



Full length article

The financing of Chinese outbound mergers and acquisitions: Is there a distortion between state-owned enterprises and privately owned enterprises?

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ABSTRACT

This study offers novel theoretical and empirical insights into the financing of China's outbound mergers and acquisitions (M&As). We examine whether the financing of Chinese outbound M&As is distorted between state-owned enterprises (SOEs) and privately owned enterprises (POEs). We conduct an empirical study using a dataset of 224 outbound M&A deals. We find that SOEs enjoy a higher level of financing capacity in terms of debt and equity compared with POEs, although SOEs demonstrate lower stock performance, which implies that there are financing distortions in Chinese outbound M&As. Furthermore, we find that state ownership compensates for the poor M&A performance of SOEs through positively moderating the effect of debt financing, which leads to a "fictional" prosperity for SOEs. This result denies our theoretical prediction that builds on a Western theory concerning the disciplining function of debt financing on firm value; it provides evidence that the positive effect of debt financing in Chinese outbound M&As is derived from financing discrimination.

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1. Introduction

Despite various analyses concerning the financing discrimination within China, limited attention has been paid to its influence on Chinese firms' outbound activities. In fact, from the very beginning of the "go-global" strategy, the state-owned banks have been promoting specific types of outbound foreign direct investment (OFDI) by offering loans with preferential terms (Cai, 1999). A special loan programme has been established by the Export and Import Bank of China to finance state-owned enterprises (SOEs) (Schüller and Turner, 2005). Although the financing patronage has prompted a large number of SOEs to engage in OFDI, prior studies claim that it may lead to wasteful investments and less economic prosperity for China in the long term (Morck et al., 2008). In short, a salient problem in China is the financing distortion, which means that the financial resources are distortedly allocated to SOEs instead of to China's most efficient POEs (Guariglia and Poncet, 2008).

The support for the financing distortion, however, is based on anecdotal evidence. Little research has quantitatively addressed the issue of whether financing distortion indeed exists among new Chinese global players. It is worthy noting that outbound mergers and acquisitions (M&As) has become the major approach of OFDI for Chinese firms. From 2004 to 2013, China increased its transaction value tenfold in, from only 3 to 33.79 billion US dollars (Ministry of commerce of China,

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2014). The capital market distortions in China are very likely to influence China's outbound M&As. It is expected that these distortions affect the financing decisions of Chinese SOEs and POEs in different ways, resulting in non-optimal financing patterns. Moreover, the capital market distortions could possibly affect the performance of China's outbound M&As. The research has discussed these possible effects but has never quantitatively tested them. Therefore, this paper tries to fill this gap in the literature by studying *what the effects are of the distortions in China's capital market on Chinese outbound M&As*.

To answer this question this paper quantitatively analyzes a data set of 244 outbound M&A deals by Chinese firms between 2000 and 2013. This dataset allows us not only to test the differences in financing decisions between SOEs and POEs, but also makes it possible to relate the capital market distortions and the financing decisions to the performance of China's outbound M&As over different time periods. By comparing these results, it is possible to get a full understanding of the effects of the capital market distortions.

This paper tries to complement the research on the financing and the performance of China's OFDI. It extends the general internationalization theories by testing how the specific institutional environment influences OFDI from that country. (Child and Rodrigues, 2005) emphasize that "the case of China strongly suggests that international business theory needs to take fuller account of the potential relevance of domestic institutional factors in developing and transitional countries". In this paper, specific attention is given to the financing issues related to ownership diversity. The ownership diversity of Chinese firms may have implications for the extent to which their outbound M&As present heterogeneous financing decisions (Child and Marinova, 2014).

The remainder of this study proceeds as follows. Section 2 reviews the prior literature and develops the hypotheses. Section 3 outlines the data and methodology. Section 4 describes the empirical results. We discuss the theoretical and managerial implications in Section 5, before drawing a conclusion in Section 6.

2. Literature review and hypotheses development

2.1. Financing and payment decisions in outbound M&As

In perfect capital markets, a firm's financing decision between debt and equity does not affect the value of a firm or investment (Modigliani and Miller, 1958). In other words, finance and capital structure does not matter in investment decisions, as long as the cost of capital reflects the risk associated with the investment. However, perfect capital markets do not exist in reality, and imperfections like tax and financial distress influence the capital choices of firms.

China has a very different context for organizations and individuals in terms of institutions and the corresponding contemporary management practices (Barkema et al., 2015). The contextual difference is also manifested in the internationalization of Chinese companies. China's capital market is distorted in several ways that can influence the way firms finance and pay for their outbound M&As, and their performance. Since its launch, the "go-global" strategy has been encouraging Chinese SOEs to improve their international competitiveness and establish international champions (Child and Rodrigues, 2005; Morck et al., 2008). In 2004, the "Outbound Catalogue" was issued for the first time, in which the government lists the preferred host countries and industries for Chinese firms to invest in (Voss et al., 2008). Meanwhile, the Chinese government has appointed 22 SOEs to receive fixed subsidies annually to build competitive multinationals (Deng, 2007). In particular, China is the only country in Asia that not only encourages OFDI, but specifically promotes outbound M&As. The financial support from the Chinese government has made outbound M&As a common strategy towards internationalization.

Considering this institutional background, it is not surprising that SOEs and POEs have different patterns of financing decisions concerning Chinese outbound M&As. First, SOEs have better access to loans from the state-owned banks compared with POEs. Besides, a large part of SOEs' M&As has been funded through raising capital via primary offerings (Hong and Sun, 2006). Prior literature indicates that Chinese SOEs are particularly dividend-averse; over half of all SOEs pay no dividends to shareholders. As such, SOEs are likely to raise equity for their overseas investments instead of making dividend payments (Lim et al., 2012; Morck et al., 2008). By contrast, raising funds for M&As is much more difficult for POEs. This is attributed to the difficulty in accessing loans and the time-consuming process for obtaining the authorization to either go public or issue additional stock in the Chinese stock market. Given the firm size, transaction scale, limited financing channels and other factors, POEs would thus be forced to use internally generated cash to pay for their M&As. Thus, regarding the financing sources, we hypothesize that:

H1a: SOEs are more likely to use debt to finance M&As compared with POEs.

H1b: SOEs are more likely to use stock to finance M&As compared with POEs.

H1c: POEs are more likely to use internally generated cash to finance M&As compared with SOEs.

In addition to the financing sources, cash payment may be a good option for SOEs. This is because SOEs have easier access to external financing sources in the forms of debt and stock. Meanwhile, offering stock directly to acquirers would change the ownership structure of SOEs and dilute the control of the state by introducing foreign shareholders (Amihud et al., 1990; Chen et al., 2009). This seems undesirable to the state, thus SOEs and the state would use stock payment in a cautious manner. Considering these arguments, it makes cash payment attractive and practical for SOEs. Stock payment, by contrast, can help POEs circumvent the financing discrimination and enable them to become active on the international M&A market. Thus, regarding the payment method of financing, we hypothesize that:

H1d: SOEs are more likely to use cash to pay for M&As compared with POEs.

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