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Effects of foreign acquisitions on financial constraints, productivity and investment in R&D of target firms in China

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ABSTRACT

This paper examines whether foreign acquisitions lessen financial constraints, improve investment in research & development (R&D) and productivity of the target firms in China based on a sample of 914 cross-border mergers and acquisitions (CBM&A) over the period of 1994–2011. Using investment to cash-flow sensitivity to measure financial constraints, we find that foreign acquisitions in China are associated with a reduction of target firms' financial constraints, irrespective of the ownership type of the target firm. However, the extent of financial constraint reduction is pronounced for non-SOEs compared to state-owned enterprises (SOEs). This study also provides evidence that foreign acquisitions improve Chinese target firms' productivity and investment in R&D.

1. Introduction

The economic and institutional reforms in the emerging countries, particularly, Brazil, Russia, India and China (BRIC), are widely seen as pivotal in attracting foreign direct investment (FDI) inflows into these countries. FDI inflows into BRIC which stood at 4,712.6 million US dollars in 1990 increased to 285,325.2 million US dollars in 2013 (UNCTAD, 2015). In similar vein, cross border mergers and acquisitions (CBM&A)[1] which constitute a dominant share of FDI and a popular strategy for penetrating into foreign markets are on the rise (Du & Boateng, 2015). According to the UNCTAD (2015), CBM&A inflows into China increased from 1340 million US dollars in 1990 to 50,148 million US dollars in 2013, being the highest among the BRIC countries. It is argued that cross-border investment inflows do not only bring in the private and needed capital but have implications for productivity and investment in research & development (R&D) of the host country firms (Harrison & Mcmillan, 2003; Harrison, Love, & Mcmillan, 2004; Miozzo, DiVito, & Desyllas, 2016). This is especially important for emerging country firms which typically face financial constraints that curtail their ability to undertake value enhancing projects, invest in R&D, and to upgrade existing facilities to enhance productivity (see Almeida, Campello, & Weisbach, 2004).

While recent studies have examined whether acquisitions can potentially mitigate financial constraints of target firms and increase the number of investments (see Almeida, Campello, & Weisbach, 2011; Erel, Jang, & Weisbach, 2015;Khatami, Marchica, & Mura, 2015) in the context of developed countries, relatively li ttle evidence exists in emerging countries (Cull, Li, Sun, & Xu, 2015). The few studies that examine the financial constraints in emerging countries focus on domestic firms with no study on the effects of foreign acquisitions on financial constraints, R&D and productivity of target firms.

However, Peng, (2008) and Antal-Mokos (1998) indicate that acquisitions are, particularly, sensitive to the efficiency of the financial markets and the market for corporate control. Acquisition transactions greatly rely on institutional framework that ensures transparency, certainty, and contract enforcement (Peng & Heath, 1996). Yet institutions (formal and informal), market for corporate control and corporate governance systems in emerging countries are weak compared to developed countries (Du & Boateng, 2015; Xu, 2011). Lin, Peng, Yang, and Sun, 2009 argue that the weakness

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[1] We define CBM&A in this study as a takeover of assets and liabilities of Chinese target by a foreign company or a foreign company and Chinese company come together to merge. Following UNCTAD (2000), we place emphasis on the transfer of control of assets and operations from a local firm to a foreign firm, with the former becoming an affiliate of the later or two companies with different nationalities coming together with the foreign company exercising some control over operations and decision making.

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of institutions in emerging countries may lead to smaller, more volatile, and less liquid markets, which reduces the potential for acquisitions. More importantly, Xu (2011), Guler and Guillen (2010) point out that, for technology spillover to occur, a set of institutions should be in place to facilitate access to resources, technology and improve productivity. For example, contract law and private property rights enforcement protect the interests of acquiring firms and reduce the risk of dissipation of technology in the host country and are important for investment in technology (Xu, 2004). Unfortunately, institutions in emerging countries are weak with many firms controlled by dominant shareholder often the state thereby exacerbating agency problems.

The above is against the backdrop that studies examining FDI spillovers via technology transfer and productivity of which CBM&A is a dominant part have produced mixed results (see Bertrand, 2009; Miozzo et al., 2016; Sinani & Meyer, 2004). While it is argued that acquisitions may lessen the target firms' financial constraints and increase investment in R&D and productivity, policy makers have raised concerns about the beneficial effects of acquisitions to the target firms (Bertrand, 2009; Miozzo et al., 2016). For example, the Chairman of the Welcome Trust indicated that past acquisitions of Pfizer of USA have mostly led to a substantial reduction in R&D activity of target firms (Financial Times, 8 May 2014). Indeed, the effects of foreign acquisitions on financial constraints of the target firms and the extent to which acquisitions can alleviate financial constraints and improve R&D activity and productivity of target firms have not been systematically examined in the emerging country environment where institutions are weak.

In this paper, we investigate whether foreign acquisitions lessen financial constraints, and improve productivity and investment in R&D of the target firms in emerging countries. We use a sample of 914 inward CBM&A in China which occurred over the 1994 – 2011 period to analyse whether Chinese firms have financial constraints before being acquired, and to what extent do foreign acquisitions mitigate financial constraints and enhance investment in R&D and productivity of target firms in the post-acquisition period.

The choice of China for an empirical examination of financial constraints is based on the following reasons: First, China is a major player in the global market for corporate control and attracts over 45 and 50 percent of the volume and value of acquisition activities by foreign firms occurring in BRIC countries (UNCTAD, 2015). Despite this, the past empirical efforts have paid no attention to foreign acquisitions in China, perhaps due to paucity of data. CBM&A research in the context of China has focused exclusively on acquiring firms (see Boateng, Wang, & Yang, 2008; Du & Boateng, 2015; Rui & Yip, 2008). With the availability of data in respect of target firms, this study provides us with rare opportunity to analyse the effects of foreign acquisitions of Chinese targets on financial constraints, investment in R&D and productivity.

Second, Chinese firms like their counterparts in other BRIC countries are faced with financial constraints (Cull et al., 2015; Hericourt & Poncet, 2009). However, financial constraints faced by Chinese firms have several dimensions and may differ from that found in developed markets. Financial constraints in China appear to be driven by both market and non-market factors such as central and local government ownership of firms with associated interferences which distort credit allocation in China (Cull et al., 2015; Poncet, Steingress, & Vandenbussche, 2010). Many of the resources and organisation structures of local firms are built around nonmarket forms of transactions thereby making it harder for acquirers to evaluate properly target firms for post-acquisition restructuring with far-reaching implications for productivity (Tong, Reuer, & Peng, 2008). Institutions in China are not only weak but also the government is deeply involved in business through ownership and control of firms in both financial and non-financial sectors (Du & Boateng, 2015; Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004). Consequently, instead of government protecting private property rights and enforcing contracts by separating itself from businesses, there is no clear separation between Chinese government and businesses (Xu, 2011). The above has implications for firm investment strategies and productivity because host country institutions affect foreign firms' organisational capabilities to transfer technology, access external resources and take risks in the host country (Guler & Guillen, 2010). Although, over the past two decades, China has reformed its enterprises through privatisation and reduce restrictions in the banking sector, Boateng, Huang and Kufuor (2015) suggest that problems still remain in the banking sector. The above considerations motivate the choice of China for this study.

The results of this study indicate that foreign acquisitions in China are associated with a reduction of target firms' financial constraints, irrespective of the ownership type of the target firm. However, the extent of constraint reduction is pronounced for non-SOEs (i.e. domestic and foreign private-owned enterprises) compared to state-owned enterprises (SOEs). Our results also suggest that the foreign acquisitions increase productivity and investment in R&D of the target firms. The study contributes to the literature in the following ways. First, we contribute to the large body of literature on capital market imperfections and firm investment in emerging country context where massive institutional reforms have taken place over the past two decades. In particular, we shed lights on financial constraints and how ownership type of banks in emerging markets affect efficient allocation of capital in formal financing sector. This is significant in that the ability of Chinese financial system to allocate capital more efficiently and guarantee fair access to finance for all companies is a key yardstick for measuring the success of the reforms carried out so far. Second, obtaining technological know-how and developing technical capabilities are increasingly important for sustainable economic growth in emerging economies. Acquisitions (market for firms) are an important part of business process of redeploying resources into more productive uses compared to the market for some resources (Gupta & Govindarajan, 2000). By examining the effects of acquisitions on target resources (financial constraints), investment in R&D and productivity, we provide evidence on efficiency gains derived from foreign acquisitions in an environment where institutions are weak.

The remainder of this article proceeds as follows. The next section reviews the literature on the effects of foreign acquisitions on the target financial constraints, productivity, R&D investments and develops the research hypotheses of the study. Section 3 presents the sample selection as well as the analytical method used in this study followed by the discussion of the results. The final section concludes the paper and discusses the implications of the study.

2. Literature review and hypothesis development

2.1. Theoretical background and financial constraints

The neoclassical models of investment assume that capital markets are perfect (Modigliani & Miller, 1958). However, the assumption of perfect market is inconsistent with what happens in the real world where the cost of internal and external finance diverge (Laeven, 2003). Carpenter and Petersen (2002), Laeven (2003), Poncet et al. (2010) and Cull et al. (2015) point out that the financial constraints stem predominantly from capital market imperfections such as information asymmetry, weak institutions and corporate governance systems. In this regard, a firm's