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State ownership, institutional effects and value creation in cross-border mergers & acquisitions by Chinese firms

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ABSTRACT

This paper considers the effects of state ownership and institutional influences on value creation through cross-border mergers & acquisitions by Chinese firms during the period using a sample of 468 firms. The findings indicate that Chinese bidders experience wealth gains ranging from 0.4771% to 1.5210% over a 10-day event window. The cross-sectional analysis indicates that state ownership, formal institutional distance, reforms in the foreign currency approval system exert significant impact on shareholder value. By considering the state ownership and institutions, this study provides evidence that government and institutions play a huge role in value creation of emerging market firm internationalisation through cross-border mergers & acquisitions (CBM&A).

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1. Introduction

The recent empirical literature has paid notable attention to the role of governments on emerging market firms' decisions to expand internationally through M&A (see Luo, Xue, & Han, 2010; Peng, 2010; Rui & Yip, 2008; Xiao & Sun, 2005). These studies indicate that emerging market institutions and governments play an important role in outward M&A decisions by firms in emerging markets. However, studies that examine the effects of state and institutional factors on the value of outward M&A by emerging market firms are fairly scant. Prior studies have focused mostly on the effects of economic factors in acquiring firm value and have produced mixed results (see Calomiris, Fisman, & Wang, 2010; Chen, Goldstein, & Jiang, 2007; Datta & Puia, 1995; Gregory & McCorriston, 2005; Markides & Itner, 1994). This paper extends the prior literature by examining the effects of state ownership and institutional factors on firm value. The main objectives of this paper are twofold: (i) to investigate whether government involvement through state-owned enterprises (SOEs) creates value for Chinese acquiring firms; (ii) to examine the impact of institutions on the shareholder value of Chinese acquiring firms.

We draw on the institutional perspective to address the above objectives for a number of reasons. First, institutions defined as "the rules of the game" have a significant impact on emerging market firms' behaviour because government and societal influences are stronger in emerging market economies compared to developed countries (Hoskisson, Eden, Lau, & Wright, 2000). Institutions help shape firm structures and influence firms' strategic choices and competitiveness (Fligstein, 1996; North, 1990). The role played by home country institutions in shaping international expansion behaviour has implications for firm value because institutions affect the cost of doing business, have an impact on firms' confidence and create winners and losers in the marketplace (Boddewyn & Brewer, 1994; Kofele-Kale, 1992; Leone, 1986). Good institutions facilitate effective functioning of market mechanisms, enabling firms and individuals "to engage in market transaction(s) without incurring undue costs or risks" (Meyer, Estrin, Bhaumik, & Peng, 2009: 63), and increase firm value (Shleifer & Vishny, 1994). However, "bad" institutions increase the cost of doing business (Ang & Michailova, 2008). Second, state ownership unavoidably brings political objectives into corporate decision making, which can damage corporate value (Shleifer & Vishny, 1994). Conversely, it is argued that state ownership of firms in emerging markets can lead to preferential treatment from the government and favourable allocation of resources, thereby enhancing the value of a firm (Sun & Tong, 2003; Tian & Estrin, 2008).

In this paper, we examine the effects of state ownership and institutional variables on firm value using acquirers' returns (a direct measure of shareholder value and investors' future expectations), which is consistent with the strategic goal of wealth maximisation of a firm (McGee, Thomas, & Wilson, 2008).

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The focus on Chinese CBM&A during the 1998–2011 period as an empirical context for the study is motivated by the following: (i) China is the largest emerging economy and CBM&A are growing exponentially and constitute a predominant entry strategy of foreign direct investment (FDI) by Chinese firms (UNCTAD, 2012). The value of CBM&A purchases by Chinese firms, which stood at only US$185 million in 1991, reached a value of US$37,111 million in 2012 (UNCTAD, 2013). China accounted for approximately 66.49% of CBM&A purchases from Brazil, Russia, India and China (BRIC) countries plus South Africa in 2012 (UNCTAD, 2013). Like other emerging economies, the surge in CBM&A activities by Chinese firms is attributed to a number of reforms and changes in the environment in which CBM&A operate. The reforms include the establishment of (i) two stock exchanges, namely, Shanghai and Shenzhen Stock Exchanges in 1989 and 1991, respectively; (ii) simplification and decentralisation of foreign exchange administration and the establishment of a foreign exchange market to facilitate trading of the Chinese Renminbi with several currencies; (iii) changes in government policies towards outward foreign direct investment (OFDI) and enterprise reforms. In particular, the "go abroad strategy[1]" initiated by the Chinese government to provide financial and other support mechanisms, reduce institutional constraints and help Chinese firms to become global champions has been a tremendous push behind the rise in CBM&A activities. These key reforms embarked upon by the government together with the 'go abroad' strategy initiated in 1999 have largely contributed to the growth of cross-border mergers & acquisition activities. However, despite these reforms, state-owned and state-controlled firms remain the dominant force in CBM&A activities (Chen & Young, 2010). The involvement of SOEs in CBM&A allows us to capture their effects on firm value.

This paper makes two primary contributions to the literature. First, it contributes to institutional theory and its application in international business and finance research, particularly with respect to value creation in CBM&A by emerging market firms. Thus, the paper sheds light on emerging market firm responses to institutional pressures. Second, this study contributes to the empirical research on cross-border investment by emerging market firms, with specific reference to China, which has seen massive reforms unparalleled by any other emerging economy over the last two decades. Given the uniqueness of Chinese reforms and heavy government involvement in CBM&A to help firms acquire the resources that China lacks, we believe that the results of this study could serve as a lesson for policymakers and senior managers in other emerging countries regarding policy directions in their quest to become influential players in the global market for corporate control.

The rest of the paper is organised as follows. The next section provides a brief theoretical background with respect to CBM&A and firm value and the role of institutions. This background is followed by the study's hypotheses. We then discuss the data and research methodology used in this study. The results and discussion follow. The final section provides a conclusion and implications of the study.

2. Theoretical background

2.1. CBM&A and firm value

Several theories explain the possible sources of gains following international mergers and acquisitions. Four of the common theories identified in the emerging market literature concern market development and power, the resource based view, internalisation and diversification. First, CBM&A activities provide emerging market firms with the fastest means to access new markets, expand their product and consumer markets internationally, overcome trade barriers and increase firm value (Boateng, Wang, & Yang, 2008; Deng, 2009). Boateng et al. (2008) found that market share and power are one of the highest ranked motives for CBM&A by Chinese firms and noted that market power is a source of value for acquiring firms.

Second, the resource-based view literature suggests that one important reason for CBM&A is to gain access to strategic assets, such as natural resources, product differentiation, patent-protected technologies, and superior managerial and marketing skills. Acquisition of these capabilities and resources promotes technological learning, facilitates the development of skills and competencies, improves economies of scale and consequently increases firm value (Barney, 1991; Vermeulen & Barkema, 2001). In the context of China, Deng (2009), Rui and Yip (2008), and Boateng et al. (2008) reported that emerging market firms as latecomers lack resources and they strategically use CBM&A to achieve specific goals, such as acquiring strategic capabilities to offset their competitive weaknesses and increase firm value.

Third, the internalisation framework is premised on the contention that firms extract above-normal returns from CBM&A investment by internalising host country imperfections when their firm-specific assets cannot find comparable value elsewhere (Buckley & Casson, 1976; Caves, 1971; Morck & Yeung, 1991; Morck & Yeung, 1992). Researchers argue that the economic rents derived from internalisation can be converted into a higher value for emerging market firms (Aybar & Ficici, 2009; Boateng et al., 2008; Gubbi, Aulakh, Ray, Sarkar, & Chittoor, 2010).

Fourth, CBM&A allow firms an opportunity to reduce costs and risks when entering new foreign markets (Seth, 1990). Diversification as a source of value comes from exchange rate differences and the ability to lower the cost of debt and reduce variance in the cash flows if the cash flows of acquirers and targets are less correlated (Bhagat, Malhotra, & Zhu, 2011; Morck & Yeung, 1992).

2.2. Institutional theory and CBM&A

Over the past decade, institutional theory has emerged as an important way to explain the behaviour of firms in emerging markets (Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007; Child & Rodrigues, 2005; Hoskisson, Eden, Lau, & Wright, 2000). The theory suggests that institutional contexts (i.e., the combination of formal rules, informal constraints and their enforcement characteristics) create the impetus for action patterns in an organisation. Scott (1995) identifies three pillars of the institutional framework: the regulatory (existing laws and rules), the cognitive (widely shared social knowledge and social perceptions that are taken for granted), and the normative (social norms, values, and culture). Together, these pillars constitute a broad base from which a country's institutional profile may be analysed. As applied to research in management, the institution-based view posits that firms are shaped by the home and host countries' institutional environments. Firms require legitimacy in addition to economic efficiency to survive and succeed (Scott, 1995) and make strategic choices based on their interactions with institutions (Peng, 2002). It is therefore argued that firms must consider wider influences than firm- and industry-level factors when crafting and implementing strategies to gain competitive advantages, such as support from the state and society.

In the case of China, state-sponsored and state-supported acquisitions have become the normal mode through which Chinese enterprises enter and penetrate a host country (Child & Rodrigues, 2005). When conducting CBM&A activities, firms engage with institutional processes in both the home and host countries (Rosenzweig & Singh, 1991; Xu & Shenkar, 2002). In the home country, firms are subject to the home government's

[1] A national policy encouraging overseas direct investments by Chinese firms.

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