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Shared Governance: Institutional Investors as a Counterbalance to the State in State Owned Multinationals

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ABSTRACT

State owned multinational enterprises (SMNEs) are entities that are partly or wholly owned by the state and that engage in foreign direct investment. SMNEs with partial state ownership share equity ownership with private investors, some of which may be institutional investors. We argue that equity ownership by institutional investors can provide a counterweight to state ownership, and their shared governance can improve SMNE strategic decision making on international diversification. Institutional investors, however, need strong formal institutions to perform their shared governance role effectively. Because formal institutions are typically weaker in developing countries, institutional investors likely play a less effective role in SMNEs located in developing countries. We test our arguments on the international diversification decisions of 253 listed SMNEs from 42 home countries over the 2002–2007 period, finding substantial support for our hypotheses. Our study offers new insights on the role of institutional investors in the international diversification of state owned multinationals.

1. Introduction

For many years, international management scholars paid little attention to state owned enterprises (SOEs). This was expected because most state owned enterprises did not engage in foreign direct investment (FDI); their number also declined drastically during the 1990's wave of privatizations and economic liberalization (Aulakh and Kotabe, 2008). Recently, however, state owned enterprises have become active foreign investors and important actors in the global economy. In 2010, there were at least 650 state owned multinationals (SMNEs) with more than 8500 foreign affiliates; more than 40% of these SMNEs were majority owned by their home-country governments (UNCTAD, 2011). FDI by SMNEs was $US 146 billion in 2010, representing about 11% of world FDI flows (UNCTAD, 2011), and SMNEs now control almost two trillion US dollars in foreign assets (Sauvant and Strauss, 2012).

Cuervo-Cazurra et al. (2014) suggest that more work on SMNEs is not only useful for understanding SMNEs, but can also enrich existing theories of the firm, by integrating theoretical perspectives from both international business and political economy. He et al. (2015) argue that SMNEs are undergoing a renaissance and should receive more attention from international management scholars. Because of their growing importance in international markets, a new stream of research on SMNEs has emerged in recent years (Buckley et al., 2007; Cui and Jiang, 2012; Cuervo-Cazurra et al., 2014; Duanmu, 2014; Estrin et al., 2016; Knutsen et al., 2011; Li et al., 2014; Meyer et al., 2014; Shapiro and Globerman, 2012). Most of this research has focused on the role of the state in internationalization patterns of SMNEs. Alternatively, the role played by other investors in SMNEs' international activities, in particular institutional investors, has received little attention to date.

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Institutional investors include "bank trusts, insurance companies, investment companies (mutual funds), investment advisors (brokerage firms), pension funds, and endowments with at least $100 million in equity (Grinstein and Michaely, 2005)" (quoted in Dalton et al., 2008: 29). Institutional investors have dramatically increased their participation in equity markets since the 1980s, especially in developed countries (Gillan and Starks, 2003). For example, institutional investors own approximately 66% of U.S. corporate equity, thereby giving them considerable economic influence (Ferreira and Matos, 2008). Institutional investors have also begun to invest in SMNEs. For instance, in 2007, institutional investors were corporate equity owners in SMNEs headquartered in a variety of home countries, such as Volkswagen (14.66%), ENI (34.21%), Petrolio Brasileiso (27.16%) and Singapore Airlines (31.04%).

When institutional investors are corporate equity owners in SMNEs, they create shared governance with the state. This suggests an important research question: *How does shared governance by institutional investors and the state affect state owned multinationals' governance and strategic decisions*? We expect, first, that the role played by institutional investors in a SMNE is more complex than that in private firms. When shares of a SMNE are publicly traded on a stock exchange, equity participation of institutional investors may create a contest for corporate control that increases the overall complexity of managing the SMNE (Pargendler et al., 2013). At the same time, institutional investors may help constrain opportunistic behavior by the state, by shifting the balance of bargaining power within the SMNE from the state to private owners (Pound, 1992; Useem, 1996).

We therefore argue that equity ownership by institutional investors in SMNEs can provide a counterweight to state ownership. Their shared governance can improve SMNE strategies in areas such as international diversification. Herein, we first examine the baseline relationship between state ownership and international diversification of SMNEs. After clarifying the state's role in international expansion of SMNEs, we introduce institutional investors and examine their moderating influence on shared governance and subsequent strategic decisions in SMNEs' international expansion.

We argue, however, that institutional investors need strong formal institutions to perform their shared governance role effectively. Because formal institutions are typically weaker in developing countries, institutional investors are less effective as a counterweight in SMNEs from developing countries. Thus, we investigate the contingent effect of formal institutions on the influence of institutional investors on firm governance and strategies across different countries. We test our hypotheses on a panel of 253 listed SMNEs from 42 countries over 2002–2007.

Our study enriches research on SMNEs and contributes to international management research in several important ways. First, we incorporate a new influential factor (i.e., the role of institutional investors) to examine SMNEs' corporate governance and international strategies, and thus extend research on SMNEs' international activities. Second, we provide insights into how and why state and institutional investors influence SMNE decision making on international diversification. More generally, we suggest that who owns and how much they own of a firm are important considerations for understanding the relationship between the firm's governance structure and its international strategy. Third, we extend prior research by focusing on the role of institutional investors in countries with varying qualities of formal institutions (Ferreira and Matos, 2008), building on insights from the institution-based view (Peng et al., 2008). Researchers have found that country institutional environments affect the level of influence played by institutional investors in corporate governance of firms (Gillan and Starks, 2003). Our research on the role played by institutional investors of SMNEs from home countries that vary in the quality of their formal institutions provides new evidence for the influence of the interaction between the institutional environment and firm corporate governance. This finding provides the fourth and perhaps the most important contribution of our work. Our research demonstrates the value of agency theory for understanding the strategic behaviors of SMNEs and the influence of complex home country institutional environments on the effects of ownership in these organizations. Therefore, our research suggests that an integration of institutional theory and agency theory is necessary to understand the effects of ownership on corporate strategies. Neither theory alone provides a complete picture of the ownership-strategy relationship. As such, our research extends our understanding of both institutional theory and agency theory through the integration of the two.

2. Theoretical framework and hypotheses

2.1. International activities of SMNEs

Research on international diversification and foreign direct investment (FDI) has been substantial. Scholars argue that international diversification can produce benefits for firms through the exploitation of firm-specific advantages and/or exploration of strategic assets, leading to improved firm performance (Hitt et al., 2014; Hitt et al., 2016). However, international diversification can also be a risky corporate strategy that can negatively affect firm performance by generating structural complexity (Hitt et al., 1997) and liabilities of foreignness (Zaheer, 1995; Zaheer and Mosakowski, 1997).

Hitt et al. (2006) comprehensively reviewed antecedents, moderators and outcomes of international diversification, and suggested that ownership significantly influences firms' international expansion. More recently, Marano et al. (2016) conducted a meta-analysis on the international diversification–performance relationship. The authors investigated multiple factors, among which, ownership types (i.e., ownership concentration, inside ownership, foreign ownership, family ownership) were important influences on firms' internationalization. Because of these studies and others, there is considerable evidence on the key factors that affect international diversification. However, because of the paucity of research on SMNEs and even less research on SMNE internationalization activities, we know little about SMNEs' international diversification strategies.

The current research on international activities of state owned firms has focused on how state ownership influences FDI patterns. For instance, Buckley et al. (2007) suggested that state-owned firms are able to obtain easy funding at below market rates to support their international expansion. Knutsen et al. (2011) indicated that state ownership affects the way host country institutions influence FDI decisions and allows SMNEs to deal better with poor rule of law and corruption. From a political perspective, Cui and Jiang (2012)