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The termination of international joint ventures: Closure and acquisition by domestic and foreign partners

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ABSTRACT

We study different modes of terminating international joint ventures, namely closure and acquisition, and find that different forces govern the two termination modes. Decisions regarding asset specificity and the size of the venture affect the likelihood of closure, but not that of acquisition. In contrast, full acquisition by one of the partners is related to history of the venture before the joint venture was formed, to decisions made at the time of the creation with respect to equity split between partners, and to subsequent changes of these initial decisions. Joint ventures that were created *de novo* are more likely to be closed down than those that were previously fully owned by one of the parties. The proportion of equity initially held by each partner and subsequent increases in this proportion increase the likelihood of the venture being fully acquired by that partner.

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1. Introduction

Many studies have shown that international joint ventures (IJVs) confront high chances of termination (see Kogut, 1988 for a seminal paper and Nemeth & Nippa, 2013 for a recent survey). Termination can occur in different ways: by dissolving the venture or by having one of the partners fully acquire the venture, and these different modes of dissolution may be prompted by different causes. For example, Kogut (1991) found that unexpected industry growth increases the likelihood of acquisition by one of the partners, but unexpected fall in industry shipments does not increase likelihood of dissolution. Hennart, Kim, and Zeng (1998) also found that the determinants of termination of JVs explain the selling of JVs, but not their liquidation, while Chang and Singh (1999) found that older firms shut down businesses, but younger firms sell them. Furthermore, they found that businesses that have entered by acquisition are more likely to exit by sell-off, a finding that was also reached by Mata and Portugal (2000) in the context of foreign firms. Even if the possibility of acquisition by different partners is generally acknowledged, (e.g. Meschi & Riccio, 2008), studies looking at dissolution of joint-ventures by acquisition typically focus on acquisition by the foreign partners (e.g. Puck, Holtbrügge, & Mohr 2009), and the study by Hennart, Roehl, and Zietlow (1999) remains as one of the few that have examined the issue of which partners acquire and which divest the joint venture.

In this paper we analyze the process of joint venture termination and consider the alternatives by which termination can occur. We distinguish the factors that lead to closure from those that lead to acquisition by the domestic and foreign partners. Most of the studies mentioned above discuss a single set of determinants of joint venture termination and report evidence that while one type of termination is affected by the hypothesized forces, the other is not. In contrast, we develop explicit hypotheses for the factors that lead to the different types of termination. We explicitly distinguish acquisition by foreign and domestic partners and are able to identify forces that have opposite effects upon each type of termination.

Specifically, we are able to uncover the impact that ownership split at the formation of the joint venture and at different points of its evolution exerts upon the termination of joint ventures by acquisition and upon which partners end up fully acquiring the joint venture. First, ownership before the formation of the joint venture matters; those joint ventures being created by a partial acquisition of a previously fully owned business have a greater likelihood of terminating by being bought back by the former owner. Second, ownership arrangements at the time of the

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formation of the joint venture also matter for the likelihood of full acquisition and for which partner ends up becoming the sole owner of the venture. We find that disproportionate equity splits not only create instability, but also tip the acquisition process toward the majority owner. This is further reinforced by renegotiations over equity split that occur after the formation of the joint venture. Joint ventures in which one of the partners increases its equity share are more likely to be later fully acquired by that partner.

Closure, in contrast, is related to the antecedents of the joint venture, to joint venture size and to intangible investments made at the inception of the joint venture. Joint ventures that are created from scratch, those that are small, and those that do not rely much on intangible assets are more likely to be shut down than those that are created from a partial acquisition of a previously existing firm, those that are large, and those that rely more on intangibles.

Our analysis carefully controls for the evolution of joint venture termination over time. Even though some studies have controlled for age in their analysis, to our knowledge, the way the likelihood of termination of IJVs evolves over time has not been thoroughly examined, except for the studies of Park and Russo (1996) and Park and Ungston (1997). The fact that we distinguish between different termination modes may exacerbate a problem that is common to all the studies relying on age dependence, that is, the relationship between the probability of an event and age: the evidence that the probability of terminating a joint venture decreases over time can be spurious and arise because the sample includes a proportion of firms that do not confront the risk of termination via that particular termination mode. We account for this possibility and, indeed, find that there is a non-negligible fraction of joint ventures that may never terminate by any of the three modes considered. We find that termination by domestic acquisition is roughly constant over time. In contrast, the chances of termination by acquisition by the foreign partner increases over time, which fits well the view of joint ventures as options to expand (Kogut, 1991). Finally, the chances of termination by closure increase after a few first years, which is consistent with the view of multinationals as footloose organizations (Gorg & Strobl, 2003).

2. Modes and determinants of joint venture termination

International joint ventures can be terminated by shutting down their facilities or by continuing operations under the full ownership of either the domestic or foreign partner. These three different outcomes are likely to be governed by different forces and the attributes of the joint ventures are likely to exert disparate impacts upon the probabilities of terminating in different ways.

2.1. Ownership before the formation of the joint venture

While most of the literature implicitly regards joint ventures as new entities created by the partnering firms, the truth is that joint ventures can be created by partial acquisition of equity in an ongoing firm (Chen & Hennart, 2004; Chen, 2008). A common reason for making a partial acquisition is to mitigate the asymmetric information problem inherent to full-acquisitions (Chen & Hennart, 2004; Reuer & Ragozzino, 2008). By keeping the former owner with an interest in the firm following the partial acquisition, his incentives to mis-represent the true state of the firm and to engage in non-observable value reducing activities is diminished.

To the extent that partial acquisitions are a way of overcoming problems of asymmetric information associated with full-acquisitions, it is reasonable to expect that the successful development of these acquisitions eventually terminates with the joining party fully acquiring the ownership (Steensma, Barden, Dhanaraj, Lyles, & Tihanyi, 2007; Puck et al., 2009). Indeed, Zaheer, Hernandez, and Banerjee (2010) report that those international acquisitions that were preceded by a form of alliance between the acquired and the acquiring companies show better returns than those that were not preceded by such alliances. When uncertainty is high the asymmetry of information is exacerbated and sequential investment and divestment become more likely (Reuer & Shen, 2004; Folta & Miller, 2002).

However, not all acquisition joint ventures will be successes and develop according to plan. While there is little knowledge about what proportion of joint ventures terminate according to the plan, one of the few studies on this matter (Makino, Chan, Isobe, & Beamish, 2007) provides evidence that unanticipated termination by far dominates with only 10% of the joint ventures being terminated according to what had been planned. Steensma et al. (2007) show that joint ventures in which there is conflict between partners are likely to become fully owned, especially if decision power is markedly unbalanced between partners.

One way of terminating a joint venture that came about through the partial acquisition of an ongoing firm is a full reacquisition by its former full owner (Chi & Seth, 2009). When partners of such a joint venture conclude that the match between them is not good, a buyback is an easy way to end the venture, as it amounts to a return to the previous position. It has been argued that this would be a natural route for terminating joint ventures partially acquired by a foreign party as this party would be insufficiently committed to the venture (Hennart et al., 1998; Steensma et al., 2007). This argument extends naturally to any acquiring partner and thus, firms that were previously wholly domestic are more likely to return to their wholly domestic status, while those that were previously fully owned by foreigners are more likely to become wholly owned by foreigners again.

Hypothesis 1. Joint ventures that were created from an already existing firm are more likely to be bought back by the original owner than to be acquired by the joining party.

2.2. Contractual arrangements—Initial equity share

Conditions that are relevant for the longevity of joint ventures include the initial contractual arrangements established between partners. Different partners make different contributions to the joint venture and these contributions are reflected in the agreements under which JVs are formed (Blodgett, 1991). Although control of a joint venture cannot be taken to be identical to the distribution of equity among partners (Zhang & Li, 2001), the initial distribution of equity reflects the distribution of bargaining power among partners and control over the firm (Yan & Gray, 1994; Mjoen & Tallman, 1997).

For the joint venture to be stable, the arrangements must be such that all parties are satisfied with them. Uneven distributions of equity may have costs for the stability of the joint venture, because the smaller the share that one partner has in the joint venture, the greater the likelihood that it will behave opportunistically (Inkpen & Currall, 2004), and free-ride on the other partner.

Joint ventures with uneven equity splits have been found to be more prone to termination (Blodgett, 1992), which is likely to occur due to the initiative of the dominant partner to avoid this opportunistic exploitation. Furthermore, to the extent that large equity shares reflect a partner's high contribution to the joint venture, a large share in the venture is an indication that the firm may more easily survive without the other party than vice-versa. Therefore, if one partner holds a disproportionately high equity share in the firm, the chances are that it will eventually acquire full control of the firm.

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