Emerging Market Multinationals and the Effect of Institutional Distance on Equity Participated in Cross Border Acquisition

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Abstract
Cross border acquisition is an essential aspect in accessing different international markets. With the rise of Emerging Market Multinationals, cross border acquisition has been their primary vehicle in accessing to those different markets. Motivations and intentions of Emerging Market Multinationals differ from established Market Multinationals in the value of strategic and tacit assets acquired in a cross border acquisition. These assets are effectively transferred when the equity acquired in the host company is significant and is in an established developed economy. This paper examined the relationship of institutional distance based on an economic freedom index between the acquirer’s nation and host nation with the equity participated in the acquisition. Although the outcomes of the analysis are moderately significant, they show a positive relationship between institutional distance and equity participation.

Keywords
Emerging Markets — Market Multinationals — Equity Participation

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Introduction
Cross border acquisition (CBA) is a complete or partial takeover that involves two firms headquartered in two different countries. This strategic phenomenon has been increasing in value and in number of acquisitions in the past several decades. Several factors have been contributing to this phenomenon. Such factors include technological developments, liberalization of economies, and industry consolidation [1]. Different motives encourage companies to acquire other companies overseas. Access to less competitive markets and benefiting from relatively weaker regulations can substantially affect a company’s operations. While some CBAs ventures are successful and add value to their shareholders, most CBA are considered to be failures or do not add value to their shareholders. According to different studies, failure rates in CBA ranges between 50 to 70 percent [1].

With the rise of emerging economies in the 1970s and 1980s, the term “Third World Multinationals,” gained access in the global economy and eventually evolved to Emerging Market Multinationals (EMNE) [2]. The rise of such markets formed new competition with Developed Market Multinationals (MNE) and therefore created a greater effect on the global economy. Understanding the emergence of these markets is essential in unveiling possible potentials within EMNEs and identifying comparative advantages. Today, EMNEs are active in CBA in developed and developing markets. The notion of EMNEs contributing to MNEs contradicts with past beliefs and theories in international trade on the flow of capital. The theory states that capital flows from capital abundant countries to poor countries, labor abundant, or capital-scarce countries no longer apply in today’s terms concerning CBA by EMNEs. This paper will review past research studies and examine the relationship between a sample of EMNEs with the development and institutionality of the host country.
For the purpose of this paper, institutional distance between countries will be compared based on an Economic Freedom Index (EFI) measured by the Heritage Foundation and the Wall Street Journal. EFI provides a more accurate basis for institutional distance for this paper because it addresses annual changes on political and fiscal regulations that affect the environment of CBAs. It is based on how citizens of a country are able to control resources such as labor, property, and capital. In a context of a free society, it enables people to produce and consume goods with no government constraints [3]. Furthermore, countries with high levels of economic freedom enjoy more income compared to countries with less freedom. It also reflects on the quality of education and health services offered. On the other end of the spectrum, some countries have excessive government constraints and inefficiencies in public services. It also includes high government spending in the economy that reflects on the role of government in an economy.

The EFI measures ten essential aspects of business and fiscal policy. The ten categories are: labor freedom, business freedom, trade freedom, fiscal freedom, government spending, monetary freedom, investment freedom, financial freedom, property rights and freedom from corruption. Each category has its own score and the total scores of these categories form a country’s score.

1. EMNE

In this paper, Brazil and Chile represent a sample of EMNEs that researchers believe have a more aggressive ownership equity in CBA [4, 5]. Both countries have had major political transformation in the same period accompanied with pro-market fiscal reforms. Brazil represents BRIC countries and is one of the potential economic superpowers in the world [6]. Chile represents EMNEs of a smaller scale. Despite their geographical proximity, the institutions of both countries are quite different from each other. In past research papers in the CBA field, researchers have focused their interests on developed economies. Also in research papers that focused on EMNEs, they focused their interests on major EMNEs markets such as China and India [7, 8]. Brazil’s and Chile’s potential in growth in CBA can enable both economies to be compatible to developed economies.

Brazil and Chile have also had sustainable growth rates for the past several years. Figure 1 below represents the change in outward of Foreign Direct Investment (FDI) for a five-year period. The graph below demonstrates the growth rate of Brazil and Chile in contrast to Developed Economies and shows significant growth rates in both countries compared to Developed Economies.

1.1 Chile

Chile’s political transformation in the past 20 years has been significant and has clearly been reflected on its economy. Two decades ago, Chile was not a potential emerging economy. But after transforming to a market-oriented economy, foreign trade helped boost the Chilean economy to being the second largest investor in South America [9]. It is able to reach such status without government incentives to companies investing abroad. In a period of five years from 2004 to 2009, Chile’s outward flow of direct investments increased by 510.3 percent, surpassing all emerging economies of its size such as the Philippines and the Czech Republic [10].

In the economic freedom index by the Heritage foundation, Chile ranks seventh in the world and first in South America. Chile’s leading status is due to low government spending and pro-market fiscal policies. It also ranks South American countries in the transparency of courts and its legal systems. In a high corruption rate region, Chile represents the lowest rate of corruption in the South American region. Chile has also signed free trade agreements and investment protection agreements with their trading partners and potential partners. Razo and Calderon believe that the Chilean government has provided stable economic conditions to promote Chilean firms in investing abroad without giving direct incentives to those firms [9]. In Figure 1, Chile’s growth rate was the steadiest among Brazil and all other developing economies and is likely to continue with high growth rate in the next several years.

1.2 Brazil

Brazil is one of the ten largest economies in the world. According to the International Monetary Fund, it has surpassed Great Britain in total GDP. Most notably, Brazil has been associated with the BRIC countries; an acronym used in different business journals that represents fast potential superpowers fueled by domestic economic growth and pro-market reforms. It is considered to be well-developed in agriculture and manufacturing and lately has expanded to international markets. Commodities market, manufacturing, and the appreciation of the Real have been major attributes to the Brazilian economy. It is also an economy that has presence in a wide range of industries. Market stabilization and fiscal policy reforms in the 1990s attracted investments from other countries. Brazil also does not allocate direct incentives for Brazilian firms to invest abroad.

Internationalization of Brazilian firms has been triggered by seeking different markets for competitive advantages, meeting international demand, and in reducing their dependency
on local markets [6]. Furthermore, Brazilian firms seek natural resources, low costs, and favorable government policies. However, The Heritage Foundation notes that Brazil has inefficiencies in government agencies due to poor public services. Brazil also faces challenges in attracting foreign investors in investing in Brazilian enterprises. It was ranked low based on the ease of doing business on the World Bank’s Ease of Doing Business 2011 report. Understanding challenges and government roles in both countries can help in understanding how equity participated is affected by institutional distance with the host country given different incentives and obstacles. Furthermore, knowing dominant industries in Brazil and Chile can be reflected on CBA direction and compatibility of industries in acquisitions.

2. Literature Review

For EMNEs, internationalization is a path to access different markets. More importantly, EMNE are encouraged to expand internationally to acquire strategic and intangible resources. Some business scholars believe that the relative scarcity of technology, management skills, and quality in the developing world encourages them to invest abroad and specifically in relatively more advanced environments [11, 8]. Deng argues that EMNE are encouraged to invest in developing nations to be able to leapfrog growth cycles in technology to compensate their competitive disadvantage [7]. He further argues in his technology example that companies when acquiring existing firms in developed nations, are able to benefit from the existing advantages of the acquired company.

Strategic asset seeking is considered the most significant motive for EMNEs to acquire abroad [7]. Such assets can be difficult to transfer. CBA can be a vehicle of internationalizing that enables EMNE to acquire the strategic assets that can help EMNEs in solving complex strategic problems [8]. A sample of Indian firms by Gubbi and colleagues showed that EMNEs acquisitions have generated positive returns for their shareholders’ as opposed to past researchers who have believed the opposite for MNEs.

Furthermore, a major distinction between EMNEs and MNEs is the advantage of the “latecomer” status, which is reflected on low labor costs and government policies [5]. Another distinction arises from the advantages sought in the acquisition. From an MNE’s perspective, internationalization is triggered by firm’s advantages to access to new markets and resources. For EMNEs, Internationalization is triggered and also attracted by potentials in developing other advantages and potentials [8].

2.1 Institutional Distance

Institutional distance plays a major role in influencing cross CBA decisions. Differences arising from cultural, economic, administrative, geographic, and political differences can be a potential challenge in CBA. Business scholars have argued that there is a positive relationship with the cost of doing business in another country with its institutional distance. When distances are further apart, the cultural nature increases uncertainty, which reflects on knowledge and information to flow between two countries and therefore increases the cost [12]. Moreover, economist Stephen Hymmer, introduced the concept of “liability of foreignness,” that believed in the comparative advantage of local enterprises over non-local enterprises.

The national culture of a nation is found to be an influential aspect of a firm’s organization [13]. It can influence openness to foreign markets and strategic changes. In “Multinational Management, A strategic approach” by Cullen and Parboteeah [14], the authors noted the cultural effects on doing business with emerging markets. The book gave an example of how culture affects doing business in China compared to the United States. Business happens at a slower pace in China relative to the US; thus, it requires several trips to China to negotiate a deal. Moreover, negotiation might also encounter challenges from both parties. Chinese negotiators tend to not say no in a negotiation that can be perceived as an agreed upon deal. Although the issue of cultural compatibility in businesses today is fading away, it is still a challenge for multinational enterprises when acquiring abroad.

Cultural influence on institutional distances is indirect. Although it is an important aspect in post-acquisition deal; however, outcomes of these effects on the acquisition are not clear. Past scholars have used Hofstede’s analysis of culture classification [13]. Studies that were based on Hofstede’s analysis have produced conflicting outcomes. Some studies have found that when distances are further apart, it encourages full ownership, while other studies using the same base of cultural distances proved no significant effect. Berry, Guillen, and Zhou believe that Hofstede’s analysis is not applicable to today’s studies because the analysis is only based on cultural differences and does not count for other issues in business [12]. Moreover, Hofstede’s analysis assumes the cross-cultural distances are constant and do not change throughout time. This notion contradicts with the global integration in businesses in today’s world.

2.2 Equity

The risk associated with CBA extends beyond the host country. The degree of ownership by the acquirer further determines the risk associated to EMNEs. It determines the return on investment as well as control of the entity. More importantly to EMNEs, it determines the effective transfer of tacit assets [15]. Only a few studies have been done on the impact of institutional distance on equity sought in the target firm in CBA. As mentioned previously, some researchers believed it encourages a more aggressive equity ownership and other researchers believed it had no relation. Also, other studies have found that the relationship between cultural distance and equity sought in acquisition tends to have a curvilinear shape [4, 5]. As for EMNEs, their latecomer status encourages them to acquire more aggressively and possibly attain full ownership. It allows an effective transfer of tacit assets to
EMNEs.

In addition to return on investment and asset acquisition, different factors influence share of ownership in a CBA [15]. An important factor in studying CBA is industry type. Chari and Chang have found that when companies engage in a CBA activity in a different industry, they tend to be partial ownership.

2.3 Hypothesis
Past researchers in cross-culture trade emphasized on how cultural and institutional differences may hinder businesses among nations with great cultural differences. Recently, with the emergence of new economies and the rapid growth of those economies, cultural and institutional compatibility has not been a major issue in regard to doing business. In fact, recently, some researchers believe that it actually may increase benefits for the acquirer in acquiring management style of an established MNE and other strategic assets.

Hypothesis: The higher the institutional distance of the target’s home country, the more equity an EMNE will seek in a CBA.

3. Methodology

3.1 Definition
The analysis in this paper will be based on completed announced cross-border acquisition for a five year period between 2007 and 2011. The reported deals were reported by the Thomson Financial SDC Platinum Database for Worldwide M&As. Thomson Financial is the most used database by researchers, investment banks, and law firms in regard to M&As and global issues. The sample that will be used to test the hypothesis is based on Brazilian and Chilean firms acquiring in companies headquartered in other nations.

The database was adjusted to accommodate tested hypothesis. Some CBA deals included Brazil or Chile as being the acquirer and the target simultaneously and the ultimate parent company of the acquirer would be headquartered at a different nation. Those acquisitions were eliminated in the sample to only represent the tested hypothesis of acquisitions done by only Brazil and Chile that represent emerging economies. As observed, the nations of the target companies represent a great number of different countries with varying institutional distance. The sample that is extracted from the Thomson Financial database includes details on each acquisition. Those details were gathered to form a better understanding on each attribute affecting acquisitions and the model as a whole.

3.2 Measures
The equity acquired in the target firm is the dependent variable. It represents the percentage of equity the acquirer acquired after the acquisition. As mentioned previously, the equity acquired by the acquirer represents the risk associated with the acquisition that reflects on the effective transfer of strategic and tacit assets. In the sample tested, the equity acquired by Brazil and Chile had an average of 76.41%. This high percentage in equity acquired is reflected by the aggressiveness of EMNEs in acquisitions to overcome their latecomer status [5].

Institutional distance measured by the economic freedom of countries represents the distance between the acquirer and the target. Institutional distance is the independent variable in the model tested. Because of the nature of the field of international management and more specifically CBA, there are several factors and attributes causing and affecting each activity. Thus, the use of moderation in statistical models in management has become of more importance [16]. Aguinis believes that the statistical power in management is reduced below acceptable levels due to the different variables affecting the model.

For the sample tested, several factors in the model will be controlled to understand the magnitude it has on the model. The controlled factors will be the year the acquisition took place, home country effects and industry effects. The industry of acquirer included six different industry categories. It included Financial, Manufacturing, Natural Resources, Services, Trade, and Other. These factors were controlled by using dummy variables in the regression model.

4. Results and Analysis

Table 1 below represents the statistical output of the model tested. The $R$ square which represents the model’s ability in explaining the variance in equity is about 14%. However, the adjusted $R$ square for this model is about 8.2% and is adjusted to penalize predictor variables that do not add meaningful effect to the model.

<table>
<thead>
<tr>
<th>Table 1. Regression Statistics</th>
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<tbody>
<tr>
<td>Multiple R</td>
</tr>
<tr>
<td>R Squared</td>
</tr>
<tr>
<td>Adjusted R Squared</td>
</tr>
<tr>
<td>Standard Error</td>
</tr>
<tr>
<td>Observations</td>
</tr>
</tbody>
</table>

The $F$ value of the model is at 0.0006, which implies the significance of the hypothesized effect of institutional distance on equity. With the implementation of dummy variable as controls, the effect of the model increased. The controls were on the year the acquisition was announced, the acquirer “Brazil or Chile,” and from the six different categories of industry. As predicted and in-line with other research papers, the effect of institutional distance in EMNEs on equity is positive, meaning that when distances are further apart between two countries, it predicts a more aggressive ownership of equity.

Some of the controls did not have a significant effect on explaining the model or in predicting equity, suggesting that Brazil and Chile have the same effect of institutional distance on equity.
The P-values of institutional distance, year, and industry were all significant since they were all less than 0.05. Thus, these variables help in interpreting equity. The table below represents the output of the statistical model. The final model is:

\[
\text{Equity} = 69.988 + 0.764 \times (\text{EFI difference}) - 14.978 \\
\text{(Year 2009) - 17.382 (Year 2010) + 25.558 (Trade)}
\]

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>P-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>69.988</td>
<td>8.332</td>
<td>0.000</td>
</tr>
<tr>
<td>EFI Difference</td>
<td>0.764</td>
<td>0.308</td>
<td>0.014*</td>
</tr>
<tr>
<td>Trans. Value</td>
<td>-0.002</td>
<td>0.005</td>
<td>0.620</td>
</tr>
<tr>
<td>Country</td>
<td>-1.632</td>
<td>5.337</td>
<td>0.760</td>
</tr>
<tr>
<td>Year 2008</td>
<td>-6.217</td>
<td>7.313</td>
<td>0.396</td>
</tr>
<tr>
<td>Year 2009</td>
<td>-14.978</td>
<td>7.522</td>
<td>0.048*</td>
</tr>
<tr>
<td>Year 2010</td>
<td>-17.382</td>
<td>6.160</td>
<td>0.005*</td>
</tr>
<tr>
<td>Year 2011</td>
<td>-0.179</td>
<td>6.644</td>
<td>0.978</td>
</tr>
<tr>
<td>Financial</td>
<td>2.825</td>
<td>9.083</td>
<td>0.756</td>
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<tr>
<td>Manufacturing</td>
<td>4.795</td>
<td>7.908</td>
<td>0.545</td>
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<tr>
<td>Natural Resources</td>
<td>2.473</td>
<td>9.893</td>
<td>0.803</td>
</tr>
<tr>
<td>Services</td>
<td>9.563</td>
<td>9.352</td>
<td>0.308</td>
</tr>
<tr>
<td>Trade</td>
<td>25.558</td>
<td>12.275</td>
<td>0.039*</td>
</tr>
</tbody>
</table>

### 5. Discussion

After reviewing the results and outcome of the statistical analysis, it can be concluded that the effect of institutional distance on equity participated is moderately significant. This phenomenon may be unique to the case of EMNEs compared to MNEs as past research papers have suggested. The findings in this paper also suggest and concur with past research papers in the aggressiveness of EMNEs in acquisition [4, 5]. The sample analyzed showed a high percentage of equity participated exceeding 70% with a 53% of it included full ownership. With the controls included in the analysis of this paper, the year and industry category are found to have some effect on the model; concluding that the status of an economy and industry have some effect on equity ownership. The sample taken in this paper (Brazil and Chile) is believed to represent a fair sample of EMNEs based on the outcome of the statistical analysis.

The findings in this paper agrees with past researchers in concluding that the status of an economy and industry category are found to have some effect on the model; the year and industry category are found to have some effect on the model; concluding that the status of an economy and industry have some effect on equity ownership. The sample taken in this paper (Brazil and Chile) is believed to represent a fair sample of EMNEs based on the outcome of the statistical analysis.

The potential of these findings can also help in understanding different aspects and attributes to CBA within EMNEs. Future research can be in studying the different attributes of company characteristics such as value of company and attributes in the role of government in the economy of the host country.

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