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Cross-border opportunity sets: An international empirical study based on ownership types

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ABSTRACT

This paper is the first, to our knowledge, to make the distinction between the investment opportunity set of real assets versus portfolio securities. We perform a large scale formal investigation of the investment opportunity set in global acquisitions based on ownership type over the period of 1985–2012. Compared to private acquirers, government acquirers have a much reduced investment opportunity set. Government acquirers invest in fewer target nations and industries, settle for smaller stakes, invest in countries with lower quality legal institutions and in nations with which political relations are more positive and see a 50% higher deal failure rate.

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1. Introduction

The notion of investment opportunity set plays a key role in finance, both in theory and empirics. In portfolio investment, investment opportunity set defines the efficient portfolio frontier, which in turn helps generate the capital market line and capital asset pricing model, etc. The size of the investment opportunity set underlies the gains from diversification, from expanding to international stocks, to investing in nontraditional assets. It is generally acknowledged that investors gain from a greater investment set, while reducing the investment opportunity set causes a reduction in investors' wealth and an increase in risk. Examples of changes in size include the expansion of the investment opportunity set through international diversification across exchanges in different countries, and the reduction of this set for foreign investors to a restricted list of 'investible'.

Our understanding of the role of investment opportunity set in real assets, however, is not as well developed. This is, to a large extent, due to the fact that the real asset opportunity set is more complex. For a multinational

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firm domiciled in country 'x' desiring to invest in foreign country 'y', either through direct investment or acquisition, its investment opportunity set would depend on several factors. First, there is the issue of whether the size of the investment opportunity set depends on the identity of the home country of the multinational firm, i.e., could a multinational firm from country 'x' be allowed in invest in the real assets of country 'y'? Will they be excluded from investing in a particular set of industries? These constraints on investment opportunity set, which could be country pair and country-industry pair specific, differ from the broad restriction on portfolio investment in which 'investible' applies to all foreign investors. Second, the ownership type or affiliation of the foreign firm could matter. Constraints to invest in country 'y' may apply differently depending on whether the multinational firm is owned by private individuals or affiliated with state agencies of country 'x'. Third, unlike portfolio investment that involves a fraction of a company, real asset investment often requires full or majority control. The real asset investment opportunity set could be reduced if the foreign firm faces constraints on the percentage of ownership. The limit on ownership could affect the multinational's ability to restructure, to take risks, or to engage in innovative activities. Fourth, if completion of a transaction is highly uncertain, and thus, reducing its expected value and rendering the opportunity set as probabilistic, the result is also a reduction in the real asset opportunity set.

These differences between portfolio investment and real asset investment generate several testable hypotheses. The real asset opportunity set is country to country specific; it is also country-industry specific, and ownership-type specific. It is further reduced from the limitations on the percentage of ownership, and from greater uncertainty, where risk of failure to complete the deal is greater. As a result of the reduced investment opportunity set due to the these constraints, another empirical implication is that the more constrained the multinational is, either due to home country or ownership type, the more likely they would have to invest in less desirable real assets in the interior of the unconstrained real asset opportunity set. That is, since these constrained multinationals have a much reduced investment opportunity set, empirically, they may invest in riskier real assets such as in countries that are less stable politically or more corrupt, and in countries where the cost of successful integration is higher due to cultural difference, etc.

Although foreign firms, particularly foreign government affiliated firms, are suspected of having less success in acquiring companies in another country, this impression derives mostly from anecdotal evidence involving a few high profile cases. In this paper, we perform, for the first time, a large scale formal investigation of the investment opportunity set in global acquisitions over the period of 1985–2012. We provide empirical evidence on the extent that the investment opportunity set is reduced and the factors affecting the reduction. Our sample includes acquisitions by multinational firms from 149 countries in 134 target countries. Although real asset investment may take either the form of direct foreign investment (FDI) or acquisition, and this choice is an interesting topic in itself, we choose to conduct our study on acquisitions by multinational firms. This choice is dictated by the need for a large sample in order to perform statistical tests and have greater confidence in the results.

We first focus on the empirical evidence regarding the size of the opportunity set for all firm ownership types (i.e., privately owned and government owned) depending on country characteristics. We find that relatively smaller target nations, less open target nations, and target nations with weaker legal protection are less likely to see cross-border merger activity regardless of ownership type.

We next examine if the ownership type of a firm is related to the investment opportunity set. Specifically, we compare government-affiliated (heretofore "government") acquirers to private acquirers. This is an issue of practical importance as there are many large state-owned firms as remnants of state monopolies in former controlled economy countries.[1] Our results indicate that government acquirers invest in fewer countries and fewer industries than their private counterparts. Specifically, 134 target nations have received at least 50 cross-border deals and 115 of those target nations have received at least one cross-border acquisition from a government acquirer. Target nations differ with respect to the ratio of government cross-border deals to non-government cross-border deals. For instance, Estonia and Bermuda see a ratio of government cross-border deals to non-government cross-border deals that is roughly an order of magnitude higher than that of China. Based on the Fama and French 49 industry classification, 49 (48) industries have received private (government) cross-border M&A activity. Overall, 18 of the 49 industries have received fewer than 10 government cross-border investments. Similar to private firms, government acquirers are less likely to invest across

[1] In China, for instance, state owned firms account for 83% of total market capitalization for the country (Lee, 2007).

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