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# Farmers Fox Theory: Does a country's weak regulatory system benefit both the acquirer and the target firm? Evidence from Vodafone-Hutchison deal

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## ABSTRACT

The extensive research on cross-border mergers and acquisitions performed in different institutional settings shows that legal and regulatory infrastructure, level of investor protection, and key macroeconomic factors are the most important determinants. With this in mind, we analyze and discuss the telecommunications market leader Vodafone's cross-border acquisition of Hutchison equity stake in CGP Investments, which had long-time delayed (litigated) in an Asian emerging market—India—in the view of corporate gains tax. Regarding theory testing and development, we test six theories propounded in management-related literature. Further, based on limitations of the existing theories we develop new theory—*Farmers Fox Theory*—and offer lawful propositions for future research that would advance the current international business and institutional knowledge. We therefore conclude that a given country's weak regulatory system benefits both the acquirer and the target firm; simultaneously, this behavior would adversely affect on economic/fiscal income of a nation.

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## 1. Introduction

Mergers and acquisitions are possibly the most aggressive strategic organizational response to resource dependence [1]. Indeed, foreign merger or acquisition is a potential mode of entry into a global market. Further, an acquisition involves transfer of an asset between two owners of different countries who are taxed differently. By and large, a great amount of overseas investment crop up in the outward appearance of acquisitions [2]. For example, number of world foreign mergers or

acquisitions has been increased from 23% of total volume in 1998 to 45% in 2007 [3]. In particular, number of deals (deal value) of word economy cross-border mergers and acquisitions (hereinafter, CB-M&As) has increased from 1,582 (US\$21.09 billion) in 1991 to 7,018 (US\$1,022.72 billion) in 2007 at a massive growth rate 344% (4,748%), and thereafter sharply declined to 5,769 (US\$525.88 billion) in 2011 because of recent

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global financial crisis.<sup>1</sup> The main drivers of these CB-M&A waves are being globalization, technological innovation, bull financial market, deregulation, and privatization [9].

A country's governance system, constitutional framework, legal environment, trust and relationship, and culture play a key role in international negotiations, and their *ex-ante* and *ex-post* accounting earnings [10,11,12]. For example, in [10,13,14,15,16,17,18,19,20] the authors show that legal framework, level of investor protection, cross-culture, corporate governance system, financial markets environment and quality of accounting standards are important factors while making deals triumphant, and the same factors could affect firm's value and profitability. In addition, a country's macroeconomic factors, such as, gross domestic product (GDP), tax system and tax incentives, exchange rate, and inflation rate likely to be influenced the border-crossing mergers or acquisitions [21,22,23,24,25]. More importantly, local political events could affect foreign direct investments for both the inbound and outbound flows [26,27,28]. In some instances, physical distance also plays a role in international investments [29].

However, many emerging markets (EMs) have failed to show a good governance system in several international trade activities, especially foreign direct investments (FDIs) and cross-border acquisitions. For instance, Indian government has been utterly failed to take an appropriate action in FDI proposals (e.g. retail market, telecom sector), and CB-M&A deals.<sup>2</sup> For example, Vodafone and other multinational giants in different sectors from different nations were badly experienced to the put forth of regulatory authorities' peculiar guidelines. In fact, it is being a "stranger in a strange land" [30].

With this in mind, we outline our objective, and contribution to the international business (IB) literature. We thus emphasize on tax litigation in cross-border deals that is attached with Indian government. In particular, we show India's CB-M&A market during 2000-2011, case background, and case analysis and discussions. Regarding theory testing and development, we test six theories propounded in management-related literature (theory of foreign direct investment, eclectic paradigm, Uppsala theory of firm internationalization, liability of foreignness, institutional theory, and information asymmetry theory). Based on limitations of existing theories, we develop a theory in light of regulatory framework – Farmers Fox Theory – that would advance existing IB knowledge; also offer some important propositions for new research. The selection of words 'Farmers' and 'Fox' are stubborn, hence they are purposeful that similar to Dunning's view [31].

The remainder of the paper is set up as follows. Section 2 outlines the extensive literature on CB-M&As. Section 3 explains the method. Section 4 shows India's CB-M&As market and regulatory framework. Section 5 presents case information. Section 6 discusses point and counterpoint of the given case. In Section 7, we test various business theories, and propose a new theory and offer lawful propositions. Section 8 concludes the paper.

## 2. Review of related literature on CB-M&As: A law and governance perspective

Given the outstanding backdrop to the study, we have reviewed the studies that ranging from a macroeconomic determinant to a firm-specific determinant of CB-M&As. We therefore outline the review of literature in two schools. First, it presents the extensive contributions on various factors, which determine foreign investments and cross-country acquisitions. Second, it draws a set of synopsis from the most relevant determinant of taxation in foreign mergers.

### 2.1. Review of studies related to foreign investment and M&A deals

Corporate structures create superior value to the firm when it has multinationalized [32]. Thus, a global expansion strategy is likely to be appealed by two essential channels, namely foreign direct investments (FDIs) and M&As. It is evidenced that these channels influence [favourable/unfavourable] by numerous economic, political, legal and so forth of institutional factors. For instance, regarding the effect of political events on FDIs in Germany and Japan, German firms invest in less advanced-economies; conversely, internal political conflicts in the host countries of the less advanced-world adversely affect foreign investments. On the other hand, intergovernmental networks or relationships, and relative weight of economic environment are important key factors in determining border-crossing investments by Japanese firms [27,28].

In [33] authors argue that strength (weakness) of a legal framework would influence international investments. In other words, mergers or acquisitions (volume) may increase and target firms improve their efficiency after merging with a company established in countries where a stronger investor protection offers [20]. In fact, target firm usually adopts the accounting standards, disclosure practices, and governance structures of the acquiring firm [13]. Further, it describes that when there is no formal change of the domestic legal system, firms in a country may adopt different levels of investor protection, depending on the firms they merge. Furthermore, acquiring firms pay a higher premium for targets from countries with a weak regulatory setting or less institutional environment because of significant asymmetric information and agency issues [12,19,34].

In [15] the author finds that financial variables and other institutional factors play a crucial job in both inbound and outbound capital flows. Thus, size of financial markets is one of the determinants when a domestic enterprise invests or acquires a firm abroad. The author estimations indicate that a 1% rise of the stock market to GDP ratio is associated with a 0.955% increase in CB-M&As activity. In case of U.S. foreign acquisitions, bidding firms benefit from mergers or acquisitions take place in economies with a worse or weak financial markets regulatory setting [17]. In other words, it states that stronger the financial regulatory system, and therefore bidder firm shareholders should experience positive returns, or else, weak (negative) [12]. More recently, a study shows that bidder firms of targets based in civil-law nations have outperformed to the deals based in common-law nations. It also suggests that buying a firm in economies where higher restrictions on capital mobility could add premium to the acquiring firm shareholders' wealth [10]. Similarly, geography or territory, quality of accounting

<sup>1</sup> See [4,5,6].

<sup>2</sup> For instance, in [7], authors show a delayed oil and petroleum deal between Vedanta and UK's Cairn Energy; on the other hand, a broken telecom deal between India's Bharti Airtel and South Africa's MTN [8].

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