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Foreign vs domestic ownership on debt reduction: An investigation of acquisition targets in Italy and Spain☆

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ABSTRACT

This paper examines the role of foreign versus domestic ownership in reducing the debt levels of acquired firms in Italy and Spain over the period 2002–2010. Acknowledging that lower debt levels can mitigate the risk of failure and thus enhance the chances for a positive post-acquisition performance and survival, we particularly examine the causal effect of foreign and domestic acquisitions on two firm-level debt measures: gearing and short-term leverage. To estimate causal relationships, we control for selection bias by applying propensity score matching techniques. Our results indicate that foreign acquisition leads to a significant and steady reduction in the debt ratios of the target companies. In contrast, the relationship between domestic acquisition and debt reduction appears to be smaller and statistically less robust.
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1. Introduction

In the current paper, we examine the influence of foreign ownership on debt reduction of acquisition targets. While the extant literature is rather restricted to the implications of foreign ownership on profitability, we focus instead on the changes in debt ratios of a target company after a takeover deal. Since debt ratios have long been identified as predictors of failure (when increased) (Beaver, 1966; Graham & Rogers, 2002; Leland, 1998), identifying the role of foreign ownership in reducing these ratios, and hence increasing the chances of survival of the new entity after the deal, is adding one vital piece to the post-acquisition performance puzzle.

The impact of foreign ownership on performance has been in the forefront of the international business and finance literatures for several decades. Yet, findings remain inconclusive. There is an abundance of evidence supporting the superiority of foreign-owned firms over their domestic counterparts (Boardman, Shapiro, & Vining, 1997; Douma, George, & Kabir, 2006; Gedajlovic, 1993). From a resource based view, firms owned by foreign firms, typically large ones, can benefit from firm-specific advantages of the parent company, – i.e. technological expertise, networking, access to capital etc. – which can positively influence firm performance (Aybar & Ficici, 2009; Douma et al., 2006; Dunning, 1998). From an agency point of view, foreign firms are assumed to be better monitored and controlled, presenting an overall more robust financial performance (Jensen & Meckling, 1976; Thomsen & Pedersen, 2000). Nevertheless, industry and country specific factors (Barbosa & Louri, 2005; Globerman, Ries, & Vertinsky, 1994), high agency costs (Demsetz & Villalonga, 2001) and institutional factors (Heugens, Van Essen, & Van Oosterhout, 2009) have been reported to offset the benefits of foreign ownership.

The rich extant literature on cross-border acquisitions is equally convoluting. On one hand, several studies on cross-border takeover deals have found a positive impact of foreign ownership on performance associated with firm-specific advantages of the foreign acquirer (Li, Li, & Wang, 2015; Markides & Ittner, 1994; Ning, Kuo, Strange, & Wang, 2014). On the other hand, there is overwhelming evidence suggesting that acquisition deals do not manage to create shareholder value, but rather destroy it (Agrawal,

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Jaffe, & Mandelker, 1992; Aw & Chatterjee, 2004; Craninckx & Huyghebaert, 2011; Martynova & Renneboog, 2008).[1]

From the above, it is easy to discern that, as long as the literature is restricted to the direct implications of foreign ownership on profitability, a consensus regarding the role of foreign ownership on post-takeover performance cannot be reached. Nevertheless, with the 7th global Merger Wave[2] well under way, it is imperative to better understand not only the direct but also the indirect implications of foreign acquisitions on performance. So far we know that a reduction in debt levels minimizes the risk of failure and thus enhances the chances for a positive post-acquisition performance and survival. Meanwhile, foreign ownership has been long associated with better performance (Boardman et al., 1997; Douma et al., 2006; Heugens et al., 2009 Douma et al., 2006; Heugens et al., 2009), and even lower financial risk (Fatemi, 1984; Michel & Shaked, 1986). Yet, we are still unclear on *whether foreign ownership has in fact a direct impact on the debt levels of acquired companies.* To our knowledge, none of the former studies have explicitly factored in the impact of foreign ownership on debt reduction.

Our study contributes to the international business literature in three distinct ways. First, we inform the international business audience of the changes associated with foreign ownership on debt levels of acquired firms after a takeover deal. We particularly examine the causal effect of acquisitions on two firm-level debt ratios: gearing (short and long term debt to shareholders funds ratio) and short-term leverage (short term debt to total assets ratio). Second, while most empirical studies have concentrated on the acquirer's performance (Haleblian, Devers, Mcnamara, Carpenter, & Davison, 2009), we offer specific insights on the impact for the target company after the deal. The few studies on target firms have clearly shown significant differences on performance that cannot be ignored (Shleifer & Vishny, 2003). At the same time, the survival of a target firm is paramount for both the acquirer (as a parent company) and the economy in which it operates (Haskel, Pereira, & Slaughter, 2007; O'Donnell & Blumentritt, 1999; Rugman, Verbeke, & Yuan, 2011). Third, we compare matching samples of both domestic and foreign acquired firms,[3] which allows us to isolate the effect of foreign ownership and measure it with a higher degree of confidence.

Finally, acknowledging the significance of the institutional context on the ownership-performance/debt relationship (Heugens et al., 2009), specifically in bank-based economies (Kroszner & Strahan, 2001), we focus on two of the largest bank-based economies, namely Italy and Spain. Domestic firms in the two countries, being characterized by an overreliance on bank credit and a restricted financing availability, offer an ideal setting for our study. By achieving a better appreciation of the factors leading to lower debt ratios for the Italian and Spanish firms, we open the ground for new context-specific theory development with significant managerial and policy implications.

The paper proceeds as follows. Section 2 discusses in more detail how our contribution is related to previous studies. Specifically, we bring together two strands of the literature to inform our discussion: the literature on foreign ownership and performance and the literature on debt, risk and performance. Section 3 outlines the empirical model specification and describes the data, whereas Section 4 reports the empirical results and investigates their robustness. Section 5 provides conclusions and further implications, and, finally, Section 6 discusses limitations and suggests directions for future research.

2. Literature review and hypotheses development

2.1. Foreign versus domestic ownership and performance

An extensive number of scholars from different strands of the literature have been involved in deciphering the impact of foreign ownership on performance. Despite the voluminous studies, findings are still inconclusive, with empirical studies depicting both positive and negative relationships.

From a resource based view, foreign ownership has been early associated with positive performance, as a result of ownership-specific advantages bestowed to foreign owners. Technological expertise and specialized production processes, superior management and marketing capabilities, as well as access to financial and human capital are only some of these key advantages identified (Caves, 1996; Douma et al., 2006; Dunning, 1998). When effectively deployed in a foreign market, these advantages help their proprietors exploit host market imperfections, and overcome transaction costs, the liability of foreignness and other barriers of internationalization (Barbosa & Louri, 2005; Dunning, 1998; Harris & Robinson, 2003; Markides & Ittner, 1994). Indeed, several empirical studies have provided evidence for the superiority of foreign firms over their domestic counterparts[4] (Boardman et al., 1997; Caves, 1996; Douma et al., 2006; Gedajlovic, 1993; Heugens et al., 2009). Meanwhile, foreign ownership has been associated with higher overall productivity (Harris & Robinson, 2003), and greater firm resistance to domestic demand contractions (Varum, Rocha, & Valente DA Silva, 2014).

Nevertheless, from an agency point of view, foreign corporate ownership has been associated with both positive and negative effects: the benefits and costs associated with higher control. Foreign ownership is known to enhance managerial control and hence shareholder protection, especially in the presence of institutional voids (Heugens et al., 2009). By exhibiting higher concentration of share ownership, corporate foreign owners, such as large multinationals, can "set and effectively impose control mechanisms that maximize performance" (Jensen & Meckling, 1976, p. 17), leading to the dominance of foreign- over domestically-owned companies (Boardman & Vining, 1989; Thomsen & Pedersen, 2000). Yet, the imposition of high control mechanisms is also known to increase transaction costs, which, coupled with tunneling effects and minority shareholder expropriation, can impose serious negative performance effects (Demsetz & Villalonga, 2001; Heugens et al., 2009).

2.1.1. Insights from the acquisition literature

Acknowledging international acquisitions as an important foreign entry strategy (Dunning, 1998; Li et al., 2015), the cross-border acquisition literature has contributed significantly to the foreign ownership – performance debate. On one hand, cross-border deals have long been accredited a higher impact on performance than domestic ones, mainly due to synergistic gains

[1] Business correspondents in the Financial Times (FT) and other business magazines are also expressing serious concerns for the increasing record failures of acquisition deals (i.e. Masoudi, 2014, FT).

[2] . . . starting in 2011, as a consequence of the rise of the big emerging countries (BRICs).

[3] Very few past studies have explicitly compared foreign and domestic acquisitions (see, for example, Arnold and Javorcik, 2009).

[4] A number of empirical studies have corroborated the dominance of foreign firms over the domestic ones. For example, Willmore (1986) analyzes a matched sample of foreign and domestic firms in Brazil and finds foreign firms to have higher productivity and greater capital intensity. Similarly, Boardman et al. (1997), using data from the largest 500 non-financial Canadian businesses, reveal a clear performance dominance of multinational firms over the domestic ones. Even studies offering contrasting evidence, such as those by Globerman et al. (1994) and Barbosa and Louri (2005), have to control for size to allow for any variations in their findings, suggesting that foreign companies tend to be much larger than their domestic counterparts, skewing the results in their favor.

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