State ownership, institutional effects and value creation in cross-border mergers & acquisitions by Chinese firms

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A B S T R A C T

This paper considers the effects of state ownership and institutional influences on value creation through cross-border mergers & acquisitions by Chinese firms during the period using a sample of 468 firms. The findings indicate that Chinese bidders experience wealth gains ranging from 0.4771% to 1.5210% over a

10-day event window. The cross-sectional analysis indicates that state ownership, formal institutional distance, reforms in the foreign currency approval system exert significant impact on shareholder value. By considering the state ownership and institutions, this study provides evidence that government and institutions play a huge role in value creation of emerging market firm internationalisation through cross-border mergers & acquisitions (CBM&A).

1. Introduction

The recent empirical literature has paid notable attention to the role of governments on emerging market firms' decisions to expand internationally through M&A (see Luo, Xue, & Han, 2010; Peng, 2010; Rui & Yip, 2008; Xiao & Sun, 2005). These studies indicate that emerging market institutions and governments play an important role in outward M&A decisions by firms in emerging markets. However, studies that examine the effects of state and institutional factors on the value of outward M&A by emerging market firms are fairly scant. Prior studies have focused mostly on the effects of economic factors in acquiring firm value and have produced mixed results (see Calomiris, Fisman, & Wang, 2010; Chen, Goldstein, & Jiang, 2007; Datta & Puia, 1995; Gregory & McCorriston, 2005; Markides & Itnner, 1994). This paper extends the prior literature by examining the effects of state ownership and institutional factors on firm value. The main objectives of this paper are twofold: (i) to investigate whether government involvement through state-owned enterprises (SOEs) creates value for Chinese acquiring firms; (ii) to examine the impact of institutions on the shareholder value of Chinese acquiring firms.

We draw on the institutional perspective to address the above objectives for a number of reasons. First, institutions defined as‘‘the rules of the game’’ have a significant impact on emerging market firms' behaviour because government and societal influences are stronger in emerging market economies compared to developed countries (Hoskisson, Eden, Lau, & Wright, 2000). Institutions help shape firm structures and influence firms' strategic choices and competitiveness (Fligstein, 1996; North,

1990). The role played by home country institutions in shaping international expansion behaviour has implications for firm value because institutions affect the cost of doing business, have an impact on firms' confidence and create winners and losers in the marketplace (Boddewyn & Brewer, 1994; Kofele-Kale, 1992; Leone, 1986). Good institutions facilitate effective functioning of market mechanisms, enabling firms and individuals ''to engage in market transaction(s) without incurring undue costs or risks'' (Meyer, Estrin, Bhaumik, & Peng, 2009: 63), and increase firm value (Shleifer & Vishny, 1994). However, ''bad'' institutions increase the cost of doing business (Ang & Michailova, 2008). Second, state ownership unavoidably brings political objectives into corporate decision making, which can damage corporate value (Shleifer & Vishny, 1994). Conversely, it is argued that state ownership of firms in emerging markets can lead to preferential treatment from the government and favourable allocation of resources, thereby enhancing the value of a firm (Sun & Tong,

2003; Tian & Estrin, 2008).

In this paper, we examine the effects of state ownership and institutional variables on firm value using acquirers' returns (a direct measure of shareholder value and investors' future expectations), which is consistent with the strategic goal of wealth maximisation of a firm (McGee, Thomas, & Wilson, 2008).

The focus on Chinese CBM&A during the 1998–2011 period as an empirical context for the study is motivated by the following: (i) China is the largest emerging economy and CBM&A are growing exponentially and constitute a predominant entry strategy of foreign direct investment (FDI) by Chinese firms (UNCTAD, 2012). The value of CBM&A purchases by Chinese firms, which stood at only US$185 million in 1991, reached a value of US$37,111 million in 2012 (UNCTAD, 2013). China accounted for approximately

66.49% of CBM&A purchases from Brazil, Russia, India and China (BRIC) countries plus South Africa in 2012 (UNCTAD, 2013). Like other emerging economies, the surge in CBM&A activities by Chinese firms is attributed to a number of reforms and changes in the environment in which CBM&A operate. The reforms include the establishment of (i) two stock exchanges, namely, Shanghai and Shenzhen Stock Exchanges in 1989 and 1991, respectively; (ii) simplification and decentralisation of foreign exchange adminis- tration and the establishment of a foreign exchange market to facilitate trading of the Chinese Renminbi with several currencies; (iii) changes in government policies towards outward foreign direct investment (OFDI) and enterprise reforms. In particular, the ‘‘go abroad strategy’’ initiated by the Chinese government to provide financial and other support mechanisms, reduce institutional constraints and help Chinese firms to become global champions has been a tremendous push behind the rise in CBM&A activities. These key reforms embarked upon by the government together with the ‘go abroad’ strategy initiated in 1999 have largely contributed to the growth of cross-border mergers & acquisition activities. However, despite these reforms, state- owned and state-controlled firms remain the dominant force in CBM&A activities (Chen & Young, 2010). The involvement of SOEs in CBM&A allows us to capture their effects on firm value.

This paper makes two primary contributions to the literature. First, it contributes to institutional theory and its application in international business and finance research, particularly with respect to value creation in CBM&A by emerging market firms. Thus, the paper sheds light on emerging market firm responses to institutional pressures. Second, this study contributes to the empirical research on cross-border investment by emerging market firms, with specific reference to China, which has seen massive reforms unparalleled by any other emerging economy over the last two decades. Given the uniqueness of Chinese reforms and heavy government involvement in CBM&A to help firms acquire the resources that China lacks, we believe that the results of this study could serve as a lesson for policymakers and senior managers in other emerging countries regarding policy directions in their quest to become influential players in the global market for corporate control.

The rest of the paper is organised as follows. The next section provides a brief theoretical background with respect to CBM&A and firm value and the role of institutions. This background is followed by the study’s hypotheses. We then discuss the data and research methodology used in this study. The results and discussion follow. The final section provides a conclusion and implications of the study.

2. Theoretical background

2.1. CBM&A and firm value

Several theories explain the possible sources of gains following international mergers and acquisitions. Four of the common theories identified in the emerging market literature concern market development and power, the resource based view, internalisation and diversification. First, CBM&A activities provide emerging market firms with the fastest means to access new markets, expand their product and consumer markets interna- tionally, overcome trade barriers and increase firm value (Boateng, Wang, & Yang, 2008; Deng, 2009). Boateng et al.

(2008) found that market share and power are one of the highest ranked motives for CBM&A by Chinese firms and noted that market power is a source of value for acquiring firms.

Second, the resource-based view literature suggests that one important reason for CBM&A is to gain access to strategic assets, such as natural resources, product differentiation, patent-pro- tected technologies, and superior managerial and marketing skills. Acquisition of these capabilities and resources promotes techno- logical learning, facilitates the development of skills and compe- tencies, improves economies of scale and consequently increases firm value (Barney, 1991; Vermeulen & Barkema, 2001). In the context of China, Deng (2009), Rui and Yip (2008), and Boateng et al. (2008) reported that emerging market firms as latecomers lack resources and they strategically use CBM&A to achieve specific goals, such as acquiring strategic capabilities to offset their competitive weaknesses and increase firm value.

Third, the internalisation framework is premised on the contention that firms extract above-normal returns from CBM&A investment by internalising host country imperfections when their firm-specific assets cannot find comparable value elsewhere (Buckley & Casson, 1976; Caves, 1971; Morck & Yeung, 1991; Morck & Yeung, 1992). Researchers argue that the economic rents derived from internalisation can be converted into a higher value for emerging market firms (Aybar & Ficici, 2009; Boateng et al.,

2008; Gubbi, Aulakh, Ray, Sarkar, & Chittoor, 2010).

Fourth, CBM&A allow firms an opportunity to reduce costs and risks when entering new foreign markets (Seth, 1990). Diversifi- cation as a source of value comes from exchange rate differences and the ability to lower the cost of debt and reduce variance in the cash flows if the cash flows of acquirers and targets are less correlated (Bhagat, Malhotra, & Zhu, 2011; Morck & Yeung, 1992).

2.2. Institutional theory and CBM&A

Over the past decade, institutional theory has emerged as an important way to explain the behaviour of firms in emerging markets (Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007; Child & Rodrigues,

2005; Hoskisson, Eden, Lau, & Wright, 2000). The theory suggests that institutional contexts (i.e., the combination of formal rules, informal constraints and their enforcement characteristics) create the impetus for action patterns in an organisation. Scott (1995) identifies three pillars of the institutional framework: the regulatory (existing laws and rules), the cognitive (widely shared social knowledge and social perceptions that are taken for granted), and the normative (social norms, values, and culture). Together, these pillars constitute a broad base from which a country's institutional profile may be analysed. As applied to research in management, the institution-based view posits that firms are shaped by the home and host countries' institutional environments. Firms require legitimacy in addition to economic efficiency to survive and succeed (Scott,

1995) and make strategic choices based on their interactions with institutions (Peng, 2002). It is therefore argued that firms must consider wider influences than firm- and industry-level factors when crafting and implementing strategies to gain competitive advan- tages, such as support from the state and society.

In the case of China, state-sponsored and state-supported acquisitions have become the normal mode through which Chinese enterprises enter and penetrate a host country (Child & Rodrigues, 2005). When conducting CBM&A activities, firms engage with institutional processes in both the home and host countries (Rosenzweig & Singh, 1991; Xu & Shenkar, 2002). In the home country, firms are subject to the home government's regulatory restrictions on outward investments, especially when the home country is an emerging economy, where capital control is common (Cui & Jiang, 2012; Morck, Yeung, & Zhao, 2008). Firms' CBM&A decisions in China are influenced by different levels of government, either through FDI incentives and support schemes or through government-administered approval systems. The approv- al system usually entails costs that can affect the value of a firm. Similarly, host country institutions may also affect a firm's value. Good host country institutions imply strong legal enforceability, which protects the interest of acquiring parties and reduces costs resulting from asymmetric information. The quality of these institutions may also speed up the process of mergers and acquisitions, which may prevent deals from becoming hostile and thereby destroying a firm value.

The literature also highlights the effects of state ownership on firm value. The effects of state ownership are subject to two interpreta- tions. One view suggests that state ownership damages corporate value because government intervention will slow down a firm's decision-making processes in an increasingly competitive environ- ment. The contrary view argues that SOEs are more likely to receive preferential treatment from the government, thereby enhancing their value (Blanchard & Shleifer, 2001). China, like other emerging economies, is characterised by active government involvement in business through ownership and regulation (Child & Rodrigues, 2005; Scott, 2002). It is well documented that Chinese firms involved in CBM&A have benefited from government support through value- added tax breaks and favourable financing (UNCTAD, 2005; Xiao & Sun, 2005). The literature examining whether state ownership has had beneficial or detrimental effect on Chinese firm value has been mixed (see Sun, Tong, & Tong, 2002;

Wei, Xie, & Zhang, 2005). We examine whether the institutions in China's emerging market economy enhance or destroy value in Chinese CBM&A.

In light of the above discussion, we propose a framework (Fig. 1) to analyse the effects of state ownership and institutional variables on the returns of Chinese acquiring companies.

3. Hypothesis development

3.1. State ownership

A number of studies (e.g., Boycko, Shleifer, & Vishny, 1996; Dewenter & Malatesta, 2001; Megginson, Nash, & van Randenborgh, 1994) argue that SOEs are less efficient compared with privately owned firms because SOEs tend to be politically rather than commercially motivated, which leads to poor operating performance. For example, to reduce social pressures, through its ownership of firms, government may pursue goals such as reducing unemployment rather than profit maximisation. Others argue that state ownership heightens bureaucracy and information asymmetry thereby destroying firm value (see Boycko et al., 1996; Shleifer & Vishny, 1994).

Bai, Lu, and Tao (2006), Guariglia, Liu, and Song (2011) and Poncet, Steingress, and Vandenbussche (2010) also argue that the pursuit of socio-economic and political objectives by emerging market governments might also induce soft budget constraints and provide some support for state-controlled firms. For example, Luo et al. (2010) and Peng, Wang, and Jiang (2008) have documented that through its ownership of firms the Chinese government provides tax rebates, foreign exchange assistance and financial support for firms engaged in outward M&A. Moreover, prior studies have also documented that firms with state ownership tend to face fewer financial constraints when conducting outward investment compared to privately owned firms (Lin & Bo, 2012; Zhou, Guo, Hua, & Doukas, 2012). Using a dataset of 20,000 Chinese firms, Poncet et al. (2010) and Guariglia et al. (2011) conclude that private firms in China face severe financial constraints on investments while SOEs do not. It is expected that government support, through lower lending rates and other incentives for SOEs, may provide a positive signal to stock markets about the future prospects of firms engaged in outward acquisitions and increase acquirer returns (Lubatkin & Shrieves, 1986; McGee, Thomas, & Wilson, 2008). We therefore argue that the political and economic advantages of preferential treatment given to SOEs are likely to be impounded in stock prices and reflected in increased acquirer returns if Chinese stock markets are efficient. The argument leads to our first hypothesis:

Hypothesis 1: Acquiring firms that are partly state-owned will generate positive abnormal returns compared to non-state owned firms.

3.2. Formal institutional distance

The quality of public institutions is used as a proxy for formal institutions. Berry (2006) contends that a more institutionally developed market is likely to provide a location with less risk where knowledge can be acquired or learned, and more institutional protection provided for investments. It follows that acquisitions by emerging economy firms in institutionally devel- oped countries, which are characterised by competitive markets and customer-centric focus, are likely to offer a rich reservoir of

learning for Chinese firms that lack cutting-edge technology and other resources that can subsequently be internalised in different markets and at home. Chan, Isobe, and Makino (2008) note that the enhanced learning experience offered by targets in more institutionally developed environments is of significant value to emerging economy firms. In a recent study in India, Gubbi et al. (2010) found a positive relationship between institutional distance and value creation of Indian acquirers. No study has explicitly examined institutional distance in China, even though former communist China has witnessed unprecedented reforms over the past two decades. An examination of the effects of institutional distance on firm value allows us to capture the regulative and cognitive constructs of China and host economies. Thus, we hypothesise the following:

Hypothesis 2: Chinese acquirers engaged in CBM&A activities in a developed formal institutional environment will generate positive abnormal returns.

3.3. Foreign exchange reforms

The Chinese authorities have changed the foreign exchange regime to a ‘buy-to-use’ policy in place of the ‘earn-to-use’ policy of the early 1990s (Voss, Buckley, & Cross, 2010). In 2003, the government implemented changes to speed up the foreign exchange application approval system for CBM&A but stopped short of completely liberalising the system. In 2006, the central authorities further liberalised the regulatory process and foreign exchange control by completely decentralising the system from the State Council to the provincial level and abolishing the US$5 billion local limit (Voss et al., 2010; Wu & Sia, 2002). It is important to note that foreign exchange reform is the only reform policy that has undergone a complete decentralisation from the State Council to the Provincial level regarding the approval of funds to undertake CBM&A.

We argue that liberalisation of the foreign exchange regime reduces bureaucracy and the costs of doing business and facilitates international transactions among Chinese firms wishing to make international acquisitions. We expect that the reforms will generate positive value effects when acquisitions are announced because of the potential reduction in the costs of doing business. It is expected that the ensuing efficiencies associated with the reforms in the foreign exchange system should convert into positive stock price movement for Chinese acquirers and that acquirers' returns will be higher than returns before the reforms on the assumption that the stock markets in China are efficient. We will therefore test the following hypothesis:

Hypothesis 3: Chinese acquirers engaged in CBM&A will create more value as a result of the reforms in the foreign exchange approval systems.

3.4. Informal institutional distance (culture)

Prior literature shows that informal institutions have a significant effect on the value of firms engaged in CBM&A. It is argued that cultural proximity improves firm value of CBM&A because the acquirers' and targets' diverse sets of routines embedded in national culture are easily accessible (Hofstede,

1980; Morosini, Shane, & Singh, 1998). Moreover, a number of researchers suggest that cultural differences between home country and host country are negatively associated with the firm value of CBM&A and that such effects may be felt in both the pre- acquisition phase (Hofstede, 1980; Kogut & Singh, 1988; Ahern, Dominelli, & Fracassi, in press) and post-acquisition phase (Geringer, Beamish, & daCosta, 1989).

In terms of the pre-acquisition cultural effect, significant cultural differences may be a source of management resistance from target firms, which can increase transaction costs (Cartwright

& Cooper, 1993) and lower the value creation of acquiring firms. For post-acquisition effects, significant cultural differences in- crease the difficulty of assimilation and transferring distinctive competencies between acquirers and targets (Datta & Puia, 1995; Geringer et al., 1989). Thus, the larger the cultural difference the more difficulty acquiring firms may have in gaining normative legitimacy as measured by informal institutions in the host country. For example, one of the main reasons for the failure of the acquisition of the TV business of Thomson in France by TCL of China was unfamiliarity with the European business operations. Accord- ing to Deng (2010): 520, ''the new company did not work well with people from different cultures, with different experiences, and with different routines.'' It is argued that the greater the cultural differences between two countries, the greater the value destruc- tion. Accordingly, the following hypothesis addresses the effect of cultural proximity on acquirers' returns:

Hypothesis 4: High cultural distance between China and the host countries of target firms will have a negative effect on the returns of the Chinese acquirers.

4. Data and research methodology

4.1. Data source

This study considers all completed CBM&A by publicly traded

Chinese firms over the period from January 1998 to December

2011. We obtained our data from the Chinese Stock Market Research (CSMAR) database. The CSMAR database provides information regarding the acquirer's name, relevant transaction dates, target name and country of origin, deal value, deal type, restructuring type, industry, and method of payment. CSMAR is a high-quality Chinese database produced by a Hong Kong based company called GTA. The M&A data began in 1998 and are updated constantly. We compared the data from the CSMAR database with the Thomson SDC Platinum M&A database and the Datastream. The CSMAR database appears to provide relatively more up-to-date information in terms of the number of acquisitions and stock returns with fewer missing values. We also cross-checked the details relating to deal values, target country of origin and other relevant details with newspapers, business magazines, and the China M&A Yearbook. Share price data were also collected from the CSMAR database, which provides daily share prices of all of the public firms listed on the Shanghai and Shenzhen Stock Exchanges.

4.2. Sample selection

Our initial population consists of 1063 CBM&A bids by Chinese firms. For inclusion in the final sample, the following restrictions were imposed on the acquiring firms:

The acquirer must be listed on the Shanghai or Shenzhen Stock Exchanges under A share, which provides data on CBM&A in China, and the company shares must be actively traded:

(i) Neither the acquirer nor the target should be a financial firm.

All firms that belong to the financial sectors, banks, life assurance companies, investment firms, insurance companies and real estate investment trusts are excluded from the sample.

The reason behind this is that financial firms have a different nature of assets and liabilities, different financial reporting systems and unique regulations, all of which may influence firm value and bias results.

(ii) The acquirer must not be involved in multiple acquisitions within three months; the effects of each acquisition must be in this way properly separated.

(iii) There should not be a contaminating announcement within 30 business days before or after the announcement because other events surrounding an acquisition may also influence stock prices, which may lead to biased results.

(iv) The acquirer must acquire more than 10% of the target because acquiring a stake less than 10% is classified as a portfolio investment rather than acquisition investment with manage- rial control under U.S. Department of Commerce guidelines.

(v) The share price data and accounting information of the acquirer must be available in the CSMAR database.