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Alliances and corporate governance ☆

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ABSTRACT

We study the link between a firm's quality of governance and its alliance activity. We consider alliances as a commitment technology that helps a company' Chief Executive Officer overcome agency problems that relate to the inability to ex ante motivate division managers. We show that well-governed firms are more likely to avail themselves of this technology to anticipate ex post commitment problems and resolve them. The role of governance is particularly important when the commitment problems are more acute, such as for significantly risky/long-horizon projects ("longshots") or firms more prone to inefficient internal redistribution of resources (conglomerates), as well as in the absence of alternative disciplining devices (e.g., low product market competition). Governance also mitigates agency issues between alliance partners; dominant alliance partners agree to a more equal split of power with junior partners that are better governed. An "experiment" that induces cross-sectional variation in the cost of the alliance commitment technology provides evidence of a causal link between governance and alliances.

1. Introduction

The question of how firms determine their boundaries remains central in the economics of organization. Oftentimes, rather than execute a project internally, a firm acquires it from another firm or cooperates on a project by forming an alliance.[1] Why would some projects be conducted within a firm's boundaries while others involve several different firms?

To answer this question we must recognize that projects are not allocated exogenously across firms. In fact, the activities conducted between firms rather than within firms are endogenous outcomes that reflect how firms construct their boundaries. We focus on one factor affecting boundaries: firm governance. In particular, we ask whether well-governed firms, i.e., firms where managerial incentives and corporate actions are aligned well, construct their boundaries in a different way from poorly governed firms.

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We address this question by looking at alliances. Because engaging in alliances is one way to manipulate firm boundaries, and well-governed companies are supposed to do this in an optimal way, we would expect variation in governance to be helpful in explaining alliance activity. We therefore investigate whether there is a link between the alliance activity of a firm and the quality of its corporate governance.

We adopt the view that alliances represent a form of "commitment technology" that can be utilized to address agency problems (Robinson, 2008). Multidivisional firms face problems in motivating division managers. Value-maximizing headquarters (HQ) would like to commit ex ante to provide ex post payments to division managers even if a project fails; however, this is not dynamically consistent. Once the profitability of a project is established, HQ has incentives to move resources ex post from low- to high-productivity projects, i.e., to engage in "winner-picking." Managers, aware that HQ will reallocate resources ex post, whatever their efforts, will shirk (Stein, 1997; Brusco and Panunzi, 2005; Robinson, 2008).

Engagement in alliances is a commitment technology available to HQ that addresses this problem. In projects undertaken within an alliance, HQ will be less able to reallocate resources ex post, engendering stronger managerial incentives ex ante. When the gains from reallocation of funds dominate the negative effects of reduced managerial incentives, the company will prefer the internal capital market solution. Conversely, when the costs of reduced managerial effort outweigh the gains from winner-picking, alliances are the optimal solutions to the commitment problem (e.g., Brusco and Panunzi, 2005).[2]

In the case of good governance, a value-maximizing CEO chooses the best strategy to execute a project. Sometimes this will be through alliance, sometimes not. The case is different, however, for bad-governance firms. For these firms, the constraints that alliances impose upon the CEO in terms of the ability to transfer resources freely will always be perceived as too binding. Therefore, even if such a commitment may be optimal for the firm, the CEO of a poorly governed firm will not engage in an alliance. He would either execute a project internally, but with little motivation for personnel and hence reduced chances of success, or would not undertake the project at all.

In other words, an alliance always involves a commitment that ties the hands of the CEO. A good-governance company will accept this commitment when it is the best strategy, while a bad-governance company will never do so. There should thus be a positive correlation between alliance creation and the quality of governance of a firm.

The role of governance should be more important when ex ante agency problems are more severe, i.e., when it is more difficult for the CEO to credibly commit long term. In these cases, the agency costs of managerial shirking are so high that alliances become the undisputed solution. Therefore, good-governance firms are even more likely to engage in alliances, while bad-governance firms will avoid them. Agency problems can be more acute either because some projects are particularly risky/long-horizon ("longshot" projects) or firms are more prone to inefficient internal redistribution of resources (e.g., conglomerate firms). We would also expect governance to play a larger role when firms are less subject to alternative (market) disciplining devices (e.g., firms operating in low-competition industries).

As the cases in which alliances are the optimal solutions expand, for example, because of a reduction in the opportunity costs of entering an alliance, the incentives to form an alliance should grow stronger. But again, this will apply only to good-governance firms; bad-governance firms will again avoid them. We thus expect to see a stronger link between governance and alliance creation when the opportunity costs of engaging in alliances decrease.

Finally, if alliances are initiated by good-governance firms, we expect these firms to be willing to share power in the alliance only with other equally good-governance firms. That is, a firm should be more willing to form an alliance with another firm that is more similar to it in size—and hence agree to a more equal division of power—if the governance of the potential partner is better. We therefore expect a positive relation between the relative quality of alliance members and their relative size.

We test these hypotheses by looking at alliances in the U.S. over 1990–2007. We start with the stylized fact that alliances create value (McConnell and Nantell, 1985; Chan, Kensinger, Keown, and Martin, 1997; Robinson, 2008). We then ask whether this value creation is related to the quality of firm governance. We show that firms with higher quality of governance are better able to reap the benefits of alliances. Firms with better governance (both internal and external) enter more alliances. Firms with a one standard deviation better internal governance (*G*-index) engage in three times more alliances per year than the sample mean. They also engage in alliances even more if good internal governance is coupled with good external governance, i.e., there is larger institutional ownership.

Moreover, alliances conducted by better-governed firms create more value. A one standard deviation better governance is related to a 73 basis points (bp) higher alliance announcement abnormal return (or 22.70% higher return relative to the sample mean of alliance announcements). Both internal and external governance contribute to enhance the return.

A portfolio strategy of buying good-governance firms and selling bad-governance ones (conditional on firms undertaking alliances) delivers an abnormal return of 0.57% (0.70%) per month, or 6.88% (8.71%) per year in the case of equal- (value-) weighted portfolios. Most of this abnormal positive performance comes from the outperformance of the good-governance firms rather than the weak performance of the poor-governance ones. All of these results are consistent with alliances being a good avenue of potential value creation, mostly exploited by good-governance firms.

[2] Alliance is not the only mechanism to overcome a commitment problem by HQ. A firm can use other alternatives, e.g., tracking stock; but, as long as these prove to be either more costly or less efficient or both, alliances may be a preferred solution.