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Institutional, cultural and industry related determinants of ownership choices in emerging market FDI acquisitions

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ABSTRACT

In this study, we tackle a relatively un-researched question: What explains partial FDI acquisitions? The choice between full, majority, and minority ownership is explained on the basis of three locational factors – the differences, or "distances," between the countries of the acquirer and target firm – operationalized in terms of (i) institutions, (ii) culture, and (iii) sectoral relatedness. The sample comprises 1389 acquisitions in India and China by acquirers from 33 nations over an 11-year period. We find that the likelihood of minority acquisition over majority or full becomes higher when acquisitions involve low institutional distance or high uncertainty avoidance distance. However, the likelihood of minority acquisition over full or majority becomes lower when acquisitions involve industry relatedness. The results add to our understanding of the advantages and disadvantages of partial versus full FDI acquisitions in emerging markets. This study adds to the nascent literature that uses country or location "distance" metrics to show how the multinational firm, being "multiple embedded" (Meyer et al., 2011), can take advantage of the dual location of home and host countries.

1. Introduction

1.1. Motivations, benefits and costs of partial acquisition FDI

The acquisition of existing companies by foreign firms, compared with greenfield investment (where a subsidiary is created from scratch), remains the most frequent type of foreign direct investment (FDI). The value and number of cross-border acquisition deals have continued to escalate over the years, rising from $98.90 billion in 1990 to US $308.05 billion in 2012 after peaking at $1022.72 billion in 2007. The numbers of cross-border acquisitions during 1990–2012 shot up from 2072 to 5400 after peaking at 7018 in 2007 (UNCTAD, 2013a, 2013b).

A significant fraction of FDI acquisitions, however, are *not* fully-owned by the acquirer, but rather are partially acquired. This paper addresses an under-researched question "Why would a foreign company stay short of 100% ownership of the target firm?" Chen (2008: 454) indicates that distinguishing between the motivations for full versus partial acquisition "*...has been missing in most previous studies*." Jakobsen and Meyer (2007) lamented the lack of research on partial acquisitions by referring to it as an *overlooked entry mode*. Within the "partial" ownership category, there is a spectrum ranging from a small minority of foreign shareholding in the local firm to nearly full ownership. Here, in terms of partial ownership, we are not referring to newly-created joint ventures where a foreign and a local partner share the ownership, nor do we refer to any greenfield FDI; rather, we are referring to the *partial acquisition of an already-existing local firm by a foreign entity*. The complexities, gains, investment costs, and risks resulting from acquiring 65% ownership of the target firm will be different from, say, acquiring 90% ownership – although both will be categorized as incomplete or partial acquisitions. One contribution of this paper is that it uses a full, majority, and minority ownership trichotomy which can yield a fine-grained and better understanding of ownership and entry motivation dynamics.

Deciding on an appropriate ownership level is of strategic importance. Antecedents, processes, and outcomes of different ownership structures greatly differ from one another (Chen, 2008; Chen & Hennart, 2004). A correctly planned ownership level can result in significant economic benefits through post-acquisition

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integration and asset synergy. An incorrect ownership level may lead to a mismatch between resource commitment and risk, inefficient integration of the target firm, and less-than-desired rent appropriation. While some prior research has focused on the level of equity participation in cross-border acquisitions (Chari & Chang, 2009; Malhotra et al., 2011), our knowledge of why and how foreign acquirers decide between levels of ownership is still limited.

1.2. Explaining the variation in FDI partial acquisition equity levels based on "Distances"

Dunning's (1988) eclectic paradigm has, for a considerable time, formed the theoretical basis for explaining the motivations and basis for FDI with its three-pronged focus on Ownership, Location, and Internalization advantages. Since his 1988 paper, economic and institutional growth has changed countries' locational or competitive advantages, especially in emerging markets. Dunning (2009) himself opined that more attention needs to be focused on the host country location, and specifically on the *differences that exist between the home country of the multinational and the location of its affiliate*. After all, the logic of FDI is that the multinational firm bridges the differences between the home and host nation, with one leg in each country. This logic is beginning to spawn new literature (e.g., Berry, Guillén, & Zhou, 2010; Hennart, 2009) where FDI patterns are explainable, not just by the characteristics of home and host country, but by the institutional, cultural, and other *differences* between the home and target nations as well. Meyer, Mudambi & Narula (2011) describe this as the multinational firm gaining advantage from the "*multiple-embeddedness*" of its several locations.

In this paper we seek to explain the level of equity in partial FDI acquisitions based on three differences between home and host nation:

(i) *Formal institutional differences*. (By "formal" institutions we mean laws, regulations and explicit practices.)
(ii) *Cultural or informal differences* – specifically in risk-taking attitudes.
(iii) *Sectoral differences* – the extent to which the industry of the acquirer is related or unrelated to that of the target firm.

1.3. Identifying "Distances" between country of acquirer and nation of acquisition target

Recent literature suggests that institutions and institutional differences between the acquirer and target nations matter. Formal institutions (laws, regulations, etc.) as well as informal mental constructs (culturally-driven) in the home and host nations impact the multinational firm's decision about which entry mode or ownership structure to adopt during foreign expansion (Demirbag, Glaister, & Tatoglu, 2007; Estrin, Baghdasaryan, & Meyer, 2009; Peng, Wang, & Jiang, 2008; Tihanyi, Griffith, & Russell, 2005). Multinational firms venturing into unfamiliar institutional environments encounter the liability of foreignness (Zaheer, 1995), which heightens external uncertainties and costs relating to the initiation, management, and overall success of foreign operations. Lin, Peng, Yang, and Sun (2009) note, however, that "*prior research on M&As tends to understate the importance of the institutional environment*".

Furthermore, studies suggest that *industry experience also matters.* When a multinational firm decides to invest in an industry that is unrelated to its core business (vs. related to its past experience), the degree of familiarity with the target industry – its know-how, technology, dominant routines, and competitive dynamics – will impact its acquisition decision (Morosini, Shane, & Singh, 1998; Yin & Shanley, 2008). A multinational firm acquiring a target in a different industrial setting than it is familiar with in its home nation faces the dual liabilities of unfamiliarity with both the country and the industry (Yin & Shanley, 2008). Although industry context has been widely examined in international business scholarship, and the role of industry has been suggested as important in determining entry decisions (Tihanyi et al., 2005; Zhao, Luo, & Suh, 2004), how industry relatedness or lack thereof affects cross-border acquisitions – particularly the level of ownership – has not yet been scrutinized.

1.4. The locational setting for this research

The empirical setting for this research is FDI acquisition in emerging markets at a time in which cross-border acquisitions of emerging market firms is growing at a rapid pace. Acquisitions in emerging markets are even more complex due to the following factors: weak or underdeveloped capital, labor, and product markets; weak legal infrastructure; bureaucracy, and enforcement of regulatory policies; and insufficient legal and intellectual rights protection or market monitoring mechanisms (Brouthers & Dikova, 2010; Meyer, Estrin, Bhaumik, & Peng, 2009; Schwens, Eiche, & Kabst, 2011). Moreover, cultural attributes in emerging markets also differ from those in developed nations. These cultural affects are reflected in differences in attitudes, beliefs, value systems, and behavioral assumptions of organizational actors. In addition, industries in emerging markets are generally characterized by their shortcomings, such as lack of world class knowledge, inadequate exposure to international competition, inappropriate dynamism and competitiveness, high levels of environmental and demand uncertainty, and extreme need for renewal (Khanna, Palepu, & Sinha, 2005; Meyer et al., 2009). The above attributes make emerging markets interesting contexts for investigating how differences between acquirer and target nations affect the level of ownership in FDI acquisitions.

The remainder of the paper is structured thus: in the next section, we propose four research hypotheses or questions for empirical examination. These questions are: (a) how does the institutional distance between the home and host (target) countries determine cross-border acquisition ownership levels in emerging markets? (b) How does the cultural distance between home and target country affect cross-border acquisition ownership choice in emerging markets? (c) How do industry relatedness/lack of relatedness influence cross-border acquisition? And (d) what is the joint effect of these variables on cross-border acquisition ownership choice in emerging markets? By pursuing these questions, we attempt to address important knowledge gaps in the current literature about the motivation and determinants of partial acquisition (Brouthers & Hennart, 2007; Haleblian, Devers, McNamara, Carpenter, & Davison, 2009).

We then discuss our sample, data, and empirical methodology, following this up by presenting our findings. Our analysis relies on a sample of 1389 acquisitions undertaken over an 11-year time period by multinational firms from 33 different home countries in 2 emerging host nations, China and India. In Section 6 we discuss the contributions and limitations of the study.

2. Literature review and hypotheses

2.1. Choosing an ownership level in cross-border acquisition (dependent variable)

The resource-based view of the firm suggests that acquisitions generate synergy-based rents by accessing and integrating valuable assets and capabilities owned by the target firm in foreign nations, thereby enabling the multinational firm to