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Investor protection and cross-border acquisitions by Chinese listed firms: The moderating role of institutional shareholders

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A B S T R A C T

This study examines whether-and if so, how-market value for the acquirers from emerging markets is influenced by changes in investor protection induced by acquisitions, in interaction with institutional shareholdings in acquiring firms. Using a sample of Chinese listed acquiring firms for the period 2002–2012, the empirical findings show that Chinese companies gain higher abnormal returns at the takeover period through acquisitions of targets domiciled in countries with superior investor protection to China. Interestingly, this relationship between investor protection and acquirer returns is moderated by institutional ownership in acquiring firms, which is however more prominent in nonstate-owned Chinese companies.

1. Introduction

Despite the fast-growing trend of firms from emerging economies making acquisitions abroad in recent years, both theoretical explanations and empirical evidence of the determinants of success of these cross-border acquisitions (CBAs) still remain limited (Chen & Young, 2010; Zhang, Zhou, & Ebbers, 2011). The extant conceptual framework and empirical evidence emerged from CBAs by acquirers from the developed countries suggest an increasing trend to investigate international business issues from a corporate governance perspective based on agency theory. This stream of literature identifies a positive relationship between corporate valuation and investor protection provided by the legal systems within a particular country (Gompers, Ishii, & Metrick, 2003; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002), in which CBAs are perceived to offer a natural experiment to examine the role of corporate governance in firm value (Bris & Cabolis, 2008; Bris, Brisley, & Cabolis, 2008). It is noted that acquirers often coming from countries with better investor protection tend to transfer their better corporate governance practices to target firms (Bae, Chang, & Kim, 2013; Erel, Liao, & Weisbach, 2012; Rossi & Volpin, 2004), leading to improved corporate governance regulations of the target assets. Such change of corporate governance in the target firms is expected to generate additional value, and thus reflected in the acquirers' abnormal share price returns (Barbopoulos, Paudyal, & Pescetto, 2012; John, Freund, Nguyen, & Vasudevan, 2010; Martynova & Renneboog, 2008). For instance, Chari, Ouimet, and Tesar (2010) claim that developed-market acquirers experienced positive and significant abnormal returns in emerging-market mergers and acquisitions. Those acquirers are allowed to extend the boundaries of the firm across borders and

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overcome problems of incomplete contracting institutions in emerging markets, thereby being benefited in the acquirers' share price at the takeover announcement.

Emerging economies are characterized with substantially different institutional settings from the West, such as the prominent concentrated ownership structure, the government-controlled organizational form (Cuervo-Cazurra, 2006; Hu & Cui, 2014; Young, Peng, Ahlstrom, Brruton, & Jiang, 2008), and the relatively weak investor protection regulations (Bhagat, Malhotra, & Zhu, 2011; Zhou, Tam, & Yu, 2013). As the choice of governance mechanisms is to some extent subject to institutional and governance regimes (Dharwadkar, George, & Brandes, 2000; Peng & Jiang, 2010; Wright, Filatotchev, Hoskisson, & Peng, 2005), the existing conclusions often drawn from the western settings might not be applicable to CBAs by firms from emerging countries. We therefore suggest that a closer examination of CBAs by firms from emerging countries from a corporate governance perspective could provide valuable insights into the current literature.

Some studies have investigated our proposed issue (Aybar & Ficici, 2009; Bhagat et al., 2011; Chen & Young, 2010; Gubbi, Aulakh, Ray, Sarkar, & Chittoor, 2010), but failed to reach a consent conclusion. In addition, very few of these studies have focused on the role of institutional shareholders who are believed to be a critical internal mechanism of corporate governance to deal with the agency problem by exercising shareholder activism. As such, it is of special interest to address the questions of whether the changes of corporate governance between the bidder and target domiciled countries explain part of the expected value creation of the acquirer, and if so, how this relationship is moderated by the effect of institutional shareholders through their shareholdings in acquiring firms.

We empirically test our theoretical claims by presenting a quantitative analysis using data containing 153 completed CBAs undertaken by Chinese listed firms between January 2002 and December 2012.

China provides an ideal empirical context for this study for two reasons. First, CBAs made by Chinese firms have increasingly gained the world's attention with a surprising achievement of US$44.5 billion by 2012, a 34% increase over 2011 and the highest since 2008. Most of these acquisitions were conducted by publicly-listed companies with leading positions in China's markets (Lau, Fan, Young, & Wu, 2007). Second, Chinese listed companies that are active in internationalization activities are characterized with the significant ownership of either the government or the individuals and families (Buckley et al., 2007; Chen & Young, 2010; Hu & Cui, 2014), resulting in a variety of agency conflicts. This allows us to further differentiate the possible effect of corporate governance in interaction with institutional shareholders on CBAs within the two kinds of acquiring firms.

Our results indicate that in 2002–2012, Chinese acquirers experienced positive and significant abnormal returns of 3.03%, on average, over an eleven-day event window. Such positive acquirer returns appear more prominent in acquisitions of targets domiciled in countries with superior investor protection to China. It is partly because Chinese companies may credibly bootstrap themselves to adopt better corporate governance standards of the target firms, thereby leading to expected market value creation on the acquirers. This finding is consistent with the bootstrapping hypothesis in the previous literature (Bhagat et al., 2011; Gubbi et al., 2010; Khanna & Palepu, 2004). More importantly, we find that this relationship between investor protection and acquirer returns is moderated by the presence of institutional shareholders acting as an internal corporate governance mechanism through their ownership in acquiring firms. Acquirers with larger involvement of institutional shareholders gain less returns from acquisitions of targets domiciled in countries with better investor protection than China. Further, the active governance role of institutional shareholders appears unique to nonstate-owned Chinese acquirers.

Although CBAs by firms from emerging markets have increasingly drawn the world's attention, the exact mechanism of how those firms survive in their overseas acquisitions still remain relatively vacant. Our study tries to look at CBAs by Chinese firms from the corporate governance perspective, which joins to the strand of literature focusing on the impact of national corporate governance standards on the abnormal announcement returns in CBAs (Barbopoulos et al., 2012; Bris & Cabolis, 2008; Bris et al., 2008; Chen & Young, 2010; Erel et al., 2012; John et al., 2010; Martynova & Renneboog, 2008; Rossi & Volpin, 2004; Zhang et al., 2011). The results suggest that Chinese firms are indeed benefited from the *bootstrapping effect* as reflected in the acquirers' share price at the bid announcement. Such market value impacts on acquirers are however to some extent decreased by institutional ownership in acquiring firms. Institutional shareholders can be regarded as another option for firms to enhance the level of their corporate governance besides CBAs. Our results also provide valuable lessons and insights for CBAs undertaken by other emerging economies that share similar institutional and governance environment as China.

The remainder of the paper is organized as follows. Section 2 reviews the relevant literature, and develops the hypotheses to be examined in this paper. In Section 3, we lay out the research design, which is followed by the main results and robustness check in Section 4 and 5, respectively. Section 6 concludes and discusses the implications of our results.

2. Theoretical background and hypotheses development

2.1. Investor protection, corporate governance and acquirer returns

Agency theory has long considered corporate governance to be important factor in the motivations for firms' overseas acquisition activities (Erel et al., 2012; Rossi & Volpin, 2004), and the determinants of value creation in CBAs (Bris & Cabolis, 2008; Bris et al., 2008; Chen & Young, 2010; Colombage, Gunasekarage, & Shams, 2014; Dutta, Saadi, & Zhu, 2013; Martynova & Renneboog, 2008). It argues that firms from countries with weak legal investor protection are often acquired by firms from countries with strong investor protection, suggesting that CBAs are an effective channel for worldwide convergence in corporate governance standards. Specifically, the target firm usually adopts the corporate governance standards of the country of the acquiring firm. when the bidder is subject to stronger investor protection than the target, acquisition can increase the target's corporate governance regulation either by *law effect* in a full takeover or by *control effect* in a partial takeover (Bris & Cabolis, 2008; Martynova & Renneboog, 2008). Additional value can be created

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