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Board composition, family ownership, institutional distance and the foreign equity ownership strategies of Turkish MNEs

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ABSTRACT

In much of the developing world, families represent the dominant form of firm ownership. This study investigates how this influences equity ownership strategies when firms venture abroad. Drawing on agency theory and institutional theory, we investigate the direct effect of board composition and family ownership on the equity-based ownership strategies of multinational enterprises (MNEs) in their affiliates, and how institutional distance may moderate this. Examining foreign affiliates of listed Turkish MNEs, we find that a high ratio of independent directors is negatively linked to levels of equity ownership of MNE affiliates. We also find that a high ratio of inside directors on the board is positively associated with the equity stake of MNEs in their affiliates. The significant interaction effect between board composition, family ownership and institutional distance helps explain the unexpectedly weak effects of institutional distance.

1. Introduction

How do families impact the internationalization activities of firms in which they hold a significant stake? This study investigates the effects of board composition and family ownership on the equity ownership strategies of multinational enterprises from emerging markets (EM MNEs) in their affiliates. Further, we assess the moderating effect of institutional distance on this relationship. MNEs may be subject to pressures from a range of different institutional regimes, reflecting both investor country of origin and where the foreign operations take place. There is an extensive literature on how MNEs behave abroad (Almond et al., 2005; Brewster, Wood, & Brookes, 2008), which has tended to concentrate on the relative infusion of policies and practices from the country of origin. Less attention has been accorded to the association between the MNE's internal corporate governance mechanisms and foreign equity ownership (e.g. Rhoades & Rechner, 2001; Filatotchev, Strange, Piesse, & Lien, 2007; Musteen, Datta, & Herrmann, 2009; Filatotchev & Wright, 2011). Internal corporate governance reflects both institutions, and the strategies dominant owner interests adopt in response to them. When formal regulation is weak or uncertain, the nature of the latter is vested with particular importance. Whilst weaker institutional coverage may be associated with greater agency problems (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000), this does not preclude actors from improvising solutions that secure the best returns possible under the circumstances (Lane & Wood, 2012). Within an emerging market (EM) context, we explore how international investment strategies may be molded by corporate governance realities and dominant ownership forms. This study makes extensive use of recent advances in institutional theory and develops insights into the implications of family capitalism for key players. It further evaluates how internal corporate governance mechanisms intersect with external ones in imposing a specific agenda on the firm.

We combine two key theoretical perspectives in international business research: agency theory and institutional theory. Agency theory signifies a challenge to the traditional Chandlerian notion of the firm and recasts it as primarily a vehicle for releasing value to the

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owners. Hence, it favors external and internal corporate governance arrangements that support owner primacy and mechanisms for aligning managerial decision-making that maximizes short-term returns (Jensen & Meckling, 1976). In line with agency theory, it may be argued that board composition is a major factor in the strategic planning process of MNEs, by affecting their risk perception and approach towards internationalization (Filatotchev & Wright, 2011). Consequently, board composition is likely to be a crucial precursor of managerial skill to engage in internationalization strategies (Carpenter & Fredrickson, 2001; Filatotchev et al., 2007; Filatotchev, Stephan, & Jindra, 2008). However, how boards are composed is likely to be closely bound up with the institutional setting.

Agency theory and institutional theory have appeared as important approaches to explain foreign entry strategies of MNEs. Gaur and Delios (2015) argue that institutional arrangements impact both on external and internal corporate governance arrangements. Building on the tradition of North (1987), Gaur and Delios (2015) cast institutions as providers of incentives or disincentives for rational actors, encouraging optimal or sub-optimal paths of decision making, which can be understood in agency terms. They conclude that both ownership concentration and ownership identity mold performance. Those strands of institutional theory that see private property rights as the most important regulatory feature share the basic concerns of agency theory surrounding the need to reign in managers and prioritize the release of shareholder value (La Porta et al., 2000a), enabling syntheses between these two traditions (Gaur & Delios, 2015). From an integrated perspective, it can be assumed that risk preferences and other interests of decision-makers, such as board members, are shaped by institutional distinctions between home and host countries. Consequently, the predicted effects of board composition on the entry mode choices of MNEs are determined somewhat by institutional distance. Apart from the separate effects of board composition and institutional distance on entry strategies, we also investigate whether the institutional distance between home and host countries has a moderator effect on the relationship between board composition and MNE entry strategy. However, it could be argued that the relationship between institutions and structures is a two way one, and that actors will undertake actions that not only respond to, but in many instances bypass or seek to remold those institutional arrangements not to their liking (Lane & Wood, 2009). The latter forms a central concern of this paper.

We focus on an EM setting, given that in such contexts institutions are less closely coupled or aligned, which might provide more opportunities for norm entrepreneurs to challenge and reform existing ways of doing things (Dore, 2008). At the same time, institutional shortfalls may make agency issues much more visible (La Porta et al., 2000a). In many EMs, the legal system is less predictable and/or effective and the market for corporate control less developed, with family owned and controlled firms the dominant ownership form (Amsden & Hikino, 1994; Claessens, Djankov, & Lang, 1999; Demirbag & Yaprak, 2015; Guillén, 2000). Boards of directors that contain family members, rather than independent members, may have a greater effect on the firm's strategic decisions (Demirbag, Mirza, & Weir, 1995; Selekler-Goksen & Yildirim-Öktem, 2009). In the absence of other external mechanisms to protect minority shareholders (Kula & Tatoglu, 2006), owner families have viewed the board of directors simply as a vehicle to maintain control over their firms (Selekler-Goksen & Yıldırım-Oktem, 2009). As Gaur, Kumar, and Singh (2014) note, firms rely on networks to overcome the consequences of institutional voids, in other words, relying on informal ties to get things done when formal modes of regulation are unsupportive or capricious. Internal corporate governance represents not only a mechanism for building on systemic strengths but also for compensating for weaknesses (Singh & Gaur, 2013; Lane & Wood, 2012). This may make family ownership a relatively efficient mode of control (Fainshmidt, Judge, Aguilera, & Smith, 2016), irrespective of the problems it might open up for minority investors.

A burgeoning body of literature deploys institutional theory to understand the strategic choices of EM MNEs (Demirbag, Tatoglu, & Glaister, 2010; Peng, 2003; Peng, Wang, & Jiang, 2008; Surdu & Mellahi, 2016; Wood & Demirbag, 2012; Wright, Filototchev, Hoskisson, & Peng, 2005). North (1990, p. 3) states that institutions are normally described as the "rules of the game in a society" which consist of formal rules and informal constraints. Institutional theory suggests that the success and survival of an MNE hinges on its compliance with the rules and belief systems prevailing in business environments (Dacin, Oliver, & Roy, 2007; Deephouse, 1996; Xu & Shenkar, 2002). The decisions of MNEs may be influenced in very diverse ways by the institutional distance between home and host countries (Campbell, Eden, & Miller, 2012).

The remainder of the study is organized as follows. The next section reviews the relevant literature and sets out the study's hypotheses. We then present the research methods, followed by data analysis and results. The final section contains a discussion and conclusions.

2. Context, theory and hypotheses

2.1. MNEs in context

What firms do, depends on both the formal and informal regulations specific to the context in which they operate (Brewster et al., 2008). As MNEs straddle national institutional domains, they are only partially rooted in each of the countries in which they operate (Morgan & Kristensen, 2006). Hence, we argue that MNEs will be more sensitive to internal corporate governance mechanisms than their domestic counterparts will, and hence, they form the primary focus of this study.

2.2. Board composition: varieties of director

In considering the composition of boards, a key distinction is between "outside" directors and "inside" ones (Johnson, Daily, & Ellstrand, 1996, p. 417). The latter represent board members who are employees of the firm (Hermalin & Weisbach, 1988; Peng, 2004). Some scholars claim that inside directors tend to exhibit risk aversion behavior in entry strategy selection (Judge, 2012) because they face losing their jobs in the event of an unsuccessful strategy. This discourages the firm from adopting internationalization strategies at all and may hamper the extent of the firm's internationalization (Filatotchev, Demina, Wright, & Buck, 2001).

From an agency perspective, inside directors who want to protect their relationship with the firm cannot objectively monitor the family members' activities (Anderson & Reeb, 2004). To maintain their position in the firm, they will choose to take sides with the founding family members who control the firm. Agency approaches further suggest that the desire of family members to protect their interests results in other investors being left worse off (Bugra, 2007; Morck & Yeung, 2003). However, the importance of family – and the strategic extension of family ties - may increase pressures to invest in or support the business interests of other members of the extended family (Morck & Yeung, 2003), which may focus the firm on local investments, rather than taking substantial stakes in foreign affiliates. Zahra (2003) argues that a focus on family orientated concerns will mitigate against investments abroad. Family firms may become conservative over time and be unwilling to enter new or unfamiliar environments and prefer to operate within zones family members are familiar with (Zahra, 2005). This may entail foregoing significant business opportunities abroad. If inside directors lack independence from the family, then they will be likely to share their expected aversion to high levels of equity ownership abroad. Hence:

Hypothesis 1a. *The ratio of inside directors (that is directors who are employed by the firm, but not family members), will be negatively associated with the extent of equity ownership of EM MNE affiliates.*

Independent directors are those who have no material relation with the firm except for board membership, this would include outside

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