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CEO tenure and ownership mode choice of Chinese firms: The moderating roles of managerial discretion

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ABSTRACT

Based on upper echelon theory, this study has explored how CEO tenure affects ownership mode choice of Chinese firms investing abroad, and how some organizational factors, such as firm size, firm age and CEO duality, moderate this relationship. Using secondary data, this study finds CEO tenure has a positive relationship with the choice of full control mode, CEO duality can reinforce this relationship, but firm size and firm age have no significant moderating effect.

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1. Introduction

Firms planning to invest overseas should choose an appropriate entry mode via which they can utilize their available resources to seize opportunities or deal with threats surrounding them and finally succeed in foreign markets (Brouthers, Brouthers, & Werner, 2003). Due to its importance, entry mode choice has been examined by a large number of studies via different kinds of theories (Brouthers & Hennart, 2007). However, past entry mode studies tend to focus on non-behavioral decision theories and thus ignore how some characteristics of decision-makers may have influences (Brouthers & Hennart, 2007). Upper echelon theory, one of the behavioral decision theories, suggests decision-makers with different characteristics may have different strategic orientations or risk-preferences, hence they may prefer different kinds of entry modes that are characterized by different risk-levels or investment horizons (Herrmann & Datta, 2002).

According to upper echelon theory, CEO tenure is one of the important demographic characteristics that may influence firm strategic choices (Hambrick & Fukutomi, 1991). For example, past studies (e.g., Jaw & Lin, 2009) suggest CEO position tenure has a significant impact on firm internationalization because it may reflect CEOs' commitment and knowledge. In term of entry mode choice, Herrmann and Datta (2002) find CEO position tenure has a positive impact on the choice of full control mode – a more risky entry mode because CEOs with greater tenure have more knowledge and are more powerful. Due to its important impact on firm strategic choices, CEO tenure is the focus of this study. Another reason why we focus on CEO tenure is that CEO tenure may have a positive, a negative or an inverted U relationship with firm risk-taking behaviors if we use different theoretical perspectives (such as agency theory and upper echelon theory) to explain its roles (Herrmann & Datta, 2002; Jaw & Lin, 2009; Kim, Al-Shammari, Kim, & Lee, 2009). Hence, we need to know whether Herrmann and Datta' (2002) finding can be generalized to different research contexts (such as China – an emerging market) because their study focuses on firms from a developed country. Repeated studies in different research settings may extend the generalizability of a theory.

Meanwhile, past studies (Herrmann & Datta, 2002; Musteen, Datta, & Herrmann, 2009) suggest full control mode is more risky than partial control mode due to some reasons, but they have ignored that partial control mode may also be very risky because partners may have opportunistic behaviors. Accordingly, past studies have not provided a more convincing explanation that full control mode is more risky than partial control mode. Consequently, past studies have not built a more theoretically sounded relationship between CEO tenure and the choice of full control mode.

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Besides the different contexts between developed and developing countries, other contextual factors may moderate the impact of CEO tenure on strategic choices or firm performance (Finkelstein & Hambrick, 1990; Jaw & Lin, 2009). Upper echelon theory suggests managerial discretion, "defined as the latitude of options top managers have in making strategic choices" (Finkelstein, 2009: 44; Hambrick & Finkelstein, 1987), may influence when a specific demographic characteristic of managers, such as CEO tenure, will have a stronger or weaker impact on firm strategic choice. However, past entry mode research has seldom examined the moderating roles of managerial discretion via the upper echelon theoretical lens. Accordingly, we developed a contingency model to test how some contextual factors, such as firm size, firm age and CEO duality, may influence managerial discretion and thus moderate the impact of CEO tenure on ownership mode choice.

Accordingly, this study, which is different from most past studies using non-behavioral decision theories, will address these research gaps by using upper echelon theory to examine whether CEO tenure has a similar impact on the choice of full control mode in different research settings and how some organizational factors (such as firm size, firm age and CEO duality) moderate this relationship. This study also intends to provide a more convincing explanation why full control mode is more risky.

2. Theoretical background and hypotheses

2.1. CEO tenure – the upper echelon theoretical perspective

Upper echelon theory suggests managers' demographic characteristics may decide how managers make strategic decisions (Hambrick & Mason, 1984). Specifically, managers' demographic backgrounds, such as age, education and tenure, may reflect their psychological orientation and capabilities, such as values, cognitions, skills and knowledge (Hambrick & Mason, 1984; Jaw & Lin, 2009). Due to bounded rationality, different aspiration levels, different or even conflicting goals, different managers may be different in their decision-making processes, including "issue identification (Dutton & Duncan, 1987), information search, and information processing (Cyert & March, 1963), as well as alternative specification and selection of the course of action" (Herrmann & Datta, 2002: 553). In another word, managers' psychological orientation and capabilities may decide they will make strategic decisions "through selective perception, by limiting their field of vision and by filtering information" (Herrmann & Datta, 2002: 553). Accordingly, firm strategic choices may "...reflect the idiosyncrasies of decision makers" (Hambrick & Mason, 1984: 193).

Applying upper echelon theory to explain how CEO tenure influences entry mode choices, we have the following theoretical arguments. During the initial stage of their tenure, CEOs tend to be more risk-averse and prefer low-risk strategies because they have very limited knowledge and power, and because risky strategies may jeopardize their position (Hambrick & Fukutomi, 1991; Herrmann & Datta, 2002; Jaw & Lin, 2009). To the contrary, CEOs with greater position tenure may become more risk-taking and prefer high-risk strategies because these CEOs have obtained more knowledge or experience and have become more powerful in making strategic decisions (Herrmann & Datta, 2002; Jaw & Lin, 2009). For example, compared with short-tenured CEOs, long-tenured CEOs are more likely to acquire more task knowledge, know better how to run their organizations, and are more familiar with decision-process (Herrmann & Datta, 2002; Jaw & Lin, 2009), which suggest they have stronger capabilities and influences to lead their firms to pursue high-risk strategies (Bergh, 2001). Meanwhile, long-tenured CEOs may have developed a patriarchal aura and have accumulated more shareholdings (Herrmann & Datta, 2002; Jaw & Lin, 2009), which may provide them with greater power and autonomy (Miller, 1991) to pursue more risky and resource-intensive strategies (Herrmann & Datta, 2002; Jaw & Lin, 2009). In addition, long-tenured CEOs may also be more confident in adopting risky strategies because of their substantial experience or knowledge and their greater power (Herrmann & Datta, 2002).

Applying the above arguments to firms' ownership mode choices abroad, we expect CEO tenure has a positive impact on the choice of full control mode because past studies suggest full control mode is more risky than shared control mode (Herrmann & Datta, 2002). First, investing firms should bear a higher percentage of investment risks (e.g., political risks) and costs if they choose full control mode for their foreign investments (Musteen et al., 2009); Second, with a higher percentage of equity stake, investing firms will have less flexibility to change their investment strategies (e.g., reduce their ownership or divest) when there are changes in their operating environments. The reduced flexibility resulted from a higher ownership may increase risks (Musteen et al., 2009). Third, with full ownership, investing firms should rely more on themselves to make important decisions to protect their own interests, which may require investing firms to have substantial local knowledge and strong capabilities to make such decisions. However, foreign investing firms need time to learn local knowledge and accumulate international experience, which may lead them to make mistakes in the leaning process (Musteen et al., 2009). While investing firms with partial ownership may rely on local partners to make the adequate decisions and thus can reduce the chances of making inappropriate decisions (Musteen et al., 2009). In sum, full control mode requires investing firms to commit more resources, to bear a higher percentage of risks, and to have more local knowledge to make right decisions, which may increase investment risks and costs, reduce flexibility, and increase the chances to make inadequate decisions. For these reasons, past studies suggest full control mode is more risky than shared control mode (Musteen et al., 2009).

But transaction cost theory seems to have the opposite prediction that shared control mode may be more risky than full control mode because shared control mode involves at least two parties and partners may have opportunistic behaviors, which may also create high risks (Gatignon & Anderson, 1988). Hence, past studies (Herrmann & Datta, 2002) have ignored the fact that shared control mode may not necessarily be less risky than full control mode when we take transaction cost theory into consideration. In this case, it is difficult to argue that full control mode is more risky than partial control mode.

However, some recent studies (Madhok, 1997) suggest we may not need to worry too much about this transaction cost argument for some reasons. First, partners' opportunistic behaviors may not exist because value-driven consideration may lead firms to focus on long-term benefits in today's dynamic environments (Madhok, 1997). Second, even though opportunistic behaviors exist, foreign investors still can avoid or reduce their impact by carefully choosing right partners or by carefully designing joint venture contracts, hence opportunistic behaviors are superfluous (Madhok, 1997). By excluding the high risks resulted from possible opportunistic behaviors of joint venture partners, we do not need to take transaction cost factors into consideration when we judge whether full control mode is more risky than shared control model. Hence we can make a more convincing conclusion that full control mode is more risky than shared control mode.

Accordingly, CEOs with shorter tenure may prefer shared control mode because these CEOs are more risk-averse and shared control mode involves lower risks, while CEOs with longer tenure may prefer full control mode because these CEOs are more risk-taking and full control mode requires firms to commit more resources and involves higher risks.

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