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Cross-border alliances and risk management☆

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ABSTRACT

We study U.S. firms' foreign expansion choices, and investigate alliances as risk management devices used to mitigate partner risk. Firms venturing abroad are constrained by the availability of potential partners. One set of partners are foreign companies the firm shares the venture with (direct partners). The second set of partners is the institutions/government of the host country (indirect partners). Firms are more likely to choose alliances (over M&As) when indirect (direct) partner risk is high (low). The sensitivity to direct partner risk varies in the cross-section, and is weakened by financial constraints and greater ease of monitoring foreign partners.

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"Without local guides, your enemy employs the land against you."
[Sun Tzu, "The Art of War"]

1. Introduction

Recent decades have witnessed a spectacular expansion of international investment by U.S. corporations. Between 1990 and 2009 only, U.S. firms were involved in over 52 thousands cross-border investment transactions. The finance literature has largely focused on cross-border M&A activity (e.g., Bris and Cabolis, 2008; Erel et al., 2012; Rossi and Volpin, 2004). However, M&As are not the only channel for cross-border expansion, nor are they even the most common one. In fact, nearly two thirds of these deals were strategic alliances, and in 17 out of 20 years, alliances outnumbered M&As.[4]

What drives the choice between alliances and acquisitions, and in particular, what makes a strategic alliance the preferred form of cross-border expansion? This question goes to the core of the very definition of the boundaries of the firm and the decision to internalize vs. outsource (e.g., Williamson, 1975; Hart and Moore, 1990).

In our paper, we study these issues through the lens of corporate finance, focusing on risk-management as a primary driver of the choice between alliances and M&As. This approach provides a new perspective on alliances, complementary to the existing literature. Traditionally, the finance literature has viewed strategic alliances as a "commitment technology" used to overcome agency problems *within* the firm. Intuitively, the manager of a partner firm has better ex ante incentives to exert effort, since he can retain a larger share of the surplus generated by the alliance, compared to an internal divisional manager, who could be expropriated by the corporate headquarters (e.g., Stein, 1997; Mathews and Robinson, 2008; Robinson, 2008). In the context of cross-border investment, however, the risk of ex post expropriation by an *external* alliance partner can be economically more relevant than the provision of ex ante optimal incentives, due to the greater monitoring difficulty, lack of knowledge of local economic conditions, or potentially limited legal protection (e.g., Grossman and Hart, 1986; Acemoglu and Johnson, 2005). Such risk can take different forms, such as unjustified and unplanned increase in prices by local suppliers, distribution fees charged by the local distribution network, or even cross-subsidization that the local partner enacts between its own business and the business managed with or on behalf of the international partner.

A cross-border acquisition could, in principle, address this problem, allowing full control of the foreign partner. However, it would also

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[4] Includes alliances and acquisitions of controlling stake; based on SDC data.

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expose the firm to the risk of hold-up and expropriation by the host country government and institutions, once the firm has committed resources by undertaking the investment (Kindleberger, 1969; Vernon, 1971). Typical example of this behavior is either direct expropriation of assets in place (e.g., Conoco in Venezuela, Repsoil in Argentina, Royal Dutch and Shell in Russia) or opportunistic behavior meant to change the contractual conditions at which the product was expected to be sold in the country (e.g., Enron in India, Nedbank in Gabon). On the other hand, since an alliance involves neither a large fixed investment nor a high integration cost (e.g., Kogut and Singh, 1988; Doz, 1996; Hennart and Reddy, 1997) it could limit the scope for losses caused by opportunistic behavior of the host country government.

These arguments suggest that the choice of the mode of cross-border expansion – via an acquisition or an alliance – emerges as an optimal response to the risk of expropriation by the partners that the firm faces when venturing abroad: its foreign partner companies, or *direct partners*, and the host country government and institutions, or *indirect partners*. The solution to the trade-off between *direct* and *indirect* partner risk will favor a cross-border alliance when the risk of expropriation by the direct partners (direct partner risk) is low and indirect partner risk is high, and a cross-border acquisition when direct partner risk is high and indirect partner risk is low.

We take these ideas to the data, studying worldwide cross-border alliances and acquisitions made by U.S. firms over the past two decades. The focus on international transactions allows us to confront the unexplored issue of the impact of host country contracting institutions and direct partner risk on cross-border corporate growth, as well as to provide an account for the empirical relevance of cross-border alliances.

In our empirical approach, we rely on the rationale of Acemoglu and Johnson (2005). They distinguish between the types of institutional arrangements that better protect against the opportunistic behavior of the two types of partner: "property rights institutions" – i.e., protection against expropriation by the government and powerful elites – and "contracting institutions" – i.e., the ability to enforce contracts between private counterparties. The quality of property rights institutions influences indirect partner risk, while the quality of contracting institutions affects direct partner risk. Therefore, following Acemoglu and Johnson (2005), we resort to proxies for direct and indirect partner risk rooted in the law and finance and financial development literatures. To proxy for direct partner risk, we utilize Legal Formalism (Djankov et al., 2003) and Procedural Complexity, which measure the quality of regulation of arm's length relationships among business partners. Our main proxies for indirect partner risk, on the other hand, are Constraints on Executive Power (Gurr, 1997) and Protection Against Expropriation (Knack and Keefer, 1995).

The reliance on country-based variables of partner risk has three advantages. First, it allows us to define ex-ante the set of characteristics available to firms when considering their expansion choices. Second, it is less subject to potential endogeneity than any type of firm-specific variable. Third, it allows to directly link our analysis to the literature on international M&As (e.g., Rossi and Volpin, 2004; Bris and Cabolis, 2008; Ellis et al., 2012).

We start by focusing on the choice of the form of cross-border expansion – i.e., alliance vs. M&A – as a function of the trade-off between direct and indirect partner risk. One potential issue could be that neither the set of U.S. firms venturing abroad nor their choices of host countries are randomly determined. We thus first examine the decision to venture abroad and the host country choice. We document that the overall quality of institutions – both property rights and contracting ones – attracts investment to a given host country. Conditional on the decision to invest abroad, the choice to expand into a given country via either an alliance or an acquisition is negatively related to both direct and indirect partner risk. To gauge the impact of these risks on cross-border expansion decisions, consider the effect of one standard-deviation increase in one of the direct partner risk proxies, Legal Formalism. This index ranges in our sample from 1.58 to 6.01, with a standard deviation of about 1.00, roughly corresponding to the difference between Canada (2.09) and Brazil (3.06).[5] Our estimates imply that one standard-deviation higher level of direct partner risk as measured by Legal Formalism is associated with a 16.45% lower probability of any cross-border deal (alliance or M&A) into a given host country.[6] Similarly, one standard-deviation higher level of indirect partner risk as measured by Constraints on the Executive Power, roughly corresponding to the difference between South Korea and Malaysia, is associated with a 4.93% lower probability of cross-border expansion into the host country. Host country direct and indirect partner risk, therefore, have a tangible impact on attracting investment.

These results allow us to control for sample selection, and focus on the impact of partner risk on the *form* of cross-border investment. As anticipated, we find that direct and indirect partner risks have opposite effects: while a greater direct partner risk makes an acquisition the preferred form of expansion, a greater indirect partner risk creates an incentive to opt for an alliance. The economic impact of direct and indirect partner risk is also substantial. One standard-deviation higher level of direct partner risk as measured by Legal Formalism (Procedural Complexity) is associated with a 5.79% (3.67%) lower probability of the U.S. firm choosing an alliance over an acquisition. Similarly, one standard-deviation higher level of indirect partner risk as measured by the Constraints on the Executive Power (Protection Against Expropriation) index is associated with a 19.51% (11.18%) higher probability of choosing an alliance.

A possible concern with these findings is that country institutions could be endogenous. For instance, property rights and contracting institutions could be a tool of economic policy designed to attract and shape the flow of foreign investment. We address this concern with two sets of checks. First, we follow Acemoglu and Johnson (2005) and resort to legal origin and European settler mortality as instruments for, respectively, direct and indirect partner risk. The results based on instrumental variables estimation confirm our baseline findings, and suggest that direct and indirect partner risks are major determinants of the form of foreign expansion.

Next, we perform a set of tests based on a diff-in-diff specification around two sets of events. First, we consider Eurozone accession. Eurozone membership represents an external shock to indirect partner risk, as it reduces the possibility of "stealth" government expropriation through high inflation, since Euro member countries surrender their monetary policy to the European Central Bank. We find that indirect partner risk loses at least 38% of its impact on the alliance/M&A choice after the introduction of the Euro.

Additionally, we focus on changes in governments following political elections as a shock to indirect partner risk. Again, as anticipated, we find that when the political regime becomes more "pro-business", indirect partner risk loses about half of its economic effect on the choice of the form of expansion. Similar results hold if we use alternative proxies of political regimes. All these tests confirm our results providing evidence in favor of a causality interpretation.

The main contributions of the first part of our analysis are the joint treatment of cross-border M&As and alliances as outcomes of risk-management policy, and the recognition of direct partner risk as a determinant of cross-border investment flows. The literature has acknowledged that international portfolio/minority investors face the "twin agency problem" of potential expropriation by companies' majority owners or by the host country government (Stulz, 2005). The risk of expropriation by a direct partner company that arises from weak contracting institutions provides an additional element of the problem. Unlike in a majority-minority shareholder type of conflict, where the

[5] To facilitate the interpretation of the results throughout the paper we change the signs of measures of direct and indirect partner risk so higher values of these measures represent higher partner risk.

[6] Throughout the paper all economic differences are reported relative to the corresponding sample means.

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