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Corporate governance reforms around the world and cross-border acquisitions

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ABSTRACT

This paper provides comprehensive, detailed documentation of major corporate governance reforms (CGRs) undertaken by 26 advanced and emerging economies. We investigate whether these reforms have altered investor protection (IP) and impacted corporate investments. Specifically, we estimate the CGRs' impacts on foreign acquirers' tendency to pick better performing firms in emerging markets. We argue the cherry picking is partly due to emerging countries' weaker IP than acquirer countries', predicting a positive relation between the degree of cherry picking and the gap in the strength of IP. Thus, if the CGRs strengthen IP, the gap will decrease (increase) following a CGR in a target's (acquirer's) country, moderating (intensifying) the cherry picking tendency. This is what we find when we estimate difference-in-differences in cherry picking before and after a CGR. These results not only demonstrate the important impacts the CGRs had, but also imply the IP gap between capital exporting and importing countries distorts firm-level allocation of foreign capital inflows and reduces the benefits of globalization.

1. Introduction

Since the late 1990s a number of developed and emerging countries have undertaken corporate governance reforms (CGRs), defined here as deliberate interventions in a country's corporate governance tradition by the state, security and exchange commission, or stock exchanges. This paper provides a comprehensive documentation of 26 CGRs undertaken worldwide over the period 1991–2007 using careful, painstakingly meticulous procedures. It details events leading up to each CGR, relevant dates, the scope of the reform, regulation contents, the level of enforcement, outcome and criticism, and other regulatory changes following the CGR. We make this database available on the Journal's website, hoping to encourage and provide useful resources to study comparative corporate governance. A brief summary of the database is provided in Appendix A.

The precise nature and strength of the CGRs vary across countries. However, they all share the common objective of strengthening investor protection (IP). Have the CGRs achieved their objective? If so, do they affect corporate investment decisions? To investigate these issues, we examine whether CGRs trigger a change in foreign acquirers' tendency to target better performing firms when they make acquisitions in emerging markets. We examine changes in the cherry picking tendency because we conjecture that one of the possible causes is the gap in the strength of IP between the target and acquirer countries, predicting that when the IP gap decreases, cherry picking will moderate, but it will intensify when the gap increases. If CGRs strengthen IP, a CGR undertaken by a target country or an acquirer country will change the IP gap.

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In the foreign direct investment (FDI) literature, cherry picking in emerging markets by acquirers from developed economies is a well-documented phenomenon. Aitken and Harrison (1999) identify a positive relation between the likelihood of foreign equity acquisition of Venezuelan firms and the local firms' pre-acquisition performance.[1] Subsequent studies document similar cherry picking tendencies in a number of Eastern European countries (e.g., Djankov and Hoekman, 2000; Javorcik, 2004; Konings, 2001; Sabirianova et al., 2005). The cherry picking phenomenon, however, seems to be unique to emerging markets with weak IP. Bloom et al. (2012), for example, find no evidence foreign acquirers cherry pick targets in the U.K., a country with strong IP.

Foreign acquirers may cherry pick because better performing firms tend to be better managed and allow for greater synergies. The difficulty of acquiring relevant local information about potential targets may also attract foreign acquirers to better performing targets.[2] These explanations, though quite plausible, ignore the cost of acquisitions. Better performing firms are valued higher, making them more expensive to acquire.

One factor affecting costs of acquisition is the strength of IP in the target country. Consider an acquirer from a strong IP country seeking a target in an emerging market with weak IP. Barclay and Holderness (1989) and Dyck and Zingales (2004) argue the reservation price of controlling equity stakes in a target includes control premiums priced at the value of private benefits consumed by controlling stockholders.[3] Because the acquirer's home country's stronger IP imposes stricter constraints on diversion for private benefits, the acquirer values the control premium less than the target's controlling shareholder.

Doidge et al. (2004) and Durnev and Kim (2005) show that when firms have more profitable investment opportunities, their controlling shareholders consume fewer private benefits because diversion for private benefits could lead to foregoing profitable investments.[4] Fewer private benefits lower the control premium demanded by the controlling shareholder, making targets with greater profitable investment opportunities less costly to acquire.[5]

According to this cost-based explanation, one cause of cherry picking is the gap in the strength of IP between the target and acquirer countries. If CGRs strengthen IP, CGRs undertaken by emerging economies will reduce the IP gap, moderating the cherry picking tendency, whereas CGRs undertaken by acquirer countries with strong IP will enlarge the IP gap, intensifying cherry picking.

To test this prediction, we examine cross-border acquisitions in 20 weak-IP target countries by acquirers from 13 strong-IP developed economies. Of the 33 sample acquirer and target countries, 20 countries have enacted major CGRs over 1998–2006.[6] If these CGRs strengthen IP, they will generate within-country variation in IP. As Table 1 shows, CGRs occurred in a staggered fashion, allowing for difference-in-differences tests to compare the type of firms targeted before and after a CGR between the treatment and control groups.

Estimation results reveal a significant increase in cherry picking following CGRs by strong-IP acquirer countries. Acquirers target firms about 15 percentiles higher in the pre-acquisition performance ranking among all firms in a country–industry–year combination after their home countries undertake CGRs. CGRs enacted by target countries, in contrast, weaken the cherry picking tendency. Foreign acquirers target firms about 13 percentiles lower in the pre-acquisition performance ranking after target countries undertake CGRs.

Confounding effects around CGR years are a major concern for studies of this kind. We follow Bertrand and Mullainathan (2003) and Branstetter et al. (2006) and include a set of dummies corresponding to the periods before and after CGRs. The re-estimation shows our results are not driven by confounding effects. Our results also are robust to changes over time in target countries' openness toward foreign capital. We conduct a battery of robustness tests using alternative specifications and sample constructions. None alters our conclusion.

Cherry picking distorts firm-level allocation of foreign capital inflows with adverse effects. Poorly performing firms, which tend be capital constrained, are denied access to foreign capital. Poorly performing firms are also denied the managerial know-how that accompanies acquisitions by firms from advanced economies. Cherry picking also reduces the spread of good corporate governance through foreign acquisitions in emerging markets. If the foreign acquirers target only better performing firms, the improved governance system is unlikely to reach underperforming firms, which may be in greater need of better governance. Improving legal investor protection in emerging economies will reduce these adverse effects by inducing foreign

[1] The cherry picking phenomenon became an important issue in the FDI literature after Aitken and Harrison (1999) identified a selection bias in FDI; namely, targets of FDI were already performing better before they were acquired. This selection bias implies much of the previously estimated positive impacts of foreign ownership can be attributed to cherry picking. Consequently, subsequent studies estimating the impact of foreign ownership on firm performance control for cherry picking in emerging countries.

[2] See Erel et al. (2012) for an in-depth study on factors affecting the likelihood of a cross-border acquisition.

[3] Diversion for private benefits takes many different forms, from excessive perks and tunneling, to outright stealing of tangible and intangible corporate resources.

[4] Durnev and Kim (2005) show that firms with more profitable investment opportunities divert less for private benefits because more diversion leads to more rejection of positive NPV projects, reducing the value of controlling shareholders' cash flow rights. In a similar vein, Doidge et al. (2004) and Doidge et al. (2009), show firms in weak-IP countries with better investment opportunities are more likely to bond themselves to fewer private benefits by cross-listing in a strong-IP country (the U.S. and the U.K.).

[5] This will not hold if an acquirer can buy 100% of a target's outstanding shares while perfectly price-discriminating between the controlling shareholder and other shareholders. Such perfect price discrimination is not possible, because at the announcement of an acquisition bid by a foreign firm from a strong-IP country, the target's share price will rise in anticipation of fewer private benefits and greater cash flows under the new ownership. This will prevent minority shareholders from selling shares at a lower price, making perfect price discrimination impossible.

[6] Five countries with CGRs do not enter the sample because of insufficient data on cross-border acquisitions and we do not count Brazil's CGR as a CGR because it is too limited in scope and is considered ineffective by legal scholars.