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The interplay between home and host country institutions in an emerging market context: Private equity in Latin America

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ABSTRACT

This study examines how the interplay between home and host country regulatory institutions affects the investment strategy of private equity (PE) firms in an emerging market context. To answer this question, we consider three different mechanisms: (1) the institutional hazard avoidance effect, (2) the institutional escapism effect, and (3) the dysfunctional institutions effect. Contrary to conventional wisdom, we argue that regulatory institutional differences between home and host countries can sometimes have a *positive* rather than a *negative* effect on investment likelihood. Our findings show that when a host emerging market has a strong regulatory institutional system relative to other emerging markets, it is more likely that this country will attract PE investments from firms based in home countries with very strong and very weak institutional systems. The empirical analyses, based on a polynomial specification and a dataset covering more than 300 PE firms that made close to 1500 investment transactions in Latin America during 1996–2011, are consistent with our main theoretical arguments.

1. Introduction

Multiple studies on cross-border investments and internationalization have emphasized the role played by institutional differences between home and host countries—what we call the *home-host-institutional-differences perspective* (Bell, Filatotchev, & Rasheed, 2012; Berry, Guillén, & Zhou, 2010; Gaur & Lu, 2007; Holburn & Zelner, 2010; Liou, Chao, & Yang, 2016; Salomon & Wu, 2012; Xu & Shenkar, 2002). Meanwhile, other studies have focused on the role played by the quality of the institutions in the host country—what we call the *host-institutions perspective* (Cuervo-Cazurra, 2016; Globerman & Shapiro, 2003; Gu & Lu, 2014; Guler & Guillén, 2010b; Khoury, Junkunc, & Mingo, 2015; Taussig & Delios, 2015; Wu, Wang, Hong, Piperopoulos, & Zhuo, 2016). Surprisingly, the theories and recommendations from these two perspectives have remained largely disconnected (for an exception, see Godinez & Liu, 2015). In addition to this lack of integration, the particular role played by home country institutions—what we call the *home-institutions perspective*—has been typically neglected (for some recent exceptions see Cuervo-Cazurra, Ciravegna, Melgarejo, & Lopez, 2018; Estrin, Meyer, Nielsen, & Nielsen, 2016; Gaur, Ma, & Ding, 2018; Luo & Wang, 2012; Tan & Chintakananda, 2016). This neglect of home country institutions relates to the fact that the literature on emerging market multinationals—which are especially susceptible to the effects of home country conditions—is still in development (Aulakh, 2007; Cuervo-Cazurra, 2012; Cuervo-Cazurra, Newburry, & Park, 2016; Cuervo-Cazurra & Ramamurti, 2014; Del Sol & Kogan, 2007; Luo & Tung, 2007; Ramamurti & Singh, 2009).

The puzzling lack of integration among these three different perspectives is partly associated with the scarcity of research about how the interplay between home and host country institutions affects investment behavior (Van Hoorn & Maseland, 2016). Focusing on regulatory institutions[1] and private equity (PE) investments in emerging markets, we offer an integrative theoretical approach that considers both home and host country institutions and the interplay between them. Our theoretical framework revolves around three different mechanisms: (1) the institutional hazard avoidance effect, (2) the institutional escapism effect, and (3) the dysfunctional institutions effect. Contrary to conventional wisdom, our theory implies that regulatory institutional differences between home and host countries can sometimes have a *positive* rather than a *negative* effect on investment likelihood. We argue that, when a host emerging market has a strong regulatory institutional system relative to other emerging markets, it is

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[1] We define regulatory institutions as governance infrastructure and policies that provide the framework for legal, social, and economic transactions, including a nation's laws, regulations, property rights, and legal structures (North, 1990, 1991; Williamson, 1979, 1981, 1991).

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more likely that this country will attract PE investments from firms based in home countries with very strong and very weak institutional systems.

We contribute to the international business literature and emerging markets literature in different ways. Our approach is novel as we provide a new theoretical framework that combines home- and host-country institutional effects in the context of PE investments in emerging markets. We show empirically that the effect of home country institutions on the likelihood of PE investments is contingent on whether the host emerging market has a relatively strong or relatively weak system of regulatory institutions. Also, our theory and empirical analyses go beyond the usual focus on MNCs and traditional FDI. Analyzing the different strategies used by PE firms to handle their portfolios of investments in emerging markets is an interesting way to study (1) how the interplay between home and host country institutions affects investments in emerging markets and (2) how firms can manage the risks associated with institutions in emerging market investments.

We test our hypotheses using a sample of PE firms—both multinational and domestic—located in different countries around the world that invested in Latin American companies from 1996 to 2011. The dataset contains 309 PE firms that made close to 1500 investment transactions during that period. Latin America is an interesting research setting because this region includes emerging markets with different and dynamic levels of institutional development while, at the same time, these nations have many cultural and historical commonalities, including language (Cuervo-Cazurra & Dau, 2009; Dau, 2013).

2. Theory and hypotheses

Our theory and hypotheses are built around PE firms[2] investing in emerging markets (Hoskisson, Shi, Yi, & Jin, 2013; Kaplan & Schoar, 2005). This non-traditional research setting has several features that provide a different way to look at the home-host country institutions conundrum. First, PE investments tend to be less industry-specific than acquisitions or greenfield investments made by traditional multinational companies (MNCs) (Ghemawat, 2007). Thus, multinational PE firms typically target a larger set of companies and countries, covering a broader range of institutional settings. Second, regulatory environments are an essential part of the PE investment system. Legal quality, financial regulations, and the capacity to establish enforceable legal contracts between investment firms and entrepreneurs are particularly important in PE transactions (Kaplan & Strömberg, 2009; Lerner & Schoar, 2005). Third, PE investment activity in a country is of a more "reversible" nature compared to traditional foreign direct investment (FDI) performed by MNCs. Therefore, PE firms are more sensitive than MNCs to changes in the institutional environment. The level of commitment of a MNC entering and operating in a new country is typically higher and longer term compared to the case of a PE firm. Finally, PE firms use a portfolio approach, combining a pool of investments that allow them to manage the return on investments in a more active way than in the case of MNCs—this translates into a more dynamic approach to manage the risks associated with the institutional hazards that are ubiquitous in emerging markets.

2.1. Home country institutions

The rise of MNCs from emerging markets has increased the importance of understanding the impact of home country institutions (Luo, Xue, & Han, 2010; Luo & Tung, 2007; Luo & Wang, 2012; Mathews, 2006; Ramamurti, 2012). Since emerging market companies are typically exposed to a wide range of institutional settings in their home countries, the role played by home country institutions in the internationalization and foreign expansion of these companies has recently led to the development of new theoretical frameworks (Cuervo-Cazurra & Genc, 2008; Cuervo-Cazurra et al., 2018; Gaur et al., 2018; Witt & Lewin, 2007). As mentioned earlier, this is what we call the home-institutions perspective.

Home country institutions can play a particularly important role in PE investments. Even though the role of home country institutions has been studied in the context of traditional FDI and MNCs (e.g. Estrin et al., 2016; Luo & Wang, 2012; Tan & Chintakananda, 2016; Zhu, Ma, Sauerwald, & Peng, 2017), research on how institutions in the home country can determine PE firms' investment decisions abroad is practically nonexistent. There is some evidence that shows that a PE firm's home country network can shape foreign expansion (Guler & Guillén, 2010a). However, there has been little research on trying to understand how a PE firm's home country institutions can affect PE investment decisions.

Evidence shows that firms may "escape" from weak institutional settings in the home country by investing abroad (Shi, Sun, Yan, & Zhu, 2017; Tallman, 1988; Witt & Lewin, 2007). Differently from MNCs, PE firms can more easily "escape" an institutionally hazardous home country by making cross-border investments instead of domestic ones—PE firms could even stop investing in the home country and only use it as a base of operations for investing abroad. Strong home country institutions can also increase the interest of investing abroad. For instance, due to higher capital availability, it may be easier for PE firms from countries with strong institutions to set up funds dedicated to invest abroad. Also, PE firms from advanced economies with robust regulatory institutions are able to develop stronger and more advanced investment capabilities due to a higher level of sophistication of the PE industry in their home countries—these capabilities can be useful when investing abroad. In short, both weak and strong home country institutions can stimulate PE investments abroad.

2.2. Host country institutions

Cross-border and domestic investment activity differs significantly across nations. Previous literature has found that the level of institutional development in the host country can explain some of these differences (Aguilera & Cuervo-Cazurra, 2004; Connelly, Certo, Ireland, & Reutzel, 2011; Dau & Cuervo-Cazurra, 2014; Gu & Lu, 2014; Guler & Guillén, 2010b; Khoury et al., 2015; Taussig & Delios, 2015). As mentioned earlier, this is what we call the host-institutions perspective. The evidence shows that weak regulatory institutions in the host country can have a negative effect on the amount of foreign direct investment (FDI) received and on the international expansion of firms (Delios & Henisz, 2003; Globerman & Shapiro, 2003). Scholars have also found that investment decisions of venture capital firms are influenced by the strength and characteristics of the institutional environment in the host country (Guler & Guillén, 2010b). Overall, regulatory institutions are crucial due to their effects on transaction costs and the uncertainty associated with economic exchange (North, 1990; Scott, 2001; Williamson, 1979, 1981, 1991). Thus, regulatory institutions can enable or constrain investment activity in a host country—both domestic and coming from abroad (Busenitz, Gomez, & Spencer, 2000; Estrin, Korosteleva, & Mickiewicz, 2013).

More specifically, weak regulatory institutions can turn into significant obstacles to PE investment transactions. For example, a corrupt judiciary can negatively affect the enforcement of PE contracts and increase the costs of making, managing, and exiting investments (Cuervo-Cazurra, 2016; Habib & Zurawicki, 2002). Additionally, high political risk and weak property rights protection increase the transaction costs of PE firms operating in a country (Coeurderoy & Murray, 2008; Khoury, Cuervo-Cazurra, & Dau, 2014). In the context of host institutional settings, PE investments have distinct characteristics that make them different from traditional MNCs foreign investments. Given

[2] PE firms specialize in "venture capital (VC), leveraged buyouts (LBOs), mezzanine investments, build-ups, distressed debt, and related investments" (Lerner, Leamon, & Hardymon, 2012: 1).