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Information asymmetry and international strategic alliances

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ABSTRACT

This paper examines how information asymmetry affects cross-border strategic alliance formation by US firms over the period 2000–2008. We construct a measure, information costs, based on both geographical distance and the proportion of worldwide GDP the partner's home country represents. Consistent with our expectations, we find an inverse association between information costs and cross-border strategic alliances. When considering the proportion of alliances formed with publicly quoted overseas partners, we find this is unaffected by the level of information costs but rather the level of stock market development, tax rate and general economic conditions. Information costs are, however, significantly negatively related to alliances with overseas private organizations. Our results offer clear support for the on-going importance of information asymmetry in corporate decision making.

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1. Introduction

Strategic alliances are contractual agreements that bring together two or more independent firms to focus on a mutually beneficial activity. According to the OECD (2001), strategic alliance activity in the US grew from 830 transactions in 1989 to 4529 in 1999 (a multiple of 5.45) whereas M&A transactions grew from 2572 in 1990 to 7242 in 1999 (a multiple of 2.8). Furthermore, US strategic alliance activity averages two overseas transactions for every domestic one. The relevance of strategic alliances in organizing international economic activity can, therefore, not be ignored. Although several prior studies provide evidence on the motivation behind cross-border alliances (Desai et al., 2004; Gomes-Casseres et al., 2006; Chan et al., 1997; Qiu, 2010), none address the fundamental issue of why firms choose to form alliances with organizations in one particular country as opposed to any other location in the rest of the world. We address this issue by evaluating the role of information asymmetry in the choice of a partner location in cross-border strategic alliance decisions. Further, as strategic alliances are informal arrangements where opportunistic behavior cannot be ruled out (Chan et al., 1997; Kranton, 1996), we consider information availability to be an important consideration in such decisions. Specifically, we draw on the information asymmetry theory and provide evidence on how information cost influences cross-border strategic alliance formation and the conditions under which different ownership structures (public, private and government) are selected as partners in cross-border strategic alliances.

Information asymmetry is difficult to observe and many prior studies have used geographical distance as a proxy (Kalemli-Ozcan et al., 2003; Buch, 2005; Portes and Rey, 2005). In this paper, we argue that differing levels of information asymmetry, and the associated information gathering costs, do not depend solely on geographical distance but also on the level of economic activity taking place in that location. Strong economic activity draws a nation closer to the rest of the world, notwithstanding the geographical distance. Our primary explanatory variable, information costs, is a modified distance measure based on the geographical distance between the capital city of the partner's home country and Washington, DC, and the proportion of worldwide GDP that the partner's home country represents. Our metric is similar to those used by Kalemli-Ozcan et al. (2003), Alfaro et al. (2008) and Huang (2011) and reflects the fact that whilst geographical distance can introduce heterogeneity into information gathering and, thus, deter the selection of international alliance partners, this is mitigated when the partner firm is located in a country with strong economic activity. Thus, we contend that low information cost can result in reduced uncertainty which, in turn, encourages cross-border strategic alliances.

Using a large sample of non-equity cross-border strategic alliances involving US companies during the period January 2000 to December 2008, we evaluate the association between information costs and international alliances. Whilst existing studies such

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as Rossi and Volpin (2004) and Erel et al. (2011) consider acquisition bidders and targets from several countries, we focus on the strategic alliance decision made by firms in a single developed nation. The decision to enter into international strategic alliances and the factors driving that choice are far clearer when viewed from a single standpoint that is common to all sample firms. Therefore, our decision to consider US firms alone results in a clear and unambiguous picture of international strategic alliance decisions. The choice of the US is motivated by its prominence in worldwide strategic alliance formations. For example, in the 1990s, US firms were involved in 60% of total global strategic alliance activity and 53% of all cross-border activity (OECD, 2001) which far exceeds any other nation.

In a gravity model framework we provide overwhelming evidence that international strategic alliances are significantly negatively associated with information costs. Consistent with our expectations, low information costs reduce uncertainty in cross-border activity and encourage international strategic alliances. These results are robust to controlling for the desirability of the location with respect to FDI and the presence of control variables including GDP growth, stock market development, inflation, taxation, ownership restrictions, and measures of cultural distance in the alliance partner's nation.

In addition to information costs, firms organizing international alliances might be unwilling to place a project in a risky economy. Prior studies such as Alfaro et al. (2008) and Owen and Yawson (2010) overwhelming agree that more FDI flows into low risk than high risk economies. Forming an alliance with a partner from a low risk economy indirectly implies an alliance project in an economy about which it is relatively easy to gather information.[1] Our country risk measures consist of sovereign risk (Cosset and Roy, 1991) and institutional quality (Alfaro et al., 2008). Whilst the impacts of country risks are examined in their own right, they also serve as robustness checks on the information asymmetry hypothesis. We find strong evidence that cross-border strategic alliances are preferred in low risk economies.

We further examine whether the choice of the local partner's ownership structure is influenced by information costs and country risk. We consider three possible partner ownership types: publicly listed firms, private firms and government organizations. We argue that the ownership type of the local partner may impact on the desirability of the transaction and could also be related to the ease with which the transaction can be established and monitored. The nature of the local partner's ownership type may also mitigate the problems of heterogeneous information. For example, a public firm producing annual reports and mandatory announcements is relatively easy to gather information about, which can be used to determine whether it is a suitable alliance partner. Alternatively, in areas of high risk, government bodies should be relatively safe alliance partners as few governments would wish to be seen to default on an alliance agreement with an overseas firm. Thus, entering into an alliance with either a public firm or a government body should be safer than entering into alliance with a privately owned company. Broadly, we find no evidence that information costs affect the proportion of alliances formed with public partners, although these are clearly preferred in well developed economies. We do find, however, that private firms are significantly negatively associated with information costs and that both governmental and private partners are preferred in location with low stock market development, high inflation and low taxes, characteristics akin to developing economies. Our findings here suggest the presence of a substitution effect. In a developing economy, risk is a major concern and government bodies are the lowest risk option. Conversely, in a strong and developed economy, public firms are preferable alliance partners because they have fewer restrictions on their behavior.

This paper makes an important contribution to the existing literature. Our focus is on international strategic alliances involving US firms. We examine the choice of partner firm and then extend our analysis to the ownership structure of the alliance partner. We find overwhelming evidence that information costs exert a considerable negative effect on international strategic alliance activity which is consistent with studies examining international equity flows such as Buch and DeLong (2004), Portes and Rey (2005) and Aggarwal et al. (2012). This paper is also consistent with the literature that demonstrates that nearby locations are preferred in corporate investment decisions (Buch, 2005; Weitzel and Berns, 2006; Khanna et al., 2006; Kang and Kim, 2008; Uysal et al., 2008; Erel et al., 2011). It must be noted that whilst many prior studies use geographical distance alone as a measure of heterogeneous information, we construct a measure, which takes into consideration both geographical distance, and the economic activity in the overseas partner firm's location. Our measure is, therefore, truly comprehensive and better captures the issues arising in the formation of cross-border strategic alliances. We also add to the growing literature on the cost of gathering information in international investment decisions with information asymmetry as the underlying motivation.

Second we contribute to the literature that deals with country risk in cross-border investments. For example, Alfaro et al. (2008) show that low institutional quality is responsible for low FDI flowing into developing countries whilst Moeller and Schlingemann (2005) show poor gains to firms making acquisitions in countries with lower levels of investor protection. Our paper is consistent with these prior studies as it provides convincing evidence that low country risks are desirable for firms involved in international strategic alliances.

The rest of the study is organized as follows. The next section presents the variable selection and the underlying theory followed by the sample construction and descriptive statistics. The final two sections present the empirical results followed by our conclusions.

2. Theory and variable selection

2.1. Information costs

Information asymmetry plays an important role in international investment decisions. The information required when evaluating a potential foreign investment includes knowledge of accounting practices, political events, corporate culture, investor protection and institutional quality. It is not always easy to have access to this type of knowledge due to the information asymmetry that exists between domestic and foreign investors. Unlike prior studies, such as Portes and Rey (2005) and Kang and Kim (2008), that focus on the geographic distance between the domestic and foreign locations to identify proximate investment opportunities, we use a more comprehensive measure of information costs that takes into account both the geographic distance and economic weight of every country. Building on the work of Kalemli-Ozcan et al. (2003), Alfaro et al. (2008) and Huang (2011) we construct a proxy for information costs (IC) which is defined in the following equation:

$$\mathrm{IC} = \frac{1}{T}\sum_{t=1}^{T}\left(1 - \frac{gdp_{j,t-1}}{Tgdp_{t-1}}\right)d_{i,j} \quad (1)$$

[1] This is true only when the partner firm and the investment are in the same location, which is overwhelmingly the case in our data set. Nevertheless, we investigate the alternative situation as a robustness check but our primary results are concerned with the location of the partner firm.

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