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Ownership level choice and value creation in international joint ventures: The role of investor protection[☆]

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ABSTRACT

We examine the choice of ownership level and its impact on the value to the US partner in two-party international joint ventures (IJV). Using a large sample of IJVs, we find that the level of economic development of the foreign country influences the ownership choice of the US partner, but the foreign country's origin of legal system does not. The US partner gains more value when there is a dominant party in the transaction: the dominant partner possibly minimizes agency costs and provides greater stability to the joint venture. Partner, deal, and country characteristics influence the created value. Unequal ownership IJVs with English and French law countries bring more value to the US firm compared to unequal ownership in German law countries, and compared to equal ownership structure. The difference in value gain between majority and minority ownership levels is statistically insignificant across all legal systems, thereby providing additional support to the proposition that the presence of a dominant partner, whether of US or foreign origin, enhances the value of the IJV.

1. Introduction

Optimal ownership structure, efficient allocation of control rights, residual control rights, and cash flow rights in joint ventures have been important issues in international business studies. However, the impact of institutional country factors on strategic decisions in the international business context has not been extensively examined. This study examines the ownership division and the role of legal protection in the country of the IJV as issues having both choice and value consequences.

IJVs are distinct legal entities formed by firms from different countries, combining the resources of the partners to attain a common well-defined objective. We focus on two-party IJVs formed with one US and one foreign partner where the choice of ownership is a consequence of ex-ante bilateral bargaining by the firms. Both owners of the IJV are insiders but, control and agency issues are present in the IJV in a manner not dissimilar to that observed in public corporations. The degree of environmental uncertainty is greater in IJVs compared to domestic joint ventures as the IJV firms are subjected to differences in legal systems, culture, economic conditions, and regulations that make such undertakings more complex.

There are three strands of literatures that have a bearing on the discussion of IJV ownership structure. The transaction cost literature focuses on the implications of control rights on transactions costs (Williamson, 1979), whereas the property rights literature examines the distortions to ex-ante investment incentives based on ownership. Allocation of rights is a crucial issue when it is too

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costly to lay out all the contract specifics or if there is general contractual incompleteness (Grossman & Hart, 1986; Hart & Moore, 1990).

Contractual incompleteness is likely to arise in IJVs as future outcomes including innovations are not foreseen ex-ante. Equity JVs, in contrast to other organizational forms, enable partial ownership; incentives can be aligned and ex-post hold-up problems can be mitigated since equity is marketable (Dasgupta & Tao, 1998). Park and Ahn (1999) find that joint ownership can be superior to other structures. Maskin and Tirole (1999) argue that joint ownership can be optimal in the presence of put options. The third strand of literature which is useful in studying IJVs pertains to the revenue sharing rules specific to IJVs that may be different from the division of ownership and control issues. Desai Foley, and Hines (2004) discuss how transaction cost and contracting theories provide an explanation for the role of ownership in the value creation of joint ventures.[1]

Much of the theoretical literature suggests that joint control is an efficient mechanism for joint ventures. If the level of ownership and control are similar then we may see equal ownership as the prevalent distribution in IJVs. Empirically, however, in a large sample of IJVs undertaken by US firms over a quarter century span, we observe approximately 3/4th of the IJVs to exhibit equal ownership between the two parties, with unequal ownership distribution prevailing in the remaining ¼ of the sample. Furthermore, unequal ownership cases are not generally of the 50% + 1 type. In fact, in less than 1% of the cases do we observe unequal ownership exceeding 49% and lower than 51%. The observed prevalence of substantially unequal ownership provides a motivation to examine the determinants of ownership in the context of IJVs. In particular, we examine firm and country specific factors influencing the choice of the ownership level.

A U-shaped relationship between ownership level and value gain arises as a possibility. Such a relationship is likely if the level of ownership is informative about potential stability, longevity, and success of the IJV. Greater value may be created under ownerships structures that lead to greater stability of the venture. As we discuss later, the presence of a dominant partner from either country possibly might reduce potential opportunistic behavior in the bilateral arrangement, thereby improving the likelihood of success of the IJV. The stability of the venture is enhanced whether the dominant partner is the US firm or the foreign partner in the IJV.[2]

We investigate the ownership division and the role of legal protection in the country of the IJV as issues having both choice and value consequences. Therefore, we examine ownership choice in the context of the foreign county's legal system, its level of development, and cultural distance from the US among other variables. We measure the stock price response of the US firm at the time of the IJV announcement as an estimate of the value created by the joint venture for the US partner.

Earlier studies have examined the wealth creation aspect of IJVs without specific emphasis on the role of ownership. Chang, Chen, and Lai (2008) study the wealth impact of announcement of strategic joint ventures. They report that for US- Japan IVs, both the Japanese and the US shareholders gain value; with larger abnormal returns occurring when the partnering firm is small, has higher growth opportunities, and is less profitable.

While the importance of IJVs as vehicles of investment flows has been documented in international business literature, results have not been conclusive hence our interest in examining this issue while taking into consideration recent developments in Law and Finance literature. This paper fits in the current debate regarding whether legal system matters for ownership and value creation in international joint ventures.

First, we link the law and finance literature to international business by examining the role of the legal system in determining the ownership choice and the outcome of the IJV in terms of value creation. We find that while the legal system is material in determining ownership structure in the framework of international joint ventures, it is does not have a bearing on the value creation aspect of the IJV. Second we add to the previous studies on value creation of IJV by (i) taking into consideration the impact of both ownership choice and investment protection and (ii) by correcting for the potential endogeneity between ownership choice and value creation (see, e.g., Morresi & Pezzi, 2011; Amici, Fiordelisi, Masala, Ricci, & Sist, 2013; Lee, Cho, Cheong, & Kim, 2013; Teece, 2014 and Merchant, 2014).

We contribute to the literature by using - to the best of our knowledge- the most comprehensive dataset in terms of industries, countries and time period compared to any of the previous related studies. Merchant (2014) studies the effects of IJV governance structure and IJV competitive advantage on the value creation of 200 manufacturing IJVs; Lee et al. (2013) examine 297 technological and non-technological marketing IJVs from 2001 to 2007 in Korea; and Morresi and Pezzi (2011) study the value creation of 140 IJVs established in Italy between 1986 and 2006.

Our empirical analysis is based on a sample of 2210 two-party IJV announcements made by US firms spanning over the 1985–2012 period. Some country characteristics influence the ownership level choice; in line with our expectations, we find that the legal system prevailing in the foreign country influences majority ownership. The legal origin influences value creation only for dominant ownership levels. With regard to the value addition to the US partner, we find that dominant ownership whether by the US or the foreign partner has a positive impact on value gained by the US partner. US firm's ownership level and value accruing to the US firm is U-shaped around equal ownership. This suggests that the presence of a dominant partner may contribute to venture stability

[1] Desai et al. (2004) focus on the attractiveness of subsidiaries versus JVs, and study the determinants of partial ownership of the foreign affiliates of US firms. They find that whole ownership is most common when firms coordinate integrated production activities across locations, transfer technology, or plan on benefitting from worldwide tax planning.

[2] Venture stability is likely to be influenced by the governance structure; a dominant partner ameliorates opportunistic behavior by the second partner. Dahya, Dimitrov, and McConnell (DDM, 2008) report a positive relationship between the presence of a dominant shareholder and firm value in a sample of 799 public corporations across 22 countries. They find that the role of the dominant shareholder is particularly strong in countries characterized by weak shareholder protection. In a different context, the relationship between corporate value and insider equity ownership in public firms is also reported to be a curved relationship in multi-country studies (Morck, Shleifer, & Vishny, 1988, McConnell & Servaes, 1990).