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Ownership control of foreign affiliates: A property rights theory perspective

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This paper applies property rights theory to explain changes in foreign affiliates' ownership. Post-entry ownership change is driven by both firm-level characteristics and by the differences in the institutional environments in host countries. We distinguish between financial market development and the level of corruption as two different institutional dimensions, such that changes along these dimensions impact upon ownership change in different ways. Furthermore, we argue that changes in ownership are affected by the foreign affiliate's relatedness with its parent's sector, as well as by the affiliate's maturity. We use firm level data across 125 host countries to test our hypotheses.

1. Introduction

Firm ownership remains a core construct in the international business (IB) literature (Aguilera & Crespi-Cladera, 2016). The need to retain ownership and control of firm-specific assets is at the core of internalisation theory and is a founding pillar of the dominant paradigms in IB. Indeed, as discussed in the recent retrospective by Brouthers (2013), the large literature on entry modes has explored ownership decisions at the point of entry, particularly with the aid of transaction cost theory. However, there is limited understanding of how multinational enterprises (MNE) and local partners adjust their ownership shares as the external environment changes.

The existing theory on ownership change builds primarily on the tradition of Johanson and Vahlne (1977, 2009) who emphasise experiential learning and the evolutionary aspects of the process of ownership structure adjustment. However, the existing literature treats the evolution of foreign presence in a location as being, *ceteris paribus*, an incremental process of increased commitment. Accordingly, many studies adopt a theoretical framework that is in line with the Uppsala model (see e.g., Brouthers & Bamossy, 1997; and Globerman & Shapiro, 2003), which argues that firms internationalise incrementally based on their ability to successfully leverage their ownership advantages into new markets. However, to use this argument in order to explore the nature of the relationship between experience and affiliate ownership is, as Birkinshaw and Morrison (1995) point out, misleading. Rather, it is important to emphasise that the process of ownership change is driven by a variety of factors, resulting in an increase or a decrease in shares held by the foreign investor over time. Importantly, these follow not only the foreign investor's strategy but are co-determined by the local partner's incentives and motivation in holding the remainder of the affiliates' ownership shares. We incorporate this aspect into the analysis in order to consider the relative value of both the foreign and the local partner's contributions at the affiliate level. We argue that the evolution of the relative value of these contributions varies not only due to firm-level features and processes (relatedness of affiliate to parent and maturity of the affiliate), but also due to the institutional environments. Our study, therefore, contributes to the literature on internationalisation and ownership change in several ways.

First, we conceptualise post-entry changes in foreign affiliate ownership with the aid of property rights theory. Indeed, we seek to develop this literature in line with the findings of Beamish and Lupton (2016) who argue that it is important for future theory building on cooperative strategies in IB to focus research "on what is best for the agreement, or joint venture (JV), rather than what is good for either the foreign or local partner" (Beamish & Lupton

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2016: 173). Building on this perspective, we argue that much of the existing literature, views ownership structures only from the perspective of the foreign partner (i.e. parent MNE), while the local partner (i.e. host country partner) is equally important. It is necessary therefore to expand our conceptual understanding. We posit that the property rights theory is a perspective that fits this suggested purpose, and we use this theory to conceptualise post-entry changes in foreign affiliate ownership. This allows us to develop arguments to extend the traditional analysis centred on transaction costs (Brouthers, 2002) in order to consider the optimal distribution of ownership shares, emphasising effective responses to the problem of incomplete control. We use insights gleaned from property rights theory to investigate firm level and country level drivers of changes in ownership structure. In doing so, we explore the applicability of the property rights theory to the core IB theme of firm ownership (Antràs, 2014). Our main argument is that changes along the institutional dimensions and to the firm-level characteristics affect the relative value of the local and foreign partners' contributions and their outside options (e.g. sources of finance) in a non-symmetric manner.

Second, we extend the literature, building on Hoskisson et al. (2013), by contrasting the changes in the general quality of host country institutions that affect contracting opportunities, with the impact of improved financial markets in the host countries. We posit that financial market development is a distinct factor in explaining ownership change. In many emerging market economies, the quality of the financial sub-systems may exceed the overall institutional quality (Glaeser, Johnson, & Shleifer, 2001) and the two systems may well evolve independently of each other. This links with arguments of Cantwell, Dunning, and Lundan (2010), who explore the co-evolution of institutions and inward investors.

Third, by focusing on changes in ownership structure, we can better isolate institutional effects from static country characteristics. For example, institutional quality measures, when captured in levels are strongly correlated with level of development, as documented by institutional theorists (e.g., North, 1990). This confounding effect no longer applies to changes in institutions. Likewise, the dynamic approach enables us to incorporate the impact of the increasing maturity of the foreign affiliate, and also how outcomes of these processes differ for firms that are characterised by higher relatedness, building on the concept utilised by Malhotra and Gaur (2014).

We have annual observations of ownership shares for 53,625 foreign affiliates in 125 countries in our sample period of 2002–2012, whereas previous studies have mostly relied on information at the time of investment. Utilising this data, we test our hypotheses relying on the multinomial logit estimator. Our core findings, in contrast with the earlier literature, are that an increase in corruption in the host country results in a lower likelihood of a multinational reducing its holding to become a minority partner. In contrast, improvements in local capital markets make such a move more likely, as it enhances access to finance for local firms. At the micro-level, we find that maturity of firms makes an adjustment towards minority foreign control more likely and higher relatedness between the affiliate's and the parent's activities makes an adjustment towards minority foreign control less likely. Our results are detailed below and explained with the aid of property right theory.

The paper is organised as follows. We first discuss the theoretical framework and derive our hypotheses. In the subsequent section we describe the data and methodology. The final sections present and discuss the results, followed by concluding remarks.

2. Property rights theory and ownership structures

Property rights theory (Grossman & Hart, 1986; Hart, 1995) shares its essential premise with transaction cost theory (Williamson, 1985) in emphasising that contracts are always incomplete. This places the focus on ownership, since rights to income streams may not always be protected by arms' length contractual arrangements. The distribution of ownership rights becomes crucial in the presence of incomplete contracts and where investments by partners are observable but not verifiable (Hart, 1995, pp. 29 and 36). Property rights theory stresses that it is optimal for ownership control to rest with those who have the greatest impact on the value of the venture and whose output is most difficult to measure and verify (Milgrom & Roberts, 1992, p. 311). In addition, the partners' contributions to value added need to be considered in conjunction with their outside options (De Meza & Lockwood, 1998). These factors determine the nature of the control that partners exert over an investment, which follows from ownership patterns. This is explored empirically by Driffield et al. (2014), but we seek to build on this, developing arguments from Aghion and Holden (2011); Grossman and Hart (1986); Hart (1995). Despite their obvious appeal, applications of property rights theory to internationalisation issues are scarce and are either of theoretical character (Antràs, 2005, 2014) or relate to single country empirical studies (Feenstra & Hanson, 2005).[1]

Building on Carson and John (2013), we argue that the problem of efficient allocation of control rights within affiliates or JVs is analogous to the problem of control rights between a MNE and a local firm in the context of outsourcing. Furthermore, consistent with Driffield et al. (2014), the optimisation of ownership structure of affiliates or JVs can be analytically separated into two different parts: (i) that of control rights which typically come with majority control (see: Gaur & Lu, 2007), which is the property rights question, and (ii) that of specific percentages assigned to partners once the majority ownership issue is resolved – which may be seen more as an agency theory question. This distinction is consistent with the empirical evidence in two ways. First, the issue of majority control is often most contentious in JVs and mergers and acquisitions. Second, the distribution of ownership shares is non-normal, with peaks on either side of 50% (for further discussion see Driffield, Mickiewicz, & Temouri, 2014). This indicates, as one would expect, that the majority/minority distinction is critical from a theoretical as well as an empirical perspective. Although ownership is reported as a continuum, there is great significance attached to certain percentages, particularly around the majority ownership threshold (Bishop, Filatotchev, & Mickiewicz, 2002).

At the same time, according to property rights theory, the allocation of control rights should follow the relative capacity of the respective partners to positively influence the value of the venture at the margin. Yet evaluating these impacts remains difficult, even where the foreign partner's contribution is generally accepted to be more significant. Antràs (2005) illustrates this point using examples from sectors where product development or international marketing are core to the business and central to the development and amplification of firm specific assets. Yet even in these sectors, the contribution of the local partner remains significant, particularly when driven by local knowledge and resources (Feenstra & Hanson, 2005).

[1] In particular, we follow Antràs (2014), who discusses in detail the application of Grossman and Hart (1986) to the analysis of international trade and the coordination of global value chains.