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Corporate governance and state expropriation risk☆

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ABSTRACT

Recent studies show that the transfer of corporate governance structure across borders has significant valuation consequences. It is equally important to consider the valuation effect of state expropriation risk as well as its interaction with quality of corporate governance. Using a sample of cross-border acquisitions during 1989–2009, we find that targets, which operate under some degree of state expropriation risk, receive a significantly lower premium. The target shareholders are not fully rewarded for the improvement in firm governance since the benefits of improvement are mitigated under predation. Our results provide evidence for twin-agency theory of Stulz (2005) through cross-border mergers.

"Businesspeople need to think harder about political risk", The Economist, February 10th 2011"

1. Introduction

A number of studies have investigated the valuation impact of cross-border investments. In general, the improvements resulting from transfer of investor protection and corporate governance as well as bonding to better institutions have positive valuation effects.[2] However, in view of the "twin agency problems" identified by Stulz (2005), it is important to condition the valuation effects on government intervention broadly defined as expropriation.[3] Indeed, recent surveys conducted by the Economist Intelligence Unit suggest that political risk has jumped towards the top of corporate agendas.[4] World Bank's Multilateral Investment Guarantee Agency (MIGA)

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2 See for example, La Porta et al. (2002), Chari et al. (2010), Kuipers et al. (2009), Doidge et al. (2004), and Bris and Cabolis (2008).

3 The term "expropriation" refers to a wide range of activities including the outright seizure of firm assets, solicitation of bribes, overregulation and confiscatory taxation. Throughout the paper we use the terms "political risk" and "expropriation risk" interchangeably since state expropriation is a common form of political risk, which is broadly defined as the involuntarily forced divestment of foreign direct investment. In our empirical analysis, however, our main measure focuses on the risk of contract viability/expropriation and profits repatriation.

4 See for example World Investment Prospects to 2011 – Foreign Direct Investment and the Challenge of Political Risk, p.7 available at (http://www.eiu.com). Also see Bloomberg (October 20th, 2010) for the court action by Exxon and ConocoPhillips against Venezuela and by Yukos against Russia.

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reveals in their most recent survey that expropriation is the third most cited cause for companies that have scaled back, canceled, or delayed investments in conflict-affected states.[5]

The potential impact of a predatory state should be reflected in the market's expectation of cross-border merger premia. Indeed, the valuation discount due to state expropriation risk should result in target shareholders receiving a lower merger premium. Further, according to the twin agency theory of Stulz (2005), managerial diversion and state expropriation are complementary. In countries with predatory governments, managers will consume more private benefits because any money they leave in the firm may be partially expropriated by the state. Moreover, while more transparency makes it harder for insiders to appropriate from outside investors, it makes expropriation by the state easier. As a result, shareholders find it costly to improve governance and disclosure since the benefits of restraining managerial diversion are not fully realized by the shareholders but are shared with the state.[6] Thus, the value of cross-border transfer of better governance and more disclosure is also in question under predation.

Hence, in this paper, we investigate two related issues. First, what is the valuation impact of state expropriation for cross-border mergers that involve targets from predatory states. Second, what is the effect of improved shareholder protection and transparency when the target is subject to significant expropriation risk.

Our paper is related to studies that identify a number of country-level variables such as culture difference, market segmentation, legal environment and investor protection difference as sources of value gains in cross-border mergers, see for example, Moeller and Schlingemann (2005), Francis et al. (2008) and Chakrabarti et al. (2009). Nonetheless, the value implications of target government policies that influence foreign investment decision have not yet been reported.[7] In a recent paper, Ellis et al. (2012) investigate whether a country's governance explains the shareholder wealth creation by studying the stock-price reaction of cross-border acquirers to merger announcements. However, there are major differences between their and our study. First, we are interested in the wealth accrued to target shareholders and thus we look at target announcement returns (premia). Second, their governance index is a composite index that does not differentiate legal institutions from political institutions. We differentiate between the two in order to study the impact of state expropriation as well as its interaction with the legal institutions.[8] Third, our samples and methodologies are different. Their sample contains public acquirers and both public and private targets whereas we focus only on public firms for both acquirers and targets. They conduct their tests on unadjusted cross-border acquirer returns. We use a matching acquisition methodology and measure the target cross-border merger premium relative to a similar domestic acquisition for univariate tests. For multivariate tests, we use unadjusted target cumulative abnormal returns. Our work is also related to studies that focus on the value created by the transfer of corporate governance and legal standards through cross-border mergers, see for example, Bris and Cabolis (2008), Chari et al. (2010), Feito-Ruiz and Menéndez-Requejo (2011), Kuipers et al. (2009) and Martynova and Renneboog (2008). These studies find that abnormal returns are higher when acquirer's corporate governance standards are stricter than the target's. We argue that the positive value of bonding to better investor protection and stricter accounting standards are conditional on the target country's government policies towards firms. Studies by Desai et al. (2007), Desai and Dharmapala (2006) and Stulz (2005) focus on the relation between firm governance and state expropriation but do not investigate their implications on firm value. Cosset et al. (2014) study the impact of political institutions on foreign firms' choice of their U.S. cross-listing venue. Finally, whereas Durnev and Fauver (2011) study cross-sectional relationship between predation, governance and value, we use cross-border merger events to analyze the valuation effects of *changes* in corporate governance and not the levels. Further, Durnev and Fauver (2011) use Tobin's q which is significantly affected by industrial organization and hence should be adjusted with respect to firm's industry (Lindenberg and Ross, 1981).[9] For an international sample this might be more challenging since there may not be sufficient number of firms in each industry for each country.

We use a sample of 902 cross-border acquisitions from 36 target countries during the period from 1989 to 2009. Our sample period covers the period when expropriation risk posed a great threat to businesses as we acknowledge that outright asset expropriations are far less common now than they were a few decades ago. Our results, however, could extend beyond our sample period and are applicable to today's business environment as expropriation risk might take other forms such as contract viability, overregulation and confiscatory taxation. These risks still rank as some of the highest concerns on corporate agendas as they consider investing in Latin-America, Middle East and North Africa.[10]

We investigate cross-border mergers since they introduce an exogenous shock to domestic firm's ownership and thus offer an opportunity to explore the valuation consequences of detrimental state policies against foreign firms. Moreover, the target firm usually adopts the accounting standards, disclosure practices, and corporate governance regulations of the country of the acquiring firm. The

[5] See MIGA World Investment and Political Risk Report, p.94 available at (http://www.miga.org/documents/WIPR10ebook.pdf).

[6] The first order condition that equalizes marginal benefits of improving firm governance with its marginal costs shows that the optimal level of firm governance drops when the state becomes more predatory. Thus, it is optimal for shareholders to set up weaker governance and distort managerial contract from pure value maximization when state expropriation risk is high. See Stulz (2005) and Durnev and Fauver (2011) for the theoretical models. See Durnev et al. (2009) for empirical evidence on sub-optimal corporate transparency when there is state expropriation risk.

[7] The importance of political risk on volatility of stock returns and cost of capital has been studied extensively. See for example Boutchkova et al. (2012) and Beaulieu et al. (2005).

[8] We are not the first one to treat them separately. Qi et al. (2010) analyze the joint impact of country-level political institutions and legal institutions in determining a firm's cost of debt finance in international credit markets. Moreover, there is an ongoing debate in financial and economic development literature as to which institutional factors are most important. Haber et al. (2008) term this debate as the "legal origins view" versus the "political institutions view." See their paper for more detail.

[9] Most studies that explore governance-value relation use industry-adjusted Q. See for example, Gompers et al. (2003) and Bebchuk and Cohen (2005). For an extensive review on recent corporate governance and corporate control research see Netter et al. (2009).

[10] See World Investment and Political Risk 2013 Report (WIPR) available at http://www.miga.org/documents/WIPR13.pdf and for recent examples in Russia see http://expropriationnewsrussia.com/en/.