The Entry Mode Choice of Business Group Affiliation in Emerging Markets

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ABSTRACT

The relation of governance and firm entry strategic choice is heterogeneous in idiosyncratic environment. Our study examines whether the compositions of boards in terms of the insider and independent representation affect the choice of mode. We advance existing research on FDI by arguing that agency theory (AT) and resource dependent theory (RDT) can be complement to show the rationale of corporate governance mechanisms on FDI decisions. This study explains why and how corporate governance affects the mode choice based on a multi-theory perspective.

Keywords: FDI, business groups, corporate governance

INTRODUCTION

The corporate governance has been as an important function in the complexity structure of the corporate from the economic and strategic views (Daily, Dalton & Rajagopalan, 2003; Gillan, 2006; Filatotchev & Boyd, 2009). Corporate governance refers to the separation of ownership and control mechanisms (Fama & Jensen, 1983). Without the set of governance mechanisms, the capital value of the shareholders is likely to be destructive by managers. Studies have indicated that the mechanisms including the board composition and the incentive system affect firm strategic behavior and performance (Baysinger & Hoskisson, 1990; Dalton, Daily, Ellstrand, & Johnson, 1998; Heugens, van Essen & van Oosterhout, 2009).

However, empirical evidence on the influence of corporate governance in the international strategies has been limited (Datta, Musteen & Herrmann, 2009). Especially, the relation of governance and firm strategic choice is not easy to explore in the context of the emerging markets. The limitation is that strategic behavior is heterogeneous in idiosyncratic environment that has been ignored by Western research (Peng, & Heath, 1996; Meyer, 2004; Wright, Filatotchev, Hoskisson & Peng, 2005; Peng, Wang & Jiang, 2008). Recently, some studies note this phenomenon and impose the concept of corporate governance on the entry strategy (Lien, Piesse, Strange & Filatotchev, 2005; Fernandez & Nieto, 2006; Luo, Chung & Sobczak, 2009; Musteen, Datta & Herrmann, 2008; Miller, Breton-Miller & Lester, 2009).

Our study seeks to address the issue of entry strategy in the emerging markets by examining whether the compositions of boards in terms of the insider and independent representation affect the choice of mode. The structure of boards is as the important element of intra-organizational governance to detect the major strategy (Baysinger & Hoskisson, 1990). In addition, our research also considers the incentive element of insider who is CEO needs to be motivated to take risk on the long strategy. In the traditional literature about the foreign direct investment, the higher foreign commitment implicates the higher risk (Gatignon & Anderson, 1988). The insider who avoids risk without incentive prefers to hide
information to make the lower risk decision based on the agency role.

The governance of boards and incentive systems has in common as primarily functional mechanisms. Based on the special context in emerging markets, the characteristic of business group (BG) have been emphasized (Granovetter, 1995; Chang & Hong, 2000; Khanna & Palepu, 2000; Schulze, Lubatkin & Dino, 2003; Eddleston, Kellermanns & Sarathy, 2008; Miller, Lee, Chang & Le Breton-Miller, 2009). Granovetter (1995: 95) defined business groups as “sets of legally independent firms bound together in persistent formal and/or informal ways.” Especially, the most of ownership is concentration by business group in emerging markets (La Porta, Lopez-de-Silanes F, Shleifer A, Vishny, 1999; Claessens, Djankov & Lang, 2000). Based on the business group has motivation to appropriate the whole capital, the BG ownership as endogenous consideration in the process of strategic decision (Eddleston, Kellermanns & Sarathy, 2008; Guillen, 2003; Filatotchev et al., 2007). Our study explores that BG ownership also becomes one of factors to affect affiliates on entry strategic decision.

Building on the corporate governance literature, our study examines governance mechanisms as synthesizing economic and social elements to impact on foreign investment decisions. This study aims to extend corporate governance and FDI research in several ways. First, the integration of governance structure with FDI strategy does matter to offer extension and bridge of two fields in the context of emerging market. Second, we propose that the boards’ function and incentive system will enhance the commitment of FDI. Third, our research adds how the BG ownership affects affiliate strategic behavior that enriches the content of corporate governance area.

LITERATURE REVIEW AND PROPOSITIONS

FDI as contracting process involves information searching and evaluation to decide one mode in the host county (Hannart, 1991). Besides, different entry modes are characterized by the level of control, risk, and resource requirements (Andersen & Gatignon, 1986; Agarwal & Ramaswami, 1992; Kim & Hwang, 1992). The higher equity modes include the higher control needs, risk, and resources such as greenfield investment and acquisitions that is the higher integration and intraorganizational information processing in the firm. In contrast, the non-equity or lower equity modes involve the less resource, and the firm needs to share control with the local partner. Moreover, the external risk can be transferred to the partner who is able to absorb uncertainty including local culture and institutional factors (Makino & Neupert, 2000; Hennart & Reddy, 1997). From economize rationale, foreign firms prefer to choose the arm’s length (non-equity) or minority equity mode for minimizing hierarchical cost like searching and measurement information cost without the market failure. In institutional voids, however, the majority mode or wholly own are chosen by firms for minimizing external contracting cost. In addition to the efficiency goal, firms attempt to choose lower-equity mode to hold flexibility and search opportunities in host countries (Brouthers, Brouthers & Werner, 2008). From social logic, foreign firms with the limitations of local resources attempt to interact with environment to exchange resources for survival and legitimacy through various entry modes (Yiu & Makino, 2002). Furthermore, for dealing with problems of external uncertainty, resulting from the exchange of resources, firms need to develop internal devices to overcome exchange problems and search the opportunities of resources exchange (Pfeffer, 1972; Burt, 1980).

The entry mode choice has been used by multi-theoretical lenses (Brouthers & Hennart, 2007 provide the review of FDI mode literature). Research in this area is related to four theoretical traditions. The first tradition from internalization theory has been developed by Buckley & Casson (1976). According to this theory, the choice of mode is a ‘rational model’ that would be calculated by the
deliberate decision makers for maximizing profit in the MNEs (Buckley & Casson, 2009). Following this vein, Hennart (1988; 1991) added the concept of transaction cost to examine FDI as the contracting process including searching, monitoring, enforcing and monitoring information costs. Building on the comparative analysis, if the firm uses more efficient internal mechanisms to carry out contracting activities than market, then the transaction should be internalized by the firm. In other words, the hierarchical organization is chosen that is because contracting information costs are lower than market by the efficient governance mechanisms. The second approach is the Uppsala school (Johanson & Vahlne, 1977). Drawing on this approach, MNEs managers make FDI decisions following some assumptions such as the liability of foreignness and the psychic distance. The internationalization experience is one of ways to overcome the unfamiliar market (Johanson & Mattson, 1988). For this purpose, the linkage between internal organization and external environment is important to reduce information asymmetry in the FDI decision process. The third tradition is the eclectic paradigm (Dunning, 1988). According to this traditional OLI framework, the FDI choice is interaction with the firm-specific advantages (FSAs) and internalization advantages. Therefore, the entry mode decision is to exploit FSAs for capturing oligopolistic rents. The fourth perspective is resource-based view (RBV) or knowledge-based view (KBV), in contrast to the internalization view based on minimizing transaction cost, the purpose of RBV/KBV is to create value (Kogut & Zander, 1993; Meyer, Wright & Pruthi, 2009). The level of foreign investment depends on the characteristics of resources which are able to be used by foreign firms for building strategic advantages in local environment. The attributes of resources are tacit and context-specific that reduces the ratio of firms’ investment (Meyer, Estrin, Bhaumik & Peng, 2008).

Recently, the corporate governance has been emphasized increasingly on the FDI topic in emerging economies (Filatotchev, Strange, Piesse & Lien, 2007; Luo, Chung & Sobczak, 2008; Lu, Xu, & Liu, 2009). Basically, the corporate governance is the multi-theory to unlock the set of internal governance mechanisms in firms that complement with the above four perspectives. For example, the composition of boards is the resource sources to provide tacit knowledge in the process of FDI decision (Filatochev et al., 2007). Unfortunately, the governance role of board how to affect FDI choice is still ambiguous and inconsistent. The next sections are discussed deliberately.

The Independent directors and FDI decision

According to the agency theory perspective, the independent directors whose duties separate from CEOs’ provide a governance safeguard to monitor organizational strategic and operational decisions (Baysinger & Hoskisson, 1990; Datta, Musteen & Herrmann, 2009). The independent directors who are like outsider directors maintain objective views with less intraorganization social emotion to evaluate decision information. Therefore, reducing the opportunism and expropriation problems of CEOs and the majority shareholder is the primary duty of the independent directors. Usually, management decisions are low-risk considered by CEOs with less incentive reward. CEOs prefer to emphasize self-goal over organizational interests without external pressure and to be more likely to choose low-risk investment decisions. The independent directors may detect this problem and induce the higher risk decisions. Datta et al. (2009) found that firms with an independent board structure were more likely to choose the high-risk acquisitions over the low-risk joint ventures in FDI decisions in the U.S. manufacturing sector. Thus, we propose:

P1a: The more number of independent directors on the board will be associated with preference for the higher-equity mode.

However, the role of a monitoring mechanism of independent directors may be dysfunctional in
emerging markets. Drawing on resource depend perspective (Pfeffer, 1972), the directors play another role that provides relational capital compassing both human and relational capital (Hillman & Dalziel, 2003). Young, Bruton & Chan (2001) argue that the monitoring and control function of directors is limited in Hong Kong and Taiwanese boards. They also found that the resources providing and external linking are the major board function. As we mention above, if firms know more about market information, they are more likely to choose the lower equity mode to avoiding using internal hierarchical systems (the higher equity mode). Therefore, we propose:

**P1b:** The more number of independent directors on the board will be associated with preference for the lower-equity mode.

The CEO and executives on the board and FDI decision

According to agency theory, the director function is not only to protect the shareholders’ ownership through monitoring and evaluating decisions quality, but also to align the managers’ individual goal and organizational goal (Baysinger & Hoskisson, 1990). However, agency theory focus on the board’s intraorganizational governance role is still ambiguous (Dalton, Daily, Ellstrand & Johnson, 1998; Hillman & Dalziel, 2003). Dalton et al. (1998) have found no statistical support for a relationship between the director internal-governance role and firm performance.

From resource dependent perspective, combing the managers (CEO and executives) and director role (the insider director) is able to add the provision of resources function (Johnson, Daily & Ellstrand, 1996; Hillman & Dalziel, 2003). Similar to the independent director, the insider director is relevant to assessing strategic decision-making (Rindova, 1999; Pugliese Wenstøp, 2007). Herrmann & Datta (2006) propose that managers’ experience associate with entry mode choice. Moreover, they found when managers with greater interorganization cooperation experience favor lower-equity modes. The logic here is similar to our argument that firms know more external information may more likely choose the lower-equity mode because market or alliance can substitute for hierarchical systems. Clearly, the managers on the board as information brokers or bridge link the boundary of internal and external organization (Kriger, 1988). Therefore, firms are able to leverage external resources to transfer firm-specific advantages on host countries by the lower-equity mode. Thus, we propose:

**P2:** The more number of CEO and executives on the board will be associated with preference for the lower-equity mode.

The moderating effect of managers’ long-term compensation

The functions of managers and long-term compensation as devices of corporate governance are complementary. However, this argument still is not adequately explained how these two governance mechanisms interact each other, despite many studies separately explain managers on the board and their long-term compensation may associate with FDI decisions from the agency theory (Datta, et al., 2009; Strange, et al., 2009).

Although no study has examined the interaction of managers on the board and their long-term compensation, one study is relevant to our argument. Young & Tsai (2008) propose that CEO’s shareholding may act as a facilitative mechanism to encourage CEOs to play a business opportunity seeking role. They found that CEOs may develop extra-family business group ties to create social capital that associate with the compensation incentive mechanisms. The result is meaningful in our study context, because the primary function of CEO and executives are to connect external resources under the higher incentive device. Therefore, a lower-equity mode is chosen when the synergy of interaction of managers
on the board and long-term compensation. Thus, we propose:

**P3:** The long-term compensation moderates the relationship of managers (CEO and executives on the board) and the preference of lower-equity mode when there is greater long-term compensation.

**The BG ownership and FDI decision**

Based on agency theory, interlocks are instruments of corporate control by stock ownership in business groups (Mizruchi, 1996; Claessens, Djankov & Lang, 2000). The concentrating ownership in the BG firms enables to monitor affiliates’ decision activities and sustain BG competitive advantage (Fernández & Nieto, 2006). The corporate governance is different between BG and non-BG firms in risk-taking. In contrast to non-BG firms, BG affiliates are expected to be risk-averse (Demsetz & Lehn, 1985). Empirical research has found a negative relation between foreign investment commitment and BG ownership, especially BG as a set of family firms in emerging markets (Filatotchev, Strange, Piesse & Lien, 2007). For example, Miller, Breton-Miller & Lester (2010) propose that family owner is reluctant to fund acquisition behaviors based on the risk-averse assumption.

Although resource dependent theory has yet to accumulate sufficient evidence to find the relationship of BG resources and affiliates FDI decisions. We can borrow the exist studies to explore that there is not mutually exclusive between agency theory and resource dependent theory in this study. Mizruchi (1996) reviewed interlocks functions to propose that interlocks have multi-functions including monitoring and resources provision. The BG affiliates have opportunities to access resources through lower-equity modes in BG. Our proposition is thus:

**P4:** The greater BG ownership in the affiliate will be associated with preference for the lower-equity mode.

According to the deductions above, Figure 1 presents a whole view of the relationships of corporate governance mechanisms and entry mode.

![Figure 1: The conceptual framework](image)

**DISCUSSION**

This study is motivated by a lack of understanding what the implicit theoretical implication about the impact of corporate governance mechanisms on FDI in emerging economies. Recent research has found the corporate governance with multi-theory affect organizational strategic activities and outcomes in emerging markets but has not yet been systematically tested. We advance existing research on FDI by
arguing that agency theory (AT) and resource dependent theory (RDT) can be complement to show the rationale of corporate governance mechanisms on FDI decisions. Two general contributions are made to this argument.

First, the embedded practical phenomenon can not be ignored in emerging markets. If a lack of nested organizational field we would miss some theoretical views. Our study presents AT and RDT integrated on business affiliates’ FDI decisions. For example, FDI projects are embedded in affiliate and BG such as the Yieh Phui enterprise, one of affiliates of Eunited Group, made the minority mode (31% equity) at North Coast in China in 2007. Yieh Phui has three investment projects in China at East Coast and North Coast before 2007. Our research suggests that the greater of BG ownership in affiliates would be risk-averse on FDI based on the AT and seek existing or external resources based on RDT. Therefore, Yieh Phui with 36.81% Eunited Group ownership adopt the minority mode because of this investment project at North Coast where is high environment uncertainty and Yieh Phui should seek external resources, including other affiliates, prior FDI projects and joint venture partner. The image figure 2 is shown bellow:

![Figure 2: Yieh Phui Co. FDI in 2007 (project A)](image)

Second, the function of directors is heterogeneous on the boards based on AT and RDT that have been acknowledged by previous research. Our study argues that independent directors are primarily play monitoring mechanism to detect and evaluate strategic decisions. Therefore, this corporate governance device affects affiliates to choose higher-equity mode. In addition, the governance role of CEOs and executives is ambiguous without any incentive compensation. However, adding long-term compensation interacts with CEOs and executives on the boards that present the greater resource provision function on FDI decisions. The corporate governance mechanisms are not substitute but complement. The interrelationships between corporate governance factors are little known that does matter for strategic decisions and organizational outcomes. Future research may extend other governance devices to explore how to configure mechanisms in public corporate based on different theoretical assumptions.

This study is important for research in emerging and new industrial economics, such as Indonesia, Malaysia and Korea. These countries are also dominated by business groups. Developing governance characteristics should be different from Western countries that is argued by the recent research emphasized emerging markets (e.g. Khanna & Palepu, 2000; Young, Peng, Ahlstrom, Bruton & Jiang, 2008; Peng & Jiang, 2009). We propose the function of BG shareholding play a prominent resource provider in institutional voids.
CONCLUSION

Our study enriches the research boundary on corporate governance and the FDI decision in BG context. Little research explains why and how corporate governance affect mode choice based on multi-theory. Moreover, most studies examine the main effect of governance factors on decision-making, but the interaction effect is also meaningful to explore the complement effect of different mechanisms. We suggest that understanding the function of governance how to leverage on strategic decisions is needed to be considered.

This study has some limitations. We are not able to capture real resources exchange between the relationships of affiliates and others. We provide one cute that most of affiliates are the same chairman or directors in one business group. Therefore, it is possible to generate resources flow. Future research may advance in the content of resource dependent.

In conclusion, our study provides that address theoretical implications behind corporate governance on group affiliations’ FDI decisions in emerging markets. An in-depth understanding of the environment context needs to be considered in countries with less developed institutions. Considering this, corporate governance would not be masked by ‘good’ or ‘bad’ based on partial theory (Peng & Jiang, 2009). Multi-theory is appropriate for developing mechanisms in the corporate landscape.

REFERENCES


