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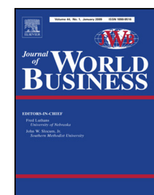

Ownership characteristics as determinants of FDI location decisions in emerging economies

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ABSTRACT

Building on agency theory and international business research, this paper explores how parent firm and subsidiary ownership factors affect FDI location decisions in emerging economies. Our analysis suggests that ownerships of block-shareholders in the parent firm (i.e., controlling family, non-family TMT members and institutional investors) and equity stake in a subsidiary owned by the parent company are positively associated with FDI location decisions in less-explored and risky areas. However, the effects of parent firm and subsidiary ownership factors may substitute for each other with respect to their integrated effect on dealing with risks associated with FDI location decisions.

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1. Introduction

Decisions related to foreign direct investment (FDI) location have attracted significant attention in international business (IB) research (Dunning, 1998). Previous studies argue that firms with similar characteristics prefer to locate in close proximity to each other, thus leading to an agglomeration of FDI (Belderbos & Carree, 2002; Chadee, Qiu, & Rose, 2003; Driffield & Munday, 2000; Shaver & Flyer, 2000). Research by Chen and Chen (1998) and Filatotchev, Strange, Piesse, and Lien (2007) shows that FDI agglomeration is particularly common in emerging markets characterized by inefficient and less-developed local institutions. Prior studies indicate that by locating their projects in FDI agglomeration areas, investing firms may mitigate strategic risks associated not only with the institutional uncertainties of a particular location (e.g., social, legal and economic risks) but also with the transactional (operational) risks of dealing with unfamiliar local counterparts (Kang & Jiang, 2012; Mudambi, 1999). However, although most investors in emerging markets prefer an agglomeration strategy to protect themselves from these two types of risk associated with their host environments, some investors attempt to gain first-mover advantages by capitalizing on unexplored opportunities in less-explored areas outside existing FDI agglomerations in a host country (Henard & Szymanski, 2001; Krugman, 1991). Despite the growing importance of this phenomenon, we know very little about organizational factors that would encourage firms to venture outside their familiar agglomerations. Specifically, there is a dearth of studies exploring how the ownership characteristics of a parent-subsidiary dichotomy may be related to an MNC's decision to select a location in a new and risky area.

In contrast to previous IB studies on FDI agglomeration, this study seeks to investigate the "centrifugal force(s)" (Krugman, 1991, 1998) that drive firms to invest in less-explored territories of emerging markets in hopes of higher FDI returns. According to Birkinshaw (1997), international firms rely not only on their organizational and management systems but also on their operational environments to explore opportunities in overseas markets. This research highlights the role and influence of a corporate ownership mode on a firm's FDI location decision. Based on this argument, we draw on agency theory and IB research to develop a framework that links a firm's FDI location decision to multilevel ownership factors whereby the firm's parent and subsidiary ownership characteristics act both independently and in combination to create a "centrifugal force" that drives the firm to venture beyond the familiar areas of FDI agglomeration toward less explored and riskier locations in an emerging market.

Our theoretical framework and empirical tests make a number of contributions to several research streams. First, extant research

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argues that firms must address significant strategic and operational risks when entering overseas markets (Hoskisson, Eden, Lau, & Wright, 2000; Wright, Filatotchev, Hoskisson, & Peng, 2005). Agency theory predicts that a risk-averse manager may choose to forgo potentially promising but riskier opportunities presented by the relatively more risky ventures in emerging economies (Filatotchev, Demina, Buck, & Wright, 2001; Hoskisson, Johnson, & Moesel, 1994). We extend this argument and suggest that the presence of large block shareholders (i.e., institutions and insiders) can serve as an important governance mechanism against this tendency toward risk aversion.

Second, IB research argues that firms can mitigate the risks of strategic mistakes and transactional uncertainties associated with FDI by collaborating with local partners (Brouthers, 2002). However, this collaboration can result in potential problems associated with a foreign partner's opportunism (Filatotchev, Stephan, & Jindra, 2008). To mitigate these costs, firms can use specific ownership strategies to safeguard their FDI investments (Davis, Desai, & Francis, 2000; Meyer, 2004). Extending this argument, we suggest that a parent company's ownership stake in its subsidiary can also serve as a "centrifugal force" that steers investment decisions toward opportunities outside the traditional areas of FDI agglomeration.

Finally, we suggest that the ownership factors associated with different levels of the parent firm-subsidiary dichotomy may act in concert (Rediker & Seth, 1995; Ward, Brown, & Rodriguez, 2009) to influence the outcome of FDI location decisions. Although previous studies have demonstrated that FDI entry modes in emerging markets are determined by factors related to country, industry, firm, and project levels of analysis (Luo, 2001), little has been done to examine the impact of multilevel nature of IB strategy on a firm's FDI location decision (Brouthers & Hennart, 2007). Therefore, this research seeks to fill this gap in the literature by conducting a multilevel analysis to ascertain the integrated effects of parent firm and subsidiary ownership characteristics on FDI location decisions. In particular, this study examines whether variations in ownership structures at different organizational levels can substitute for or complement each other in determining the final location decision for an FDI.

In line with these objectives, we developed our theoretical arguments in the context of emerging economies. According to Hoskisson et al. (2000: 249), countries or regions can be classified as "emerging" if they fulfill the following criteria: (1) a rapid pace of economic development; and (2) government policies that favor economic liberalization and the adoption of a free-market system. Emerging markets represent a unique context for theory-building and empirical tests related to our research agenda because emerging market firms typically do not share the same ownership structures as those in developed countries; emerging-economy firms are usually family-controlled and funded (Claessens, Djankov, & Lang, 2000). In turn, this unique ownership feature of emerging-market firms may affect how they choose locations for FDI. Furthermore, large emerging economies (such as China, India and Russia) tend to have very diversified markets that are not equally developed in terms of their regional economic and institutional characteristics, thus resulting in different levels of risks and opportunities for foreign investors even within the same country. Although most FDIs in these emerging economies tend to agglomerate in a manner consistent with location-specific externalities (Filatotchev et al., 2008; Strange, Filatotchev, Lien, Piesse, 2009; Strange, Filatotchev, Wright, & Buck, 2009), some firms have chosen to pursue investment opportunities in less-explored areas despite the greater environmental and operational risks associated with those locations. By using data on firm-level FDI projects from one emerging economy (i.e., Taiwan) into another (i.e., China), this study explores the complex interrelationship between ownership structure at different organizational levels (i.e., at the parent and subsidiary levels) and specific FDI location decisions.

2. Literature review and research hypotheses

Foreign investments in emerging markets are often undertaken in the context of significant environmental uncertainty. Therefore, FDI in emerging markets is associated with substantial agency costs due to managerial conservatism and the opportunism of transactional partners (Drucker, 1985; Wernerfelt & Karnani, 1987). From this perspective, the firm's FDI location decisions are influenced not only by location-specific attributes (e.g., wage levels, economic infrastructure, etc.) and/or firm-specific characteristics (e.g., industry, country of origin, etc.) but also by the risk preferences of the investing firm's shareholders and the firm's ability to curb opportunistic behavior by its local partners (Filatotchev & Wright, 2011). Building on agency and IB research, we argue that the FDI location decision may be driven by multilevel ownership factors associated with the investing firm and its subsidiary, particularly when venturing into emerging markets.

Given that a firm's degree of internationalization serves as an important indicator of the complexity that it faces, it is reasonable to suggest that there may be a link between the firm's governance parameters and its IB strategy (Filatotchev et al., 2008), particularly with respect to the firm's decision to invest in different overseas locations. When operating in emerging markets, firms usually face institutional upheavals and rapid changes, and in turn, this increases the need for long-term resource commitment. It also increases the ambiguity of managers' actions (Filatotchev et al., 2008; Filatotchev, Wright, Buck, & Zhukov, 1999), exacerbating the risk of the "principal-agent problem" related to managerial conservatism when exploiting opportunities in different locations in emerging markets. In addition, from an information-processing perspective, firms that operate in multiple markets tend to increase the complexity of their transactions and the manner in which their managers process information when developing corporate strategy, thus leading to a greater likelihood of strategic errors. Here, we argue that because the ownership structure of the parent firm can serve as an effective monitoring and incentive mechanism for mitigating these agency problems, the parent's ownership structure will have a significant influence on its FDI location decisions (Jones & Butler, 1992).

In addition, when foreign investors locate a new venture in a less-explored market, there are additional risks related to monitoring and enforcing contractual obligations with local partners (Mudambi, 1999). Governance mechanisms at the parent level cannot assist in managing these external relationships with overseas ventures, and most emerging markets lack strong legal systems to enforce contractual provisions (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997). Therefore, even when managers are willing to assume the risks associated with internationalization, the threat of uncertainties and the local partners' opportunism may ultimately steer their investments toward better-known locations and familial local counterparts associated with areas that have agglomerations of outward FDI (OFDI).

However, investing firms can safeguard their FDI investments from an overseas partner's opportunism by seeking a majority ownership stake in their FDI ventures. By holding a controlling stake in their foreign subsidiaries, firms can both better monitor their investments and enjoy better legal protection, thus effectively deterring their local business partners from opportunism. Therefore, this study asserts that FDI location decisions, especially in risky areas of emerging markets, can also be affected by the choice of subsidiary ownership structure.

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