital intensity and size are controlled for, multinational corporations domiciled in Canada are not significantly more productive than domestically owned firms in Canada, emphasizing the fact that the superior performance of foreign owned firms stems from the high capital intensity and large size that generally characterize them. Moreover, supporting Kim and Lyn’s results, Driffield and Girma (2003) also endorse their idea by stating that foreign firms in the UK pay higher wages that may offset the productivity advantages. In a study conducted by Barbosa and Louri (2005), it has been concluded that “ownership ties do not make a significant difference with respect to performance for firms in Portugal and Greece”. These findings clearly demonstrate that the effect of foreign ownership on firm performance can be both positive and negative for the developed countries.

The empirical analysis conducted for developing countries by Lecraw (1984), Willmore (1986) and Majumdar (1997) demonstrate that ownership has an impact on firms’ performance. They state that firms with foreign ownership ties perform better than domestic firms with similar characteristics. Furthermore, Chhibber and Majumdar (1999) takes into consideration foreign control considerations for the Indian market and conclude that firms with foreign ownership outperform the domestically owned firms.

Similar to the findings stated above, Blomström and Sjöholm (1999) demonstrate that foreign ownership in Indonesia results with higher labor productivity; however the percentage owned by foreigners, i.e. minority owned or majority owned, does not matter. Supporting the conclusions of Blomström and Sjöholm (1999); Khawar (2003) analyzed the Mexican market and concluded that foreign firms are more productive than domestic firm.

Dauma et al. (2003) conducted a study for the Indian market and analyzed the effect of foreign ownership on the performance of Indian firms and they concluded that foreign ownership positively affects firm performance. Akimova and Schwödiauer (2004) analyzed the Ukrainian market and studied the effect of ownership structure on corporate governance and performance

of privatized corporations in the Ukrainian transition economy. Their results demonstrate that there are significant ownership effects on performance, but the relationship is non-linear.

On the other hand, Konings (2001) made a research to test the effects of FDI on productivity performance of firms on three developing economies: Bulgaria, Romania and Poland and they concluded that foreign corporations do not perform better than domestic ones, except in Poland.

Finally, Greenaway et al. (2014); tried to comprehend the linkage between FDI and economic growth: if the Foreign Direct Investments to a country are large and come in the form of joint ventures, its effect on the performance measures of the companies taking the FDIs will be positive, leading to a significant growth channel and hence deriving us to make the conclusion that FDIs via joint ventures could be especially beneficial. Greenway et al. (2014), who analyzed the Chinese market, concluded that despite the fact that productivity and profitability initially improve with the surge up in foreign ownership; its begins to decline after an optimal point; which proposes that some domestic ownership should be prevailed to ensure optimal financial performance. The analysis conducted in the developing countries also demonstrate contradictory results, similar to the findings of the developed countries.

Before proceeding to the empirical analysis section; it is necessary to analyze the studies conducted in this subject for the Turkish market. Gunduz and Tatoglu (2003) examined the Turkish market and arrived at the conclusion that foreign owned firms have significantly better performance than domestic firms, with ROA being used as the performance measure. Isik et al. (2004) also analyzed the same subject and their findings suggest that the foreign owned banks outperform the domestically owned banks, due to the technological improvements in their operation process. Moreover, Aydin et al. (2007) investigated whether foreign owned firms perform better than domestically owned firms and concluded that firms with foreign ownership perform better than their domestic counterparts in terms of return on assets.

Based on the literature review conducted above, it can be stated that both for the developed countries, as well as for the developing countries, the results are contradictory, which clearly demonstrates the importance of this issue. Given its significance, the purpose of this paper will be to explore the relationship between foreign ownership and profitability measures for the Turkish market, which we aim to act as a guide for those corporations that will be involved with FDIs in terms of proposing the optimal level of foreign ownership.

### **3. DATA AND METHODOLOGY**

#### **3.1 Data**

The empirical study is conducted with 256 firms trading at Borsa Istanbul (BIST), using the time period between 2009 and 2014. Our initial sample consisted of 447 securities trading at BIST; where financial institutions such as banks, insurance companies, investment companies, brokerage firms and real estate investment trusts are excluded from the sample. Also, firms that do not have available date for at least 3-years are excluded in order not to have missing data problem in our analysis. As a consequence to this process, we obtained a panel data consisting of 1536 firm-year observations.

Our sample includes manufacturing, construction, public work, wholesale and retail trade, hotels and restaurants, electric, gas and water, transportation, communication and storage and technology industries. While the annual balance sheet and income statement data of the companies is taken from FINNET database; ownership data is taken from Central Registry Agency (MKK).

In this study, firm performance, which is the dependent variable in our analysis, is measured by return on asset (ROA) that is defined as the ratio of net income to total assets. The most important independent variable is “foreign ownership”. In order to fully understand the impact of foreign ownership on firm performance, we use three sets of regressions. In the first two regressions we use dummy variables: Minority and majority foreign ownership. Minority foreign ownership (Minority) dummy variable is equal to 1 if the percentage of capital paid-in by foreign investors is less than 50% and equal to 0 otherwise. On the other hand, majority foreign ownership (Majority) dummy variable is equal to 1 if the percentage of foreign ownership is greater than 50%, and 0 otherwise. In the last regression, foreign ownership percentage is used as a continuous independent variable. Table 1 below shows the summary statistics both for the groups “Minority” and “Majority” in addition to the “full sample”.

The other independent variables in the analysis are size, leverage, asset structure, foreign sales, market-to-book ratio and dividend yield. These are the control variables, included in light of finance literature, which may have an impact on the performance of the firm.

**Table 1: Mean statistics for ownership categories**

	Foreign ownership <50% (Minority)	Foreign ownership >50% (Majority)	Full sample (no restriction)
ROA	0.0096	0.0648	0.0223
Leverage	0.2655	0.2045	0.2522
Size	19.1267	21.349	19.5109
Asset structure (Tangibility)	0.3204	0.2981	0.3154
Foreign Sales	0.1879	0.2309	0.1938
MV/BV	1.4863	2.3171	1.5909
DivYield	0.0273	0.0476	0.0298
Number of observations	1142	303	1536

Sum of the number of observations for minority and majority is not equal to the total sample size due to the missing observation of ownership data for some firms.

- Size is measured by natural logarithm of total assets. Larger firms can benefit from economies of scale and therefore they have competitive advantage against smaller firms. From this point of view, it is expected to have a positive effect on performance. But, on the other hand, when the firms increase their assets unnecessarily, in other words, more than enough for their investments due to managers' own interest, this will cause an inefficient use of the sources of the firm. In this case, a negative effect of size on corporate performance could be observed.
- Another control variable is leverage, which is the ratio of short-term debt plus long-term debt to total assets. Highly leveraged firms have financial risk, which leads firms to have difficulty to finance their own investments (Myers, (1977). Moreover, firms use lower level of leverage due to the cost of debt and prefer internal financing rather than debt (Myers and Majluf (1984)). Therefore, we expect a negative impact of leverage on firm performance.
- Asset structure of a firm is the ratio of fixed tangible assets to total assets. Intangible assets is a way of estimating the growth opportunities of the firm, which is a value enhancing property. Firms with high growth opportunities have higher investment possibilities which leads to rapid firm growth. Therefore, we expect a negative impact of tangibility (asset structure) on firm performance.
- Adam and Goyal (2003) argues that the best proxy for growth opportunity is the market-to-book ratio which is one of our control variables. We expect a positive effect of market-to-book ratio on performance.
- We also add dividend yield as a control variable following the Fama and French(2000) profitability model.
- Foreign sales variable is defined as the ratio of exports to sales. This variable shows firm's independence from the domestic market. Exporters are expected to have higher firm performance as they are more productive than domestic firms (Wagner, (2007)).

### 3.2 Methodology

The empirical analysis includes three different regressions with a panel data of 256 firms and 6 years. In the first two regressions we use dummy variables to control for foreign ownership. All the regressions are estimated using the generalized method of moments (GMM) of Arellano and Bond (1991) which is also known as dynamic panel data analysis.

$$ROA_{it} = \beta_0 + \beta_1 ROA_{it-1} + \beta_2 Minority_{it} + \beta_3 Leverage_{it} + \beta_4 Size_{it} + \beta_5 AssetStructure_{it} + \beta_6 ForeignSales_{it} + \beta_7 MV / BV_{it} + \beta_8 DivYield_{it} + u_i + \varepsilon_{it} \quad (1)$$

where the subscript t indicates time and, i firm.  $ROA_{it}$  is our firm performance measure. Following Voulteenaho (2002) "lagged of ROA" is included as a regressor. This approach is similar to the profitability model of Hou and Robinson (2014) which is a modified version of Fama and French (2000) profitability model. We define  $Minority_{it}$  dummy variable as the following,

$$Minority_{it} = \begin{cases} 1, & \text{if foreign ownership percentage is less than 50\%} \\ 0, & \text{otherwise} \end{cases} \quad (2)$$

For the other regression we use Majority dummy instead of Minority. Majority dummy is equal to 1 if the foreign ownership percentage is greater than 50% and 0 otherwise. The motivation for the second regression is to check the sign of foreign ownership dummy. We expect a sign change between Minority and Majority. It is expected to have a positive effect of foreign

ownership on corporate performance. On the other hand, when the ownership of foreigners exceed the domestic ownership percentage, then the effect of foreign ownership is expected to be in the opposite direction. So, these two regressions are done in order to see whether the impact of the majority and minority dummies are in the same direction.

$$ROA_{it} = \beta_0 + \beta_1 ROA_{it-1} + \beta_2 Majority_{it} + \beta_3 Leverage_{it} + \beta_4 Size_{it} + \beta_5 AssetStructure_{it} + \beta_6 ForeignSales_{it} + \beta_7 MV / BV_{it} + \beta_8 DivYield_{it} + u_i + \varepsilon_{it} \quad (3)$$

Finally, in order to fully understand the impact of foreign ownership on corporate performance, continuous foreign ownership variable is used in the last regression. Foreign ownership variable is the percentage of the capital paid-in by foreigners. In this regression the square of foreign ownership is also used due to the possibility of non-linear relationship between foreign ownership and performance (Greenaway, Guariglia and Yu (2014)). If there is a nonlinearity between foreign ownership and performance, the sign will be different for the square of foreign ownership variable.

$$ROA_{it} = \beta_0 + \beta_1 ROA_{it-1} + \beta_2 Foreign\ Ownership_{it} + \beta_3 Foreign\ Ownership_{it}^2 + \beta_4 Leverage_{it} + \beta_5 Size_{it} + \beta_6 AssetStructure_{it} + \beta_7 ForeignSales_{it} + \beta_8 MV / BV_{it} + \beta_9 DivYield_{it} + u_i + \varepsilon_{it} \quad (4)$$

In all the regressions we have lagged ROA as an explanatory variable. Thus, implementing the methodology of “ordinary least square” will not be appropriate, since it will be biased and inconsistent. Therefore, all the regressions are estimated using the “generalized method of moments” of Arellano and Bond (1991) in order to avoid any possible endogeneity problems. In this method, first difference is used to get rid of individual effects. Arellano and Bond’s argument is that necessary instruments are “internal”, meaning estimation uses lagged values of instrumented variables. Although the external instruments are allowed, we do not use any external instruments in the analysis. We use first and second order lagged values of each explanatory variables as the instruments. To understand whether the instruments are legitimate and the model is correctly specified, we use Arellano-Bond serial correlation test for second-order serial correlation AR(2) or the m2 test of the residuals in the equations. The null hypothesis of “no autocorrelation” for AR(1) is usually rejected. But, this is as expected. The important Arellano-Bond test is AR(2) or m2 test, since it detects the autocorrelation in levels. We need to have no second-order serial correlation in the residuals of the first-difference equations. We cannot reject the null hypothesis of no serial autocorrelation for all of our three regressions. Therefore we conclude that our model specification is valid.

#### 4. EMPIRICAL RESULTS

The effect of foreign ownership on firm performance is analyzed using three different GMM regressions. In Table 2 the results of these three regressions are given. In the first two regressions, we use minority and majority dummy variables in order to understand the direction of the effect of foreign ownership on firm performance. We try to figure out the possible non-linear relationship between foreign ownership and performance. As it is seen from the results of the first two regressions, minority dummy has a positive effect on firm performance whereas majority dummy has a negative effect. This is a strong evidence for non-linearity between foreign ownership and performance.

On the other hand, the last regression uses the foreign ownership as a continuous explanatory variable. In light of the first two regressions, we add the square of foreign ownership, to capture the non-linearity between foreign ownership and firm performance. The result of the last regression shows that foreign ownership variable has a positive coefficient whereas foreign ownership square variable has a negative coefficient. This finding supports the non-linearity between firm performance and foreign ownership. In addition to the first two regressions, the last regression shows that the positive impact of foreign ownership on performance changes direction and turns to a negative effect on performance. In other words, foreign ownership has a positive impact on performance but up to a point.

When the foreign ownership percentage exceeds the threshold, it starts to depreciate the performance of the firm. One possible explanation for this finding is that foreign owners do not have enough information about the domestic market and the dynamics of the country and this may lead to inappropriate investment decisions for the firm. At this point, the effect of foreigners on the firm’s decision making procedure should be investigated. In addition to the foreign ownership, the foreigners in the firm management and in the board of directors will also have an impact on the firm’s decision and through this way on the performance of the firm. This will be the subject of our future research.

When we come to the control variables in the third regression, we observe that “size, leverage, tangibility and dividend yield” have negative impact on performance, though leverage and dividend yield are insignificant. Negative impact of size on

**Table 2: Estimation results**

	ROA (1 <sup>st</sup> Regression)	ROA (2 <sup>nd</sup> Regression)	ROA (3 <sup>rd</sup> Regression)
ROA <sub>t-1</sub>	0.196 (11.166)***	0.242 (19.385)***	0.192 (9.424)***
Minority	0.023 (3.824)***		
Majority		-0.004 (-0.969)	
Foreign ownership			0.095 (2.344)**
Foreign ownership <sup>2</sup>			-0.206 (-2.884)***
Leverage	-0.004 (-0.617)	-0.041 (-2.161)**	-0.007 (-0.940)
Size	-0.012 (-1.666)*	-0.022 (-3.379)***	-0.012 (-1.764)*
Asset Structure	-0.159 (-4.389)***	-0.131 (-11.785)***	-0.166 (-4.907)***
Foreign Sales	0.021 (0.561)	-0.076 (-4.820)***	0.026 (0.661)
MV/BV	0.001 (3.538)***	0.001 (5.891)***	0.0008 (3.042)**
DivYield	-0.002 (-0.313)	-0.011 (-3.253)***	-0.003 (-0.609)
AR (1) ( <i>m1</i> )	-4.063***	-4.186***	-4.111***
AR (2) ( <i>m2</i> )	0.427	0.653	0.349

ROA is the performance measure of the study. It is the ratio of net income to total assets. Lagged ROA is used as an independent variable. Minority is a dummy variable equal to 1 if the ownership concentration of foreign investors is less than 50% and 0 otherwise. Majority is a dummy variable equal to 1 if the foreign ownership percentage is greater than 50% and 0, otherwise. Foreign ownership is the percentage of capital paid-in by foreign investors. Leverage is the ratio of short-term debt and long-term debt to total assets. Size is the natural logarithm of total assets. Asset structure is the tangibility of firm which is defined as the ratio of tangible fixed assets to total assets. Foreign sales is the ratio of exports to sales. MV/BV is the market-to-book value of the firm and DivYield is dividend yield that is the ratio of dividend payments to market capitalization of the firm. *m1* and *m2* are the tests for first and second order serial correlations in the first-difference residuals. They are asymptotically normally distributed as  $N(0,1)$  under the null hypothesis of no serial correlation. In the parenthesis asymptotic t-statistics are given. (\*, \*\*, \*\*\* indicate 10%, 5% and 1% significance level, respectively.)

performance shows that, in Turkey, larger firms are cannot benefit economies of scale sufficiently and may be suffering from diseconomies of scale. But this is not the scope of this study.

Negative effect of tangibility, or asset structure is expected since the intangible assets are thought to be the valuable growth opportunities of the firm. (Myers (1984)). As intangible assets increase, the investment opportunity of the firm increases; which leads the firm to grow faster. Similarly, the other growth opportunity proxy, i.e. market-to-book ratio has a positive impact on performance. Despite the fact that exports to sales ratio has a positive sign in our results, which is in line with our expectations, interestingly, it is insignificant.

## 5. CONCLUSION

With the surge up in Foreign Direct Investments prevailing in the global economy; it has become necessary to see the consequences of foreign ownerships in the domestic companies. In line with this, the purpose of this study is to analyze the effect of foreign ownership on the firm performance. In the literature review, it has been observed that the empirical findings contradict with each other such that while some findings demonstrate that foreign ownership improves firm profitability, other findings conclude the opposite; which increases the significance of this subject even further.

This study has been conducted for the Turkish market, which has a very special location in terms of being located in between Europe and Asia; which pampers foreign direct investments even more. What differentiates this analysis from the rest is its methodology, as a new perspective has been gained with the implementation of "General Method of Moments". The results of our analysis indicate that while the minority dummy positively effects firm performance, majority dummy negatively effects it; which clearly demonstrates that foreign ownership up until a certain level is beneficial for the company, however after that point, increasing the percentage of foreign ownership damages the financial performance of the firm, validating the non-linear relationship between foreign ownership and performance. As Barbosa and Louri (2005) has stated; foreign ownership brings financial, marketing, technological and governance related advantages; which helps firms improve their financial performance; however having too much foreign ownership starts to deteriorate the firm's financial performance, as the firm gets too alienated from the locals and the firm is no longer able to respond to the domestic needs of its customers.

In this study, the effect of foreign ownership on firm performance has been analyzed only for one of the emerging markets, i.e. Turkey. In order to get a grasp of the full picture of the emerging markets, this study should be expanded to include the other emerging markets into analysis, with the ultimate aim of having a full picture of the effect of foreign ownership on firm

performance for the developing countries, which constitutes our future research topic. Furthermore, in order to understand the intricate dynamics of involving foreigners to the companies, besides foreign ownership; the foreigners at the top management level and also in the board of companies will also be analyzed in our future research.

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