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Outward foreign direct investment of publicly listed firms from China: A corporate governance perspective

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ABSTRACT

This study examines the influence of key corporate governance factors on the internationalization decisions of emerging economy (EE) firms. By integrating the resource-based view and agency theory, it investigates the effects of controlling owner identity, non-controlling shareholder ownership, and the interactions of these with CEO power, in order to reveal their individual and joint effects on the outward foreign direct investment (OFDI) propensity of EE firms. This empirical study of 224 Chinese publicly listed firms found positive effects of ownership of domestic institutional investors and foreign corporations on the OFDI propensity of the firms, which were moderated by the power of the CEOs in these firms.

1. Introduction

Firms in emerging economies (EEs) throughout the world are rising to prominence as a result of both their domestic growth and their internationalization (Luo & Tung, 2007; UNCTAD, 2010). Given the importance that internal governance structure can have on firms' strategies, including outward foreign direct investment (OFDI), a burgeoning stream of literature on the effects of ownership structure on the internationalization of EE firms has emerged in recent years (e.g., Bhaumik, Driffield, & Pal, 2010; Cui & Jiang, 2012; Filatotchev, Strange, Piesse, & Lien, 2007; Ramasamy, Yeung, & Laforet, 2012; Wang, Hong, Kafouros, & Wright, 2012b). With the typical concentrated ownership structure of EE firms, this line of research has generally focused on the roles played by the powerful controlling owners, with few exemptions having examined the potential interests and roles exercised by other smaller, non-controlling shareholders on firms' internationalization. Ramaswamy, Li and Veliyath (2002) point out that although powerful owners have considerable influence over EE firms' strategic decisions, other shareholders are not passive players whose interests are excluded from consideration in firms' strategic development. Therefore, this study believes that a more balanced and comprehensive approach to examine the effect of internal governance structure on EE firms' OFDI propensity should simultaneously consider the roles played by both the controlling and the important non-controlling shareholders.

Apart from ownership structure, CEOs—who are directly responsible for strategic decision making and execution—can intervene with the ownership effects of shareholders, and can subsequently affect EE firms' internationalization decisions. For instance, in firms that are owned by family groups or individuals, a powerful CEO can aggravate 'principal–principal' (PP) conflicts (conflicts between the controlling shareholder and other shareholders) since the CEO is often appointed by, and representing the interests of, the controlling owner (see Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). In state-owned enterprises (SOEs), a powerful CEO may signal a potential 'principal–agent' (PA) problem (conflict between shareholders and managers) as a result of the characteristics of both ownership concentration and separation of ownership and control (Cuervo-Cazurra, 2006; Qian, 1996). Therefore, the interaction of ownership effects and CEO intervention, as reflected in the power of the CEO, should also be investigated as an integral element of a comprehensive governance approach to understanding the OFDI propensity of EE firms.

Theoretically, this study draws on the resource-based view to examine the ownership effects of both controlling and non-controlling shareholders, and is guided by the agency perspective to reveal the interaction of CEO power with ownership effects. The resource-based view regards the resources and capabilities essential for the internationalization strategy of the firm (Peng, 2001). Prior studies suggest that entering foreign markets through OFDI demands the highest level of resource commitment in the form of institutional support, financial capital, managerial

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expertise, technological competency, foreign market knowledge, and international business experience (see Brouthers, Brouthers, & Werner, 1996; Dunning, 1998; Meyer, Estrin, Bhaumik, & Peng, 2009).

While all shareholders possess certain resources, different shareholders can contribute different types of resources to firms. For instance, controlling shareholders such as the *state owner* can provide capital, subsidies, intermediary services, and policy-related benefits to firms in their internationalization development (Cui & Jiang, 2010; Morck, Yeung, & Zhao, 2008; Wang et al., 2012b). In contrast, non-controlling shareholders such as *domestic institutional investors* and *foreign corporations* have financial capability and superior expertise that allow EE firms to mitigate financial barriers and environmental uncertainties during their international expansion (Bhaumik et al., 2010; Filatotchev et al., 2007). Collectively, the resource aspect of these shareholders forms the ownership advantages that are of critical importance for firms' OFDI. While offering resources to firms, shareholders also experience various degrees of agency challenge. Drawing from the agency theory, this study argues that to safeguard self-interests, the resource role of the shareholders is bounded by the agency problems presented in the firm. In other words, the severity of potential PA and PP conflicts resulting from the power of a firm's CEO can affect the resource role and consequently the interest of the shareholders in the internationalization development of the firm. Therefore, by integrating the resource-based view and the agency perspective, this study shows the boundary condition of CEO power on the ownership effects of different types of shareholders.

China was chosen as the empirical context of this research. While leading all EEs in OFDI volume in recent years (MOFCOM, 2012), China has also nurtured a variety of publicly listed firms with different ownership identities, ownership structures, and associated agency conflicts. The significance of Chinese OFDI and the diversity of Chinese publicly listed firms that are active in OFDI offered an ideal empirical context for this study. Accordingly, 224 state-owned and privately owned Chinese firms were studied from 2005 to 2008 to examine the effects of: (1) the identity of the controlling owner (state vs. private), (2) the ownership of domestic institutional investors and foreign corporations, and (3) the effects of these ownerships interacting with CEO power on the OFDI propensity of firms.

The main contribution of this study is two-fold. First, by focusing on the resource-based view, this study highlights the different resources that can be offered by different types of shareholders. By advancing the internationalization research on EE firms—which has placed more emphasis on the influence of firms' controlling owner—this study shows that non-controlling shareholders, such as domestic institutional investors and foreign corporations, are able to provide crucial resources to support EE firms' internationalization. Second, CEOs are an inseparable part of PA and PP conflicts (Cuervo-Cazurra, 2006), and their power has complex governance implications for the resource role of different shareholders. By integrating the agency theory with the resource-based view, this study argues that shareholders' resource contribution effect is contingent upon the salience of the agency challenges they face, which is reflected in the power of the CEO that affects the governance efficacy of the shareholders. Jointly, this study provides new insights into the research on the OFDI of EE firms from a corporate governance perspective.

2. Research context

China is becoming an increasingly important source of the world's FDI (UNCTAD, 2010), largely due to the OFDI activities led by its SOEs (MOFCOM, 2012). Beginning in its Tenth Five-Year Plan in 2001, the Chinese government established a 'go abroad' strategy for its largest SOEs to serve two important objectives for the state owner. First, the government believes that engaging in OFDI is one of the most effective ways to gain foreign knowledge and hence help increase the productivity and competitiveness of its SOEs (Buckley et al., 2007; Deng, 2009). Second, having its firms engaged in the international market helps China increase its economic and political influence internationally (Morck et al., 2008; Wang, Hong, Kafouros, & Boateng, 2012a). Apart from SOEs, privately owned firms have also shown interest in international expansion in recent years. Given the increased competition in the domestic market, private firms need to maintain their competitive edge and subsequently become more active in OFDI (Liang, Lu, & Wang, 2012). As of 2011, SOEs contributed approximately 63 percent of Chinese OFDI in stock volume, while private firms are gaining momentum in internationalization (MOFCOM, 2012).

In conjunction with the country's economic development, the Chinese equity market has also undergone rapid changes and developments during the past decade. With continuous SOE reforms through corporatization and privatization, there have been an increased number of privately owned firms listed on the Chinese stock exchanges. Research has reported a steady shift of ownership patterns of Chinese publicly listed firms from the late 1990s, when nearly all listed firms were state-owned or controlled, to the end of 2006, when more than 30 percent of publicly listed firms were privately owned (Liu & Sun, 2005; Wu, Rui, & Wu, 2013). With the rise of private firms, ownership diversity has also increased. While the controlling owners are often government or private entities, the non-controlling shareholders—particularly *domestic institutional investors* (DIIs) and *foreign corporations* (FCs)—are becoming increasingly common and important in Chinese listed firms.

Like SOEs, DIIs have undergone significant changes, especially after China's entry into the World Trade Organization (Fratzscher, Kim, & del Valle, 2001; Yuan, Xiao, Milonas, & Zou, 2009). From credit decisions to performance measurements, financial institutions have gained more autonomy and are becoming more market-oriented (Bai, 2006; Tam & Yu, 2011). Many banks are now publicly listed; are encountering increased competition in the capital market, greater investor scrutiny, and greater market pressure; and are strongly emphasizing corporate governance within their own firms, as well as in the companies in which they invest (Luo & Yao, 2010; Yuan et al., 2009). By 2006, DIIs had invested in nearly two-thirds of the firms listed on the Shanghai and Shenzhen stock exchanges, with an average shareholding of six percent (Chen & Zhang, 2012; Liu, Bredin, Wang, & Yi, 2012).

In contrast, FCs became more common after 2005. In early years, investment in publicly listed firms was restrictive, and FCs typically gained ownership in Chinese firms through 'peaceful negotiation and agreement' (Tian, 2007, p. 266). However, since early 2005, the government has addressed the concentrated state ownership issue by launching share reform to allow non-tradable state shares to be circulated on the equity market (see CSRC, 2005a). This share reform not only attracted more domestic investors, but also officially made room for foreign strategic investors from strong institutional markets, as initiated by the Chinese Securities Regulatory Commission (CSRC).[2] This regime supports Chinese listed companies to attract FC investors who possess superior knowledge, management know-how, advanced technology, and improved governance quality, which are all

[2] According to the CSRC, a foreign strategic investor is a foreign entity that has an equity interest of at least 10 percent and three years duration in an existing publicly listed Chinese company that has completed the non-tradable share reform process (CSRC, 2005b, Article 5).