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The Impact of Rule of Law on Market Value Creation for Local Alliance Partners in BRIC Countries

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ABSTRACT

Market value creation for the local partner in an international strategic alliance (ISA) that takes place in a developed market economy is well documented; however, value creation for the local partner of an alliance in an emerging market (EM) has received less attention. We contend that rule of law is a key driver of value creation for the local partner because weak rule of law in an EM may suppress the foreign partner's willingness to share its valuable knowledge assets, which are a critical source of value for the EM partner. While rule of law directly affects value creation from the ISA for the EM partner, we argue that alliance type (R&D vs. non-R&D) and local partner type (state owned vs. non-state owned) are important moderators of this relationship. We find support for our arguments in an analysis of 902 ISAs in the BRIC (Brazil, Russia, India and China) countries over 1991–2005.

1. Introduction

Strategic alliances enable partner firms to pool their resources and capabilities to develop new technologies and technological capabilities that they cannot develop on their own due to direct costs and/or risks (e.g., Duysters and Hagedoorn, 1996; Hitt et al., 2000; Li et al., 2008; Tallman and Chacar, 2011; Tjemkes et al., 2012). In an efficient stock market, investors recognize the long-term strategic advantages associated with alliance formation and react positively to alliance announcements (i.e., positive abnormal stock market return) (Anand and Khanna, 2000; Das et al., 1998; Kogut, 1988).

Market value creation for international strategic alliances (ISAs) involving two firms from different countries has been well documented for developed market partners (Koh and Venkatraman, 1991; Merchant and Schendel, 2000); however, less is known about value creation for partners from emerging markets (EMs). Even in alliance studies of joint ventures involving a developed market partner and a local partner in an EM, where one might expect more attention to alliance location, typically the framework emphasizes value creation for the developed market partner (e.g., Cheng et al., 1998; Hu et al., 1992; Jandik and Kali, 2009; Meschi, 2004).

The few ISA studies that have examined value creation from the host country perspective have demonstrated the complexity of value creation for the typically weaker EM partner (e.g., Chang and Huang, 2002; Chen et al., 2000; Huang and Chan, 2005; Miller et al., 2008).[4]

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[4] In this study, we use “emerging market partner”, “emerging market firm” and “local partner” interchangeably.

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Prior studies have shown that an ISA can benefit an EM partner through the acquisition of technical knowledge, managerial skills and marketing practices from its foreign partner (Fahy et al., 2000; Hitt et al., 2000; Jiang et al., 2011; Lamin and Dunlap, 2011; Lyles and Salk, 1996). While these benefits are appealing to the EM partner, the potential benefits, particularly knowledge benefits, may or may not materialize into value creation due to the idiosyncrasies of the host country location. Even with government support (for example, the Chinese government has been encouraging technology inflows through ISAs), many ISAs that involve local partners in EMs fail. There are multiple reasons for such failures; however, in this study, we focus on one: the challenge of materializing knowledge benefits for the EM partner. That is, although the potential knowledge benefits are appealing, the foreign partner may be unwilling to share its valuable knowledge assets, which in turn prevents the creation of market value for the EM partner and may lead to alliance failure.

Knowledge transfer is "laborious, time consuming and difficult…" (Szulanski, 2000, p. 9) and can be very "sticky"; successful transfer depends on the motivations of both sender and recipient (Szulanski, 1996). Rule of law can affect the sender's willingness to share its valuable knowledge assets with an alliance partner, especially when the ISA takes place in an emerging market because such markets typically suffer from relatively weak rule of law, increasing the potential for knowledge dissipation (Hoskisson et al., 2000; La Porta et al., 1997). The sender (i.e., foreign partner) may not be willing to share knowledge in order to protect its own competitiveness in local and international markets (Kale et al., 2000; Li et al., 2008; Oxley and Sampson, 2004).

Thus, our first research question is: *how does the level of rule of law in the emerging market affect market value creation for the local (i.e. emerging market) partner in an international strategic alliance?* In addition to a focus on institutions (i.e., rule of law), our theoretical arguments draw insights from the knowledge-based view (Grant, 1996) and transaction cost economics approach (Williamson, 1991). Specifically, we explain how rule of law affects the foreign partner's propensity to share/transfer knowledge with its emerging market partner, thereby affecting market value creation for the emerging market partner.

Our second research question is: *how do alliance type (R&D vs. non-R&D) and local partner type (state owned vs. non-state owned) moderate the relationship between rule of law and market value creation for the local partner?* First, different types of alliances involve different levels of knowledge sharing and transfer. Typically, R&D alliances require a higher degree of knowledge disclosure and sharing, and more intense interaction, between the partners (Li et al., 2008). Partners in an international R&D alliance are therefore likely to be more sensitive to the impact of weak rule of law; thus, the market value creation effects for EM partners may be more restricted.

Second, while most studies have focused on governance structure of the ISA (e.g., Child and Yan, 2003; Choi and Beamish, 2004; Dhanaraj and Beamish, 2004; Geringer and Hebert, 1989), governance structures of the partner firms have been largely ignored despite evidence that governance affects decision making behavior (Filatotchev et al., 2007).[5] For EM partners, an important and typical aspect of their governance structure is state ownership; that is, the home government holds an equity stake in the EM firm (Miller et al., 2008). Scholars have highlighted the advantages and disadvantages of state ownership (e.g., Miller et al., 2008; Steensma and Lyles, 2000).[6] However, the moderating effect of state ownership of a local partner to an ISA on the relationship between rule of law and value creation for that partner deserves more attention. We explain how state ownership of the local EM partner affects foreign partners' motivation to share knowledge and moderates the relationship between rule of law and value creation.

We test our arguments on 902 international strategic alliances in 1991–2005 that involve a local partner in one of the four large emerging markets: Brazil, Russia, India and China (i.e., the BRIC countries). We employ event-study methodology to examine the market reactions associated with ISA announcements for the emerging market partner and generalized-least-squares (GLS) regressions to examine the predictors of market value creation.

Our research contributes to the international strategy literature by developing a framework to explain the impact of rule of law on market value creation for the EM (local) partner of an ISA. We show that market value creation depends on rule of law in the host country; that is, we posit that ISAs do not automatically create value for local partners. We further show that the relationship between rule of law and market value creation for an EM partner is moderated by alliance type (R&D vs. non-R&D) and state ownership of the EM partner. Extending Oxley's (1997) work, our study detects the moderating role of alliance type, suggesting that (1) appropriability hazards are heightened in emerging markets with weak rule of law, particularly for international R&D alliances, and (2) effectiveness of governance varies between U.S. firms and EM firms whose involvement of state ownership is typically of a higher degree. Our finding that value creation for the local EM partner is subject to the joint impact of state ownership and the level of rule of law also extends prior research by Miller et al. (2008). Lastly, we contribute broadly to the ISA literature by examining how a foreign partner may alter its motivation to share knowledge with an EM partner, thus extending Szulanski (1996); Kale et al. (2000), and Inkpen and Beamish (1997).

2. Theory development

2.1. Rule of law

Despite strong economic growth, the development of regulatory institutions has lagged in many emerging markets (Meyer, 2001), resulting in ambiguity regarding the rules of exchange (Newman, 2000; Roy and Oliver, 2009; Williamson, 1991). Poorly developed institutions in EMs provide a weak base for nurturing the financial, organizational and technological resources that local firms need to

[5] Strategy scholars have also devoted considerable attention to corporate governance — in particular ownership structure (see for example, Hoskisson et al., 2002; Kochhar and David, 1996; Tihanyi et al., 2003).

[6] State ownership is widely prevalent in both developed and emerging markets (Thomsen and Pedersen, 2000; UNCTAD, 2011). For instance, Thomsen and Pedersen (2000) noted the prevalence of state-ownership in developed markets such as Austria (34%), France (36%), Italy (38%), and Norway (39%) among others.