

# **EABER WORKING PAPER SERIES**

PAPER NO. 77

## **GOVERNANCE ROLE OF SECONDARY SHAREHOLDERS: A STUDY OF CHINESE OUTWARD FOREIGN DIRECT INVESTMENT**

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# GOVERNANCE ROLE OF SECONDARY SHAREHOLDERS: A STUDY OF CHINESE OUTWARD FOREIGN DIRECT INVESTMENT

## ABSTRACT

This study examines the effects of institutional and foreign ownership on the outward foreign direct investment (FDI) of Chinese firms. Based on agency theory and the resource-based view, we argue that secondary shareholders, i.e., *institutional* and *foreign* shareholders, are active and effective governance forces in Chinese firms. They promote and support Chinese firms to engage in outward FDI through their monitoring and resource roles. Their governance effect, however, may be hindered by the power of CEOs as a result of principal-principal conflicts. Our empirical study of 224 Chinese listed firms revealed that institutional and foreign ownership is positively associated with the outward FDI propensity of Chinese firms. The positive relationship between institutional ownership and outward FDI propensity weakens when CEO power increases. There was, however, no support for the moderating effect of CEO power on the relationship between foreign ownership and outward FDI propensity.

## Keywords:

Chinese Firms, Agency Theory, Foreign Ownership, Institutional Ownership, Outward Foreign Direct Investment, Resource-based View.

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## INTRODUCTION

Corporate governance has considerable influence over the internationalisation decisions of firms and is “at the heart of the strategic decision-making process in the multinational enterprises” (see Filatotchev and Wright, 2011, p. 21). Reflecting this notion, studies have increasingly investigated corporate governance factors in firms’ internationalisation strategies, which provide new insights to the *why* (Bhaumik et al., 2010; Lien et al., 2005; Tihanyi et al., 2003), the *where* (Gomez-Mejia et al., 2010; Strange et al., 2009b), and the *how* (Filatotchev et al., 2007; Musteen et al., 2009) of the internationalisation of firms through foreign direction investment (FDI). However, the current development of this line of research is largely limited to investigation of firms from advanced and industrialised economies, despite the potential interest in extending our understanding of the recent surge of outward FDI from emerging economies (see Bhaumik et al., 2010), especially China.

What corporate governance factors drive the outward FDI of Chinese firms? We seek answers to this question from the ownership aspect of corporate governance because ownership structure is regarded as one of the most important corporate governance factors that impose strong influences on firm decisions (Connelly et al., 2010). Ownership structure in EE firms is concentrated rather than dispersed, which gives rise to “principal-principal” (PP) conflicts instead of the traditional “principal-agent” (PA) problem (Dharwadkar et al., 2000; Young et al., 2008). As a result, prior studies predominantly focused on the governance impacts of controlling shareholders on various organisational outcomes in the EE context (e.g., Claessens et al., 2000; Lien et al., 2005; Wiwattanakantang, 2001). In relation to

internationalisation, studies suggest that controlling shareholders tend to be reluctant to conduct outward FDI due to their risk preference and lack of experience (Bhaumik et al., 2010; Lien et al., 2005). Despite the presence of controlling shareholders, some EE firms actively engage in outward FDI. This leads us to argue that, from the ownership aspect, it is not the controlling shareholders but the previously neglected “underdogs” in PP conflicts that may influence the outward FDI of EE firms. In this study, we term these “underdogs” as secondary shareholders who are non-controlling shareholders but also non-trivial minority shareholders. They typically invest in a sizable proportion of the firm’s equity ownership for not only financial but also strategic purposes, which results in relatively long holding periods (see Douma et al., 2006). Their long-term commitment in the firm drives them to actively monitor the controlling shareholders and influence the firm’s strategic decisions. In EE firms, these secondary shareholders are typically *institutional shareholders* and *foreign shareholders*. They demonstrate superior capabilities of effectively monitoring the behaviour of controlling shareholders (Lien et al., 2005; Tihanyi et al., 2003) and also possess critical strategic resources that are leveraged to enhance their governance roles in EE firms (Bhaumik et al., 2010). Thus, our initial research question is re-specified to reflect our focus on these two types of secondary shareholders: *What are the effects of ownership of institutional shareholders and foreign shareholders on the outward FDI of EE firms?*

We adopt both the agency theory (AT) and the resource-based view (RBV) in our discussion of the effects of secondary shareholder ownership in Chinese firms’ outward FDI. From the perspective of the AT, the decision to internationalise is associated with a “cost-benefit trade-off” that is affected by risk preferences and interest congruence of various stakeholders (Filatotchev and Wright, 2011). From the perspective of the RBV, firms craft and execute internationalisation strategies based on the level and type of resources they hold or have

access to (Peng, 2001). Following these two perspectives, we argue that both institutional and foreign shareholders have risk preferences and strategic objectives that favour outward FDI (their monitoring role), and they also contribute resources that enable the firm to conduct outward FDI (their resource role). The dual roles are inseparable and interdependent, and they need to be examined in the context of PP conflicts. In EE firms, the dominant controlling shareholders often take the top management positions (Fagermä, 2006; Fan et al., 2008) or appoint CEOs who represent their interests (Firth et al., 2007; Heidrick and Struggles, 2007). The dual roles of secondary shareholders in supporting outward FDI may be hindered by a powerful CEO who can worsen the information asymmetry, increase agency costs for secondary shareholders, and consequently steer the firm in a direction that is more in line with the preferences and interests of the controlling shareholders.

We choose China as the empirical context of this research. As the largest emerging economy, China is a representative sample of its kind. It combines EE characteristics such as rapid economic growth, large inflow of FDI, highly concentrated ownership structure of domestic firms, and weak external governance mechanisms. Moreover, China leads all emerging economies in the volume of FDI outflow, and its firms are engaged in a wide range of outward FDI activities with various strategic, economic, and institutional motives (Buckley et al., 2007; Morck et al., 2008). The diversity of Chinese outward FDI offers an ideal empirical context for this study.

The main contribution of this study is two-fold. First, this study provides new insights into internationalisation strategies of EE firms. By investigating corporate governance factors in relation to EE firms' outward FDI, this research suggests that corporate governance is an important building block towards a theory of "unconventional" FDI, i.e., FDI conducted by

EE firms that cannot be sufficiently explained by existing theories (Child and Rodrigues, 2005; Mathews and Zander, 2007). Corporate governance issues are interwoven with the structural and institutional characteristics of EE firms, which drive these firms to exhibit motives, determinants, and strategies of outward FDI different from those of firms in developed countries (Bhaumik et al., 2010; Lien et al., 2005; Strange et al., 2009). Second, this study also contributes to the corporate governance literature with a new focus on secondary shareholders in firms with a concentrated ownership structure. Secondary shareholders have so far remained backstage despite the fact that they are an inseparable part of PP conflicts (Young et al., 2008). Their roles become prominent when EE firms internationalise through outward FDI. This is because firms that conduct outward FDI escape their domestic institutional environments that legitimise concentrated ownership (by controlling shareholders) as an effective internal corporate governance mechanism. As a result, controlling shareholders normally lack the confidence and willingness to conduct outward FDI (Gomez-Mejia et al., 2010; Lien et al., 2005). In this situation, secondary shareholders become active and effective governance forces even with the presence of dominant controlling shareholders. In general, this research builds on the synergy between corporate governance and international business research (Strange et al., 2009a) and further develops the literature.

## **THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT**

To investigate the effects of secondary shareholders on Chinese firms' outward FDI, we develop our theoretical framework from the perspectives of both AT and the RBV. AT explains the causes and implications of PA and PP conflicts and the associated corporate governance mechanisms that minimise these conflicts (Dharwadkar et al., 2000; Fama and Jensen, 1983; Shleifer and Vishny, 1997). As the "top-dogs" in PP conflicts, controlling

shareholders (e.g., family owners in Indian firms, state owners in China) take a dominant position in the governance of the firm, exert strong influence over the board of directors and the management, and ultimately affect organisational outcomes (Douma et al., 2006; Su et al., 2008; Xu and Zhang, 2008). The capable “underdogs”, i.e., the secondary shareholders, have a strong incentive to monitor the controlling shareholders so as to reduce their risks of being exploited by the latter (Dharwadkar et al., 2000; Shleifer and Vishny, 1997). This monitoring role strengthens when the level of secondary shareholders’ ownership in the firm increases, which consequently changes the dynamic between the controlling and secondary shareholders in the corporate governance of the firm. With a higher level of ownership and a strengthened monitoring role, secondary shareholders can enhance their influence over the strategic decision-making of the firm and better align the firm’s strategy with their risk preferences and strategic interests.

The RBV regards resources and capabilities as the prime determinants of a firm’s competitive advantage (Barney, 1991), which is essential for the internationalisation strategy of the firm (Peng, 2001). FDI involves the highest level of resource commitment among the commonly studied foreign market entry modes (Brouthers and Hennart, 2007; Pan and Tse, 2000). Prior studies concluded that entering foreign markets through outward FDI demands ownership advantages in the form of financial capital resources, technological competency, brand assets, foreign market knowledge, managerial know-how, and international business experience (Brouthers et al., 1996; Dunning, 1988; Meyer et al., 2009). Although EE firms are more likely to conduct outward FDI to explore new resources, some level of existing ownership advantages must be possessed for survival and effective resource exploration (Dunning, 2006; Luo and Rui, 2009). While all shareholders contribute their respective resources, which collectively form the ownership advantage of the firm, the resources contributed by

secondary shareholders are of critical importance for outward FDI. A higher level of ownership encourages secondary shareholders to contribute more resources to the invested firm (Chibber and Majumdar, 1999; Douma et al., 2006), which helps the firm overcome the financial, experiential, and technological bottleneck of outward FDI.

By integrating AT and RBV, we argue that secondary shareholders have both monitoring and resource roles in the outward FDI of EE firms. We further argue that the dual roles of secondary shareholders are inseparable and interdependent. This is because a strong monitoring effect on the controlling shareholder will reduce the perceived risk by a secondary shareholder and consequently encourage the secondary shareholder to commit more resources, such as financial capital and managerial know-how, to the invested firm. Lack of confidence in the monitoring effect, however, will cause secondary shareholders to withhold their resource contribution, which will then have an adverse effect on outward FDI. In the meantime, when secondary shareholders possess critical strategic resources, they can leverage these resources to strengthen their monitoring role. In contrast, a weak resource contribution combined with a minority shareholding position may compromise the monitoring role of a secondary shareholder. Accordingly, we recognise both the monitoring and the resource roles of secondary shareholders, not as independent variables but as mutually reinforcing, underlying mechanisms that form the ownership effects of secondary shareholders on EE firms' outward FDI. Such effects are discussed in detail in the following sections and are considered in the context of PP conflicts, in which they are moderated by the power of the CEO.

## **Institutional Shareholders**

AT literature has acknowledged the importance of the monitoring role of institutional shareholders (Filatotchev and Wright, 2011; Shleifer and Vishny, 1997). Institutional shareholders place stronger emphasis on firms' engagement of corporate governance compared to other shareholders. Research has shown that when facing PP conflicts, institutional ownership can decrease controlling shareholders' exploitive capabilities (Claessens et al., 1999; Liu and Lu, 2007). Institutional shareholders exercise their "exit and voice" strategy to maximise their influence in their invested firms (Hirschman, 1970). Compared to minority shareholders, institutional shareholders are more likely to be involved in the firm's strategic decisions because of their greater monitoring abilities (Strange et al., 2009b). In terms of the firm's internationalisation through outward FDI, institutional shareholders are likely to support this strategic decision due to their risk preference and long-term investment orientation. In EE firms, two types of institutional shareholders may exist. The first type includes large financial institutions with extensive global business networks, such as large, Chinese state-owned banks and foreign institutional investors from developed countries. Due to their globally diversified portfolios, these investors are more risk-resistant and therefore more likely to encourage high-risk investment strategies such as outward FDI (Musteen et al., 2009; Strange et al., 2009a; 2009b). The second type includes smaller local institutional investors who intend to develop risk-free portfolios but are constrained by the scale and regulations of the domestic capital market. These institutional investors will also favour outward FDI as a means of diversifying their portfolios (Lien et al., 2005). Moreover, institutional shareholders normally have a long-term investment orientation (Musteen et al., 2009; Tihanyi et al., 2003), whereas outward FDI is often conducted by EE firms to obtain strategic assets overseas to enhance global competitiveness and firm value in the long term

(Khanna and Palepu, 2006; Luo and Tung, 2007). Therefore, institutional shareholders support outward FDI to achieve strategic fit for their investment.

From the perspective of the RBV, institutional shareholders also play a significant resource role in supporting the outward FDI. Institutional investors are particularly resourceful in terms of financial capital and financing capability (Mallin, 2007; Tihanyi et al., 2003). Such capability is of critical importance to firms from emerging economies, where domestic financial market imperfections are widely acknowledged as a major barrier for firms seeking to internationalise (Buckley et al., 2007). Although some EE firms may have the privilege of receiving governmental financial support in the form of direct subsidies or low-interest loans (Luo and Rui, 2009; Morck et al., 2008), such supports are usually attached to conditions and constraints.<sup>1</sup> Unlike governments, institutional investors can access domestic and overseas financial markets without incurring extra institutional costs. As a result, Lien et al. (2005) find that firms that intend to engage in outward FDI will prefer to seek financial support from their institutional investors. In the meantime, as discussed above, the imperfection of the financial market also gives institutional investors (especially domestic ones) the motivation to provide such financial support because it is in their own benefit to diversify their investment portfolios through outward FDI of their invested firms. Accordingly, we hypothesise:

*Hypothesis 1: The level of institutional ownership in a Chinese firm is positively related to the outward FDI propensity of the firm.*

### **Foreign Shareholders**

Based on the perspective of AT, research reveals that foreign shareholders perform a strong monitoring role in the governance of their invested firms (Douma et al., 2006). Due to the high concentration of ownership by controlling shareholders in EE firms, foreign

shareholders actively exercise the monitoring role to safeguard their interests and reduce the potential risk of rent-seeking behaviour by controlling shareholders (Bai et al., 2004; Johnson et al., 2000). Studies find that foreign ownership is associated with good corporate governance (Cox et al., 2004; Wang et al., 2008) and better firm performance (Bai et al., 2004; Douma et al., 2006). Due to their monitoring capabilities, foreign shareholders are actively involved in the monitoring and planning of firm strategies (Berglof and von Thadden, 1999; Chen et al., 2002). Foreign shareholders may endorse outward FDI for two reasons. First, foreign shareholders generally invest in EE firms for market-seeking or efficiency-seeking purposes (Dunning, 2000), which can be considered a strategy of leveraging global synergy effects to reduce costs and to diversify risk. If the invested EE firms further invest overseas, especially into neighbouring emerging markets or least-developed economies<sup>2</sup>, the strategic leverage for the foreign shareholders is effectively leveraged. The foreign shareholders can then harvest greater global synergy effects without much additional effort. Second, foreign shareholders are less risk-averse than controlling shareholders of EE firms because they normally have a more diversified investment portfolio and are more experienced in risk management in international investment. The risk preference of foreign shareholders can influence the controlling shareholder, who may initially prefer to avoid the uncertainty of outward FDI (Bhaumik et al., 2010).

From the RBV, the significance of resource contribution by foreign investors to EE firms, especially the role of knowledge transfer, has been found in international joint ventures (see Hoskisson et al., 2000; Lyles and Salk, 1996; Wang et al., 2004). Foreign shareholders are motivated to contribute, among other things, technological know-how, managerial know-how, and international market intelligence because doing so can help them attract local partners (and thus gain market access) and outperform local and international rivals. Such resource

contributions by foreign shareholders are essential for EE firms that are exposed to global competition by engaging in outward FDI. These EE firms actively utilise foreign shareholder resources to redress their ownership disadvantages and prepare themselves for international competition (Child and Rodrigues, 2005). Mathews (2006) argues that by linking into foreign firms' supply chains, leveraging foreign firm's resources, and learning from foreign business partners, EE firms can enhance their global competitiveness in their internationalisation process. With the presence of resourceful foreign shareholders, EE firms benefit from not only the learning results but also the learning experience itself. Such experience can enhance EE firms' absorptive capacities as knowledge recipients (Martin and Salomon, 2003; Zahra and George, 2002), which prepares them for further knowledge-seeking through outward FDI (Luo and Tung, 2007; Rui and Yip, 2008). Additionally, foreign shareholders might also help EE firms to obtain financial resources because their presence is a positive signal to investors and creditors in the global capital market (Bhaumik et al., 2010). Both the monitoring and resource roles of foreign shareholders have positive effects on EE firms' outward FDI. This leads to our second hypothesis:

*Hypothesis 2: The level of foreign ownership in a Chinese firm is positively related to the outward FDI propensity of the firm.*

### **The Moderating Role of CEO Power**

While firms are owned by shareholders who perform their governance roles, the day-to-day operations of firms are managed by CEOs, who are also involved in firms' strategic decisions. The interaction between shareholders and CEOs induces one of the central discussions in the AT. Managerial power is an important corporate governance factor that can influence the roles of shareholders. Although the stewardship and leadership theories view CEO power as a positive factor for organisation (Cannella and Monroe, 1997; Donaldson and Davis, 1991),

agency theorists generally hold a negative view (Core et al., 1999; Jensen and Meckling, 1976). From the perspective of the AT, a powerful CEO often results in an ineffectual board that is less capable and willing to challenge the CEO (Bebchuk and Fried, 2004). Without an effective board, a powerful CEO may engage in self-serving activities to influence compensation structure, disconnect incentives and job security from performance, and conduct business transactions that benefit self-interest at the expense of shareholders (Boeker, 1992; Grinstein and Hribar, 2004). As a result, from an agency perspective, a powerful CEO can lead to poor firm performance (Lin and Lu, 2009).

In EE firms, the interactions between secondary shareholders and CEOs may also reflect the conflicts between controlling shareholders and secondary shareholders, i.e., PP conflicts (Young et al., 2008). Due to their ownership concentration, controlling shareholders usually have significant influence over the appointment of the CEO, who is closely affiliated with and/or attached to the controlling shareholders. For example, research finds that it is common in India to have CEOs who come from the families that control the firms (Fagernäs, 2006); while in Chinese state-controlled firms many CEOs are former state bureaucrats or are directly appointed by the state (Firth et al., 2007). As a result, the power and influence of the controlling shareholders does not only remain at the shareholder level; by appointing an affiliated CEO, it also extends to the management level. From the secondary shareholder's perspective, there is a necessity to monitor both the controlling shareholders and their representatives at the management level, i.e., the CEOs. The monitoring of the two requires different strategies and inputs. At the shareholder level, secondary shareholders generally use their ownership and a "voice and exit" strategy, as discussed above. At the management level, secondary shareholders need to obtain accurate and timely information to better align CEO incentives with performance and to strengthen the role of the board to monitor and dismiss

poor-performing CEOs (Mallin, 2007). CEO power then makes it difficult for secondary shareholders to perform their monitoring role. A powerful CEO can weaken the governance efficiency of the board and create a higher level of information asymmetry (Bebchuk and Fried, 2004), which subsequently increases the monitoring costs for secondary shareholders. Moreover, the weakened monitoring role will also affect the confidence and willingness of secondary shareholders to perform their resource role. It is of concern to secondary shareholders that a powerful CEO may abuse the resource contributions by shareholders for self-interest. This is particularly problematic for financial resources because such resources are tangible, non-tacit, and can be easily transferred without the need for internalisation (Peteraf, 1993). Allocation and utilisation of this resource is therefore at the CEO's sole discretion. For instance, CEOs can exercise their power to obtain outrageous compensation packages (Lambert et al., 1993), which absorb a significant amount of the financial resources contributed by shareholders. Thus, the power of CEOs in EE firms weakens the monitoring and resource roles of institutional and foreign shareholders. The moderating effect is hypothesised as follows:

*Hypothesis 3: A higher level of CEO power weakens the positive relationship between the level of institutional ownership and the outward FDI propensity of the firm.*

*Hypothesis 4: A higher level of CEO power weakens the positive relationship between the level of foreign ownership and the outward FDI propensity of the firm.*

## **METHODS**

### **Sampling and Data Collection**

To empirically test our hypotheses, we investigated the outward FDI propensity of Chinese listed firms. As most Chinese listed firms have yet to start expanding overseas, random sampling is likely to yield a disproportionate sample. To solve this problem, we followed a

two-step sampling process. In the first step, we identified firms that conducted outward FDI after they went public. A search of BvDEP's Orbis database<sup>3</sup> revealed 112 firms that (1) are incorporated in mainland China and listed on the Shanghai or Shenzhen Stock Exchange, (2) have at least one foreign subsidiary located outside mainland China, and (3) hold ten percent or more equity ownership in such a foreign subsidiary. We then paired these 112 firms with an equal number of Chinese listed firms without outward FDI. The pairing sample was obtained through stratified random sampling based on firm size, industry sector, and listing location (Shanghai vs. Shenzhen) to ensure proportionality between the pairs.

We collected data of the 224 sample firms for the fiscal year 2007-2008, primarily from BvDEP's Orbis database which was supplemented by firms' annual reports. We paid special attention to potential reverse causality that could exist in this type of dataset, a possibility that ownership can be influenced by firm's outward FDI rather than the other way around. Following Douma et al. (2006), we deemed this a low possibility issue because the ownership structure of Chinese listed firms is generally stable over time, which is consistent with other Asian firms (Douma et al., 2006; La Porta et al., 1999). More specifically, the levels of institutional and foreign ownership in Chinese listed firms are considered time-invariant in the short-to-medium term (see Buckley et al., 2006; Zou and Adams, 2008), while the outward FDI by Chinese firms is reported to be a fairly recent phenomenon that started to surge from 2005 (MOFCOM, 2009; Morck et al., 2008). All evidence suggests that our data do not contain potential reverse causality problem. Nonetheless we conducted post-hoc tests to ensure the exogeneity of the ownership variables. The results, as reported later in the paper, confirmed our initial confidence in the data.

## **Dependent Variable and Estimation Model**

The dependent variable, *Outward FDI*, was a binary variable denoting the outward FDI status of a focal firm. Following prior studies, we gave the binary dependent variable a value of one if the focal firm had conducted outward FDI and zero if otherwise (see Lien et al., 2005).

Focusing on the outward FDI propensity of firms, we estimated binary logit models to examine the effects of secondary shareholder ownership and their interactions with CEO power. Binary logit regression estimates the effects of explanatory variables on the likelihood of the occurrence of a particular event (Harzing, 2002; Madhok, 1998), which in our case is the outward FDI of a Chinese listed firm.

## **Other Variables**

The two independent variables of this study are *institutional ownership* and *foreign ownership*. They are measured by the total percentage of shares owned by the respective type of shareholders among the top ten shareholders of a firm.<sup>4</sup> Our focus on the top ten shareholders is consistent with prior studies examining the corporate governance roles of secondary shareholders (e.g., Yoshikawa and Rasheed, 2010). Shareholders outside the top-ten list are unlikely to have any significant effect in PP conflicts, especially in the Chinese context, where the shares held by minority shareholders, even in the aggregate, are usually of a negligible quantity due to the high concentration of state ownership in listed firms (Zou and Adams, 2008).

Our moderating variable, *CEO power*, is a latent and multidimensional construct, and its measurement can be based on perceptual or proxy indicators (Daily and Johnson, 1997; Finkelstein, 1992). Two commonly studied dimensions of CEO power in the corporate governance literature are the structural and ownership powers of the CEO. The former is

usually measured in relation to the compensation of the CEO (Daily and Johnson, 1997), and the latter is measured by the equity ownership held by the CEO in the firm (Lambert et al., 1993). In this study, we argue that the structural power of the CEO is more relevant in the Chinese context, whereas the presence of CEO ownership power is (at most) minimal due to the fact that most Chinese listed firms are still state-owned (Firth et al., 2007; Pi and Lowe, 2011). Accordingly, we measured *CEO power* based on compensation. We followed Fahlenbrach's (2009) method to calculate the CEO's *excess* compensation, which is the difference between the actual compensation of the CEO and the average compensation of a benchmark group based on firm size and industry type. This excess amount allowed us to eliminate size and industry effects on CEO compensation and was measured in million RMB.

We also controlled for several firm characteristics and corporate governance factors. Firms in different industries may have different patterns of internationalisation (Elango and Sambharya, 2004; Yiu et al., 2007). Our sample included firms from 36 SIC two-digit industries consisting primarily of manufacturing and service industries. We used an *industry* dummy variable to divide manufacturing firms (coded one) and non-manufacturing firms (coded zero). Besides industry type, size also matters in the internationalisation of firms. Following prior studies (e.g., Chang and Rosenzweig, 2001; Kogut and Singh, 1988), we controlled for *firm size* measured by the total assets of a firm in billions RMB.<sup>5</sup> In terms of corporate governance of EE firms, PP conflicts originate from ownership concentration of controlling shareholders. We included two control variables in our model to capture the "top-dog" aspect of the PP conflicts. *Ownership concentration* was measured by the percentage of shares owned by the largest shareholder in a firm following prior corporate governance studies in the Chinese context (e.g., Firth et al., 2007; Lu et al., 2009). Apart from ownership concentration, the type of controlling shareholder also affects a firm's internationalisation

strategy (Filatotchev and Wright, 2011). In the Chinese context, the state as the controlling shareholder has been extensively studied in the corporate governance literature (Bai et al., 2004; Firth et al., 2007; Xu and Zhang, 2008). In this study, we used a dummy variable to identify the ultimate owner of a firm, where a value of one was given if the firm's ultimate owner was a *state owner* and a value of zero if otherwise (family-run, private, etc.). Lastly, we controlled for the ratio of *independent directors*, as independent directors may also perform certain monitoring and resource roles (Lu et al., 2009; Tihanyi et al., 2009), although such roles may be limited in EE firms. The ratio was calculated by dividing the number of independent directors serving on the firm's board by the total number of directors.

## **ANALYSIS AND RESULTS**

### **Descriptive Statistics**

Table 1 shows the means and standard deviations of the variables along with their Pearson correlations. The correlation matrix shows no significant large correlation between the variables. The subsequent logit regressions returned low VIFs (all below 1.10), which suggests that the multicollinearity issue was not presented. For firms that have institutional and/or foreign ownership, the mean rate of institutional ownership was 7.08 percent, while the mean rate of foreign ownership was 11.84 percent. Considering that the average ownership ratio for controlling shareholders was 35.68 percent, the ownership by the secondary shareholders is non-negligible.

[INSERT TABLE 1 ABOUT HERE]

### **Hypothesis Testing**

Five binary logit models were estimated for hypothesis testing, and their results are presented in Table 2 below. As a baseline model, Model 1 included only the control variables. As

shown in Table 2, none of the control variables were significant, and the model Chi-square was also not significant, indicating an inadequate fit of data to the model.

[INSERT TABLE 2 ABOUT HERE]

Model 2 included the control variables, independent variables, and moderating variable. This model was estimated to test the main effect hypotheses related to institutional and foreign ownership. The model Chi-square was significant, and both independent variables were positively correlated to outward FDI propensity. The correlation coefficient of institutional ownership was marginally significant ( $p < 0.10$ ). This suggests that a higher level of institutional ownership in a firm leads to a greater outward FDI propensity of the firm. Our first hypothesis was therefore supported. Likewise, the positive relationship between foreign ownership and outward FDI propensity was strongly significant ( $p < 0.05$ ). Accordingly, a higher level of foreign ownership in a firm is associated with a greater outward FDI propensity of the firm. Hypothesis 2 was also supported.

Models 3 through 5 were estimated to test the moderating hypotheses of CEO power. The independent variables and moderating variable were centred before we calculated the interaction terms. While Model 3 and Model 4 separated the moderating effects of CEO power on institutional and foreign ownership, Model 5 tested the two hypothesised moderating effects simultaneously. Among all alternative models, Model 5 yielded the best model fit, evidenced by a significant model Chi-square, a Nagelkerke R square that was much increased from the baseline model, a reduced Akaike Information Criterion (AIC), and a model classification hit-rate that was higher than those of the previous models. The interaction term of institutional ownership and CEO power had a significant negative correlation coefficient ( $p < 0.05$ ). This implies that the positive relationship between

institutional ownership and outward FDI propensity weakens as CEO power increases. Such a result supported our third hypothesis. The interaction term of foreign ownership and CEO power had a positive correlation coefficient but the correlation was statistically not significant. Therefore, hypothesis 4 was not supported.

### **Reverse Causality and Endogeneity Check**

A potential problem with our results is reverse causality. A firm's outward FDI may attract institutional and foreign investors, and therefore, the level of institutional and foreign ownership may depend on the outward FDI status of the firm, causing a reverse causality problem for our models. To test if a reverse causality problem existed in our results, we followed the method that Chen et al. (2009) used to study Chinese listed firms. We regressed institutional ownership on outward FDI status while controlling for firm size, industry, state owner, ownership concentration, independent director ratio, and CEO power. The coefficient of outward FDI status was positive but not significant ( $P=0.213$ ). We followed the same procedure to regress foreign ownership, and again a positive but not significant coefficient for outward FDI status ( $p=0.423$ ) was obtained. These results indicate that the level of secondary shareholder ownership is not influenced by outward FDI status of the firm. Accordingly, the reverse causality issue was not evident in this study.

We also addressed the potential endogeneity problems that may arise if the levels of institutional and foreign shareholder ownership are influenced by variables omitted from our models. Specifically, it can be argued that the level of secondary shareholder ownership depends on the performance of firms. This is because institutional and foreign investors are performance-driven and therefore tend to identify and invest in firms that are outstanding on performance measures. We performed the Smith-Blundell test of exogeneity (Smith and

Blundell, 1986) to examine whether our independent variables are truly exogenous. We included Return on Assets, Return on Equity, Return on Investment, Debt/Asset Ratio, and Earning per Sharing as the instruments of the suspected endogenous variables (institutional and foreign ownership). The test returned insignificant Chi-squares for both the main effect model ( $p=0.249$ ) and the moderation model ( $p=0.435$ ), suggesting a lack of evidence of endogeneity. This result is in line with prior studies that used endogeneity tests when studying the ownership structure of Chinese listed firms (see Ding et al., 2007; Tian and Estrin, 2008).

### **Robustness Test**

We tested the robustness of our models using a split-sample double cross-validation method. Such a method is appropriate when collecting a new dataset for validation is not practical (Snee, 1977). We randomly divided our sample into two subsets of 112 firms, each with an equal number of FDI and non-FDI cases. We estimated our main effect model (Model 2) and moderation model (Model 5) on both subsamples, cross-validated the models based on model classification hit-rates, and compared the parameters of main variables and variable interactions between two subsamples. The results of these robustness tests are reported in Table 3. The cross-validation results show that there were only slight changes between within-sample and out-of-sample classification hit-rates for both the main effect and moderation models. The parameter estimates were also generally stable across two subsamples as Z-score tests returned insignificant results.

[INSERT TABLE 3 ABOUT HERE]

## **DISCUSSION**

The synergy between corporate governance and internationalisation strategy research is evident from recent studies of firms from developed or newly industrialised economies (Filatotchev et al., 2007; Strange et al., 2009b; Tihanyi et al., 2003). Our study contributes to the literature by extending this line of research into the EE context, which provides new insights into the outward FDI strategies of EE firms. In the examination of corporate governance factors, particularly the ownership structure in relation to outward FDI of EE firms, this study also contributes to the literature by revealing the effects of secondary shareholder ownership and their interactions with CEO power as a consequence of PP conflicts. Although the governance effect of controlling shareholders has been the central issue to emerge from the PP perspective (Yoshikawa and Rasheed, 2010; Young et al., 2008), we argue that secondary shareholders deserve more attention when EE firms enter into foreign institutional environments, where the controlling shareholders may become less legitimate and effective than they are at home.

The empirical tests of this study provide evidence that despite being “underdogs” compared to controlling shareholders, secondary shareholders are active and effective governance forces that positively affect the outward FDI propensity of firms. We found support for our hypotheses that the levels of institutional and foreign ownership in an EE firm are positively associated with the outward FDI propensity of the firm (Hypothesis 1 and 2). The positive effects can be explained by both the monitoring and resource roles of secondary shareholders. From the monitoring perspective, secondary shareholders promote effective governance and enhance economic efficiency of the firm (Dharwadkar et al., 2000; Fama and Jensen, 1983; Shleifer and Vishny, 1997). By performing their governance roles, secondary shareholders influence firms’ strategic decisions to achieve a strategic fit between the firm and themselves.

In relation to outward FDI, both institutional and foreign shareholders are likely to support this strategic move due to their risk preferences, long-term investment orientations, and strategic motivations for investing in EE firms. From the resource aspect, firm strategy depends on the resource endowment of the firm (Andersen and Suat Kheam, 1998; Wernerfelt, 1995). EE firms are constrained by resource deficiencies or disadvantages, especially when they internationalise through outward FDI, which demands high levels of resource commitment. Therefore, the resources contributed by institutional and foreign shareholders are of critical importance for the outward FDI of firms. Such critical resources include financial capital, technological know-how, managerial know-how, and foreign market intelligence.

We also tested the potentially moderating effects of CEO power and found partial support for our hypotheses. In support of Hypothesis 3, we found that the relationship between institutional investors and outward FDI propensity weakens when CEO power increases. This is consistent with the AT argument that a high level of CEO power often leads to weak governance mechanisms for the firm (Bebchuk and Fried, 2004), which are a barrier to effective monitoring by institutional shareholders. The hindrance of the monitoring effect triggers a loss of confidence for institutional shareholders to contribute resources, further weakening the positive effect of institutional ownership on outward FDI propensity. By contrast, we did not find support for the hypothesised moderating effect of CEO power on the relationship between foreign ownership and outward FDI propensity (Hypothesis 4). A possible explanation is that despite the diminished monitoring role as a result of high CEO power, the resource role of foreign shareholders may not be significantly affected, considering the type of resources contributed by foreign shareholders. The resource contributions by foreign shareholders are mainly intangible and are realised through know-

how and knowledge transfer. The transfer of tacit know-how and sophisticated knowledge is usually internalised to reduce transaction costs; such a transfer requires collaboration between the transferor and the recipient. Kachra and White (2008) suggest that the transfer of know-how is highly dependent upon reciprocity arrangements between organisations. Therefore, even with the decrease in monitoring caused by powerful CEOs, foreign shareholders can still exercise effective control over their resources through internalisation. With the resource role largely unaffected, the moderating effect of CEO power in relation to foreign ownership remains insignificant.

### **Theoretical Contributions**

This study contributes to the research of internationalisation strategies of EE firms. Strange et al. point out that “corporate governance mechanisms can enrich insights into international business” (2009, p. 238). Following this notion, we draw on corporate governance and internationalisation strategy literature and attempt to reveal the effects of corporate governance factors in EE firms’ outward FDI. Our findings indicate that corporate governance is an important missing piece of the theoretical framework of EE firms’ internationalisation strategies. Peng et al. (2008) propose a “strategic tripod” model that integrates resource, industry, and institutional variables as the determinants of internationalisation strategies of EE firms. This model focuses on *the firm* as the unit of analysis and on its interaction with its industrial and institutional environment. Our study suggests that treating *the firm* as a unified strategic entity may be inadequate. Different shareholders within a firm can act as separate strategic units, and they may have different strategic objectives manifested in PP conflicts. Such conflicts can influence the ultimate strategic choice of the firm. Besides ownership structure, it is also important to consider other corporate governance factors within *the firm*, such as the role of the board of directors and the

power of CEO, when studying the internationalisation strategies of EE firms. The second theoretical contribution of this study is the strengthening of the position of corporate governance in the theoretical framework of an EE firm's internationalisation strategy. Corporate governance factors do not function independently; rather, they interact with the institutional environment and firms' strategic determinants (Aggarwal et al., 2005; Gomez-Mejia et al., 2010). Therefore, the legitimacy and effect of a certain governance structure (e.g., ownership concentration by controlling shareholders) may vary if the institutional environment of the firm changes. This interaction is of special importance to internationalisation research because in an international context, firms usually need to deal with institutional environments different from those of home. Consequently, governance forces within a firm may play different roles as the firm moves across national borders.

### **Practical Implications**

Our study offers important practical implications to shareholders and policy makers. First, for secondary shareholders, making internationalisation decisions often involves a large investment. Thus, the most effective way to protect and maximise their returns is through active participation in firms' decision-making. This means that secondary shareholders should not only provide needed resources to EE firms for their international expansion but also become 'activist' shareholders to safeguard their interests by performing their monitoring role. In fact, the monitoring and resource roles of secondary shareholders are interdependent. Second, controlling shareholders should recognise and appreciate the contributions that the secondary shareholders can bring to the firm. Controlling shareholders are reluctant to engage in outward FDI, usually because of their lack of capabilities (Bhaumik et al., 2010; Lien et al., 2005) and not for lack of desire to grow internationally (Luo et al., 2010). By better aligning the interests of the secondary shareholders to that of the firm and

maximising their contributions, controlling shareholders can achieve strategic outcomes that would be impossible if relying on their own capabilities alone. For example, controlling shareholders and institutional shareholders may share the desire of international diversification; investing overseas also fits with foreign shareholders' market-seeking and efficiency-seeking motives. Controlling shareholders can take initiatives to reduce conflicts and promote synergy among shareholders by appointing unaffiliated CEOs, especially those with multinational management experience, and by engaging in open and transparent dialogues with other shareholders to reduce information asymmetry and alleviate potential PP conflicts. Lastly, when policy makers in emerging economies are making efforts to improve their weak external governance mechanisms, they should also encourage investment by secondary shareholders to improve the corporate governance standard of domestic firms. To achieve this, policy makers should foster good corporate governance systems within their financial institutions and reduce entry barriers or ownership constraints for foreign investors. By doing so, emerging economies can develop a vibrant business environment and enhance the international competitiveness of their firms.

### **Limitations and Future Research**

We acknowledge the limitations in this study, which also suggest avenues for further research. First, shareholders are heterogeneous. In this study, we define institutional and foreign shareholders as secondary shareholders. Our categorisation is limited in the sense that we assume that foreign institutional shareholders combine the characteristics of the two secondary shareholders and do not form a distinctive group. In addition, we do not differentiate different types of institutional shareholders in our analysis. We argue that this simplification is appropriate in this study, given the minimum presence of foreign institutional shareholders in our sample and the Chinese context, for which the institutional

shareholders are not nearly as diverse as their counterparts in developed countries. However, in the Taiwanese context, research has found a significant impact of foreign institutional ownership on firms' outward FDI (Filatotchev et al., 2007). In a developed economy context (US), Tihanyi et al. (2003) argue that different types of institutional investors (i.e., professional investment funds vs. pension funds) may lead to different internationalisation strategies. As emerging economies gradually release their restrictions on foreign investors, including foreign institutional investors, and as their domestic institutional investors diversify, future research should differentiate these secondary shareholders and investigate their distinct governance effects in EE firms.

Second, limitations in our measure of CEO power needs to be discussed. Finkelstein's (1992) seminal work reveals four dimensions of executive power. However, the proposed measures of this construct have yet to be well-consolidated in the literature (Daily and Johnson, 1997). In this study we measure CEO power by the *excess pay* of the CEO in comparison to the benchmark group, which only captures the structural dimension of CEO power.<sup>6</sup> Such a measure may not be replicable in other research settings where CEO power is reflected in multiple dimensions (Adams et al., 2005; Daily and Johnson, 1997). Future research should conduct a more in-depth examination of executive power. Researchers need to take into consideration the different power dynamics among CEOs, controlling shareholders, and secondary shareholders in various institutional contexts. Such an effort may result in significant methodological and theoretical contributions to corporate governance literature.

Following the direction of this study, a number of related research topics can be pursued in future research. Outward FDI strategies involve a range of strategic issues from timing, location choice, entry mode choice, and partner selection to strategic management and value

creation. While we focus on outward FDI propensity as the outcome, future research can investigate the impacts of corporate governance factors on other aspects of outward FDI strategies. Additionally, a board of directors often makes strategic decisions regarding a firm's business development. Accordingly, board characteristics, such as board composition, independence, vigilance, and diversity may have important influence over outward FDI strategies. Finally, differences in corporate governance practices between home and host countries may complicate a firm's outward FDI decisions and activities. Governance mechanisms that can reduce such complexity will be especially beneficial to firms. These different corporate governance factors and their interactions with the external institutional environment warrant future research to provide new insights to internationalisation strategy research.

## NOTES

<sup>1</sup>For example, for a Chinese firm to justify the use of state assets and governmental funding, it must provide extensive paperwork and seek approvals from multiple government organisations (Deng, 2004; Luo et al., 2010). Valuable investment opportunities can be lost due to the extensive delay in the bureaucratic process (Cui and Jiang, 2010).

<sup>2</sup>The World Investment Report 2006 declares that market-seeking is by far the most prevalent motive for EE firms to conduct outward FDI (UNCTAD, 2006). Research also suggests that a large proportion of EE outward investment is directed to neighbouring emerging markets or least-developed economies where EE firms have a relative competitive advantage (Cuervo-Cazurra and Genc, 2008; Rugman and Li, 2007).

<sup>3</sup>BvDEP's Orbis database provides rich firm-level information, especially for publicly listed firms (Bhaumik et al., 2010).

<sup>4</sup>In total, 16 firms have foreign institutional shareholders in their top 10 shareholder lists. By definition, the shares owned by foreign institutional shareholders are counted in both institutional ownership and foreign ownership.

<sup>5</sup>The numbers were not log-transformed because normal distribution is not a prerequisite for the estimation of logit models.

<sup>6</sup>There are also other alternative measures for CEO structural power used in prior studies, such as *CEO-Chairman Duality* and *Top Managers Pay Gap*. We estimated additional models using these alternative measures of CEO power and obtained results similar to those of the original model.

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**Table 1: Pearson correlations and descriptive statistics**

	1	2	3	4	5	6	7	8	9
1. <i>Outward FDI</i>	1.00								
2. <i>Institutional ownership</i>	0.14*	1.00							
3. <i>Foreign ownership</i>	0.18**	0.07	1.00						
4. <i>CEO power</i>	0.06	-0.03	0.02	1.00					
5. <i>Industry</i>	0.05	0.05	0.10	0.13	1.00				
6. <i>Firm size</i>	-0.03	0.07	0.01	0.12	-0.16*	1.00			
7. <i>State owner</i>	-0.07	-0.00	-0.14*	-0.06	-0.13	0.12	1.00		
8. <i>Ownership concentration</i>	-0.09	-0.03	-0.01	-0.05	0.00	-0.01	0.19**	1.00	
9. <i>Independent directors</i>	0.05	0.10	-0.01	0.00	0.06	0.02	0.04	0.04	1.00
Mean	0.50	5.19 <sup>a</sup>	1.85 <sup>b</sup>	0.14	0.69	19.51	0.62	35.68	0.36
Standard Deviation	0.50	6.10	7.03	3.61	0.46	96.99	0.49	15.84	0.06

\* P<0.05, \*\* P<0.01 (2-tailed). N=224.

a. 164 of the total 224 firms have institutional ownership, averaged at 7.08%

b. 35 of the total 224 firms have foreign ownership, averaged at 11.84%

**Table 2: Estimation results of binary logit models (DV: 1=Outward FDI)**

	Model 1	Model 2	Model 3	Model 4	Model 5
<i>Constant</i>	-0.28	-0.43	-0.54	-0.34	-0.47
<b><i>Control Variables</i></b>					
<i>Industry</i>	0.15	0.08	0.03	0.01	0.02
<i>Firm size</i>	-0.00	-0.00	-0.00	-0.00	-0.00
<i>State owner</i>	-0.22	-0.12	-0.09	-0.13	-0.11
<i>Ownership concentration</i>	-0.01	-0.01	-0.01	-0.01	-0.01
<i>Independent directors</i>	1.97	1.59	1.58	1.37	1.32
<b><i>Independent Variables</i></b>					
<i>Institutional ownership</i>		0.04†	0.05*	0.05†	0.05*
<i>Foreign ownership</i>		0.07*	0.07†	0.06†	0.06†
<b><i>Moderator</i></b>					
<i>CEO power</i>		0.04	0.31†	0.02	0.51*
<b><i>Interaction Terms</i></b>					
<i>Institutional ownership x CEO power</i>			-0.69†		-1.21*
<i>Foreign ownership x CEO power</i>				1.32	3.01
<b><i>Model Chi-square</i></b>	3.823	15.724*	19.985*	18.315*	27.941**
<b><i>Nagelkerke R square</i></b>	0.023	0.090	0.114	0.105	0.140
<b><i>AIC</i></b>	1.423	1.396	1.386	1.394	1.373
<b><i>Classification hit-rate</i></b>	55.80%	62.50%	62.50%	58.93%	62.95%

† p<0.10, \* p<0.05, \*\* p<0.01, \*\*\* p<0.001. N=224

**Table 3: Cross-validation robustness tests**

	Sample A (n=112)	Sample B (n=112)	Z-score test
<b>Main effect model (Model 2)</b>			
<i>Measure of fit</i>			
<i>Within-sample classification hit-rate</i>	61.61%	64.29%	n/a
<i>Out-of-sample classification hit-rate</i>	59.82%	60.71%	n/a
<i>Classification hit-rate shrinkage</i>	1.79%	3.58%	n/a
<i>Parameter estimates</i>			
<i>Institutional ownership</i>	0.043 (0.036)	0.049 (0.034)	0.121
<i>Foreign ownership</i>	0.067 (0.040)	0.106 (0.091)	0.189
<b>Moderation model (Model 5)</b>			
<i>Measure of fit</i>			
<i>Within-sample classification hit-rate</i>	64.29%	63.39%	n/a
<i>Out-of-sample classification hit-rate</i>	62.50%	58.04%	n/a
<i>Classification hit-rate shrinkage</i>	1.79%	5.35%	n/a
<i>Parameter estimates</i>			
<i>Institutional ownership</i>	0.023 (0.040)	0.034 (0.050)	-0.279
<i>Foreign ownership</i>	0.126 (0.063)	0.159 (0.107)	0.324
<i>CEO power</i>	1.226 (0.621)	2.861 (1.118)	0.197
<i>Institutional ownership x CEO power</i>	-0.336 (0.238)	0.517 (0.704)	-0.657
<i>Foreign ownership x CEO power</i>	1.263 (0.731)	-1.322 (2.464)	0.190

† p<0.10, \* p<0.05, \*\* p<0.01, \*\*\* p<0.001