ESSAYS ON FIRM ACQUISITIONS IN CHINA: PROVINCIAL DISPARITIES, TRADE BARRIERS AND FIRM OWNERSHIP

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ENGLISH SUMMARY

This doctoral research builds around the question *how do firms in China grow through acquisitions?* It is motivated by a schism between strategy research investigating firm growth in transitioning China, and the business reality of Chinese firms. On the one hand, prior studies on firm growth in China question the viability of domestic acquisitions due to pervasive institutional voids and lack of managerial skills. On the other hand, evidence suggests that Chinese firms are growth-oriented and many of them prioritize domestic acquisition growth. This thesis, therefore, aims to address this discrepancy by exploring firm acquisitions in China from a specific view of institutional heterogeneity comprising provincial disparities, trade barriers and uneven playing field for firms of different ownership types.

The dissertation consists of four research papers. The first paper explores the role of human and financial resources in a firm’s decision to acquire a target located in its home province or in another province. Drawing on the resource-based view, the key findings of this paper are that private firms drive cross-province acquisitions, and that they, compared to state-owned firms, have a much stronger propensity to do so when having financial and, especially, human resources.

The second study focuses on provincial boundaries of product diversification. The state activism lenses adopted for this study help to uncover that firms with political connections or owned by provincial government tend to conduct unrelated diversification within their home province, and even more so when it is low developed, than when acquiring a target in another province. This finding suggests that transaction costs of operating outside of home province might not be the most detrimental factor inhibiting nation-wide firm growth in China.

The third paper studies a, novel to strategy research, dimension of the political environment in China – cross-province rotations of government officials – as a factor impacting the intensity of cross-province acquisitions. Following the institutional voids and social capital literatures, the
article demonstrates that political rotations instigate cross-province acquisitions between two provinces involved in that political rotation. This factor is especially important for private firms, which are located in lower developed provinces and acquiring targets in higher developed provinces.

Finally, the fourth paper explores the relationship between domestic and cross-border acquisitions of private firms, demonstrating the potential of linking research on domestic firm growth in China with research on firm internationalization. Specifically, from the perspective of organizational learning, the paper conceptualizes and empirically tests an S-curved relationship between domestic and cross-border acquisitions also demonstrating that within- and cross-province acquisitions have different effects on cross-border acquisitions. Furthermore, the findings show that paths to internationalization are different for firms located in coastal and inland China respectively.

The findings of these papers are important both separately, each fulfilling their own respective goals, and together, allowing to generate a cumulative understanding of the impact of institutional heterogeneity on firm growth strategies in China. The findings are relevant for strategy studies in emerging markets, business practitioners aiming to expand in China and Chinese policy-makers.
DANSK RESUMÉ


Afhandlingen består af fire forskningsartikler. Den første artikel undersøger betydningen af humane og finansielle ressourcer for et firmas beslutning om at opkøbe firmaer i henholdsvis hjemregion og fremmede regioner. Trækkende på resource-baseret teori er de vigtigste resultater, at det er private firmaer, der driver opkøb på tværs af regioner. Endvidere er det private firmaer der, i sammenligning med statsejede, foretager opkøb, når og hvis de besidder de adækvate finansielle og (især) humane ressourcer.

Den anden artikel fokuserer på regionale barrierer og diversificering. Den benyttede teori om statslig intervention hjælper med at afdække hvordan firmaer med politiske forbindelser eller politisk ejerskab tenderer at foretage flere ikke-relaterede opkøb i deres hjemmeregion set i forhold til deres opkøb i fremmede regioner. Denne tendens er stærkere for firmaer fra lavt udviklede regioner. Dette indikerer, at transaktionsomkostningerne ved at operere udenfor hjemlige regioner måske ikke er den største forhindring for landsomfattende firmaekspansion i Kina.

Den tredje artikel studerer en ny dimension i strategiforskning, nemlig hvordan rotationer af politiske beslutningstagere fra en region til en anden influerer på opkøb på tværs af de samme
kinesiske regioner. Med udgangspunkt i litteraturen omkring institutionel underudvikling og social kapital viser artiklen, hvordan politiske rotationer leder til opkøb mellem de provinser som politikerne roterer mellem. Denne faktor er specielt fremtrædende for privatejede firmaer, som er lokaliserede i lavt udviklede provinser og som har opkøbsmål i højere udviklede provinser.


Resultaterne af disse artikler er vigtige både hver for sig, hvor de opfylder individuelle målsætninger, såvel som samlet. Samlet set gør artiklerne det muligt at skabe en overordnet forståelse af hvordan institutionel forskellighed influerer på firmaers vækststrategier i Kina. Resultaterne er relevante for strategiforskning i ”emerging markets”, forretningsfolk der ønsker at udvide i Kina og kinesiske beslutningstagere.
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CHAPTER 1. Introduction

The introduction to this dissertation consists of several sections. First, the motivation for the research question will be presented, followed by the description of the institutional context in China, which is central to this doctoral research. Then, the overview of the data sources and summary of the four research papers with key findings will be provided. The introduction will proceed with the discussion of the combined findings of each paper, and demonstrate how they expand our understanding of the effect of institutional heterogeneity on firm growth strategy in China. Next, specific contributions of this doctoral research for theory and practice will be presented, followed by the suggestions for future studies and the discussion of the limitations of the current research. This section of the dissertation will end with a short conclusion.

Research question

In what became a seminal paper in strategic management studies focusing on emerging markets, Peng and Heath (1996) discuss three modes of firm growth: organic, acquisition and network. They combine the influential transaction cost theory (Williamson, 1975) and resource-based view (Penrose, 1959), and theoretically and empirically demonstrate that acquisition growth in emerging markets like China is not viable (Peng, 1997; Peng & Heath, 1996). Following transaction costs perspective, they argue that weak factor markets and institutional voids in general considerably raise the costs of conducting complex deals such as acquisitions through the market. In addition to this, in line with resource-based view, the prevalence of the state in the economy results in the lack of managerial skills and independent decision-making of Chinese firms questioning their ability and motivation to conduct firm acquisitions. Together, these factors do not create the right “preconditions” for acquisition growth in China (Peng & Heath, 1996). For almost two decades, this conclusion and line of reasoning have essentially set the tone for the development of research on
firm growth strategy in emerging markets, with China remaining in the spotlight. Specifically, first, it arguably shifted the focus away from domestic firm growth onto Chinese firms’ internationalization. Extending this point, second, it has led empirical research in business and management to assume homogeneity of the institutional context in China (e.g., Lin, Peng, Yang, & Sun, 2009; Luo & Wang, 2012; Olson, Bao, & Parayitam, 2007).

With the passing of time, diverse evidence started to appear drawing a picture incompatible with the one presented above. For example, Tang and Metwalli (2012) estimated that between 2000 and 2010 over 90 percent of all acquisitions initiated by Chinese firms were domestic. Furthermore, two case studies provided a detailed account of the institutional and business reasons behind firms’ expansion across provinces (Meyer & Lu, 2004; Wei, Li, & Wang, 2007); and another study revealed that Chinese managers considered the domestic market to be key for firm growth (Liu, Xiao, & Huang, 2008). These findings compel to wonder what enables Chinese firms to conduct firm acquisitions in the absence of the right “preconditions”. Indeed, the poor understanding of domestic acquisition growth in China has recently started to be acknowledged by mainstream strategy scholars, too (Peng, 2012; Lebedev, Peng, Xie, & Stevens, 2014). Hence, domestic acquisitions of Chinese firms constitute a sizeable gap in strategy research in the context of emerging markets.

At the same time, research, mainly developed at the intersection of economics, political science and sociology, has challenged assumptions of institutional homogeneity in China. Among other things, these studies have shown that the role of the government guiding the transition from planned to market economy varies dramatically across Chinese provinces, constraining the creation of an integrated domestic market, and resulting in significant provincial disparities (Fligstein & Zhang, 2010; Howell, 2006; Krug & Hendrischke, 2008; Peck & Zhang, 2013; Zhang & Peck, 2014). It means that considering institutions as “underdeveloped” to the same extent across all Chinese
provinces is shortsighted. Research in business and management has, however, only very recently started to integrate this scholarship in firm strategy studies (e.g., Hong, Wang, & Kafouros, 2014; Liu, Lu, & Chizema, 2014; Shi, Sun, & Peng, 2012; Wu & Chen, 2014). Notwithstanding this recent development, such studies do not account for the complex interrelationships existing between the characteristics of institutional heterogeneity that may influence firm strategy differently. Addressing the interrelationships between the characteristics – or pillars – of institutional heterogeneity, therefore, represents another important gap in strategy studies of firms in emerging markets.

Integrating these two research gaps, the purpose of this doctoral study is to examine the impact of the pillars of institutional heterogeneity in China on local firms’ acquisition growth strategy. The umbrella research question is, thus:

*How do firms in China pursue acquisition growth?*

To investigate this, I draw from different theoretical perspectives such as institutional theory (North, 1990), resource-based view (Barney, 1995), social capital (Park & Luo, 2001), and organizational learning (Levitt & March, 1988; Zahra & George, 2002) and conduct four separate studies with the following research questions:

**Paper 1:** What kinds of firm resources increase chances of acquiring a target firm located outside of home province?

**Paper 2:** When do firms engage in unrelated diversification?

**Paper 3:** How do cross-province political rotations affect the intensity of cross-province acquisitions?

**Paper 4:** What is the relationship between domestic acquisitions of Chinese firms and their cross-border acquisitions?
Each of these questions hinges upon institutional heterogeneity in China. This concept refers to the difference in institutions – which are formal and informal “constraints that shape human interaction” – that exists among a) Chinese provinces due to provincial disparities and provincial trade barriers and b) firms of different ownership type in the sense that institutions propped up by the Chinese government create uneven playing field for state-owned (SOE) and privately-owned (POE) enterprises (North, 1990). The concept of “institutional heterogeneity” should not be mistaken for “institutional complexity” within the institutional logics approach (Greenwood, Diaz, Li, & Lorente, 2010). Institutional complexity implies that a firm’s behavior can be shaped by various institutional logics simultaneously, which are, similarly to institutions, defined as “the formal and informal rules of action, interaction, and interpretation that guide and constrain decision makers”, such as the logic of the state or the corporation (Thornton & Ocasio, 1999). In simplistic terms, for example, the institutional complexity of the US law firms whose behavior is shaped by market, professional and family logics is likely to be higher than that of firms in the US higher education publishing industry concerned with, predominantly, market pressures (adapted from Greenwood, Diaz, Li, & Lorente, 2010: 2). To establish the relationship between the two concepts, institutional heterogeneity in China means that firms of different ownership types and located in different provinces are likely to experience different levels of institutional complexity, which results in different firm strategies being implemented.

Another important point is that institutional heterogeneity among provinces and firms of different ownership types suggests heterogeneously distributed institutional voids which are the lack of market-supporting institutions, such as market intermediaries, as well as norms and regulations needed for a well functioning economy (Khanna & Palepu, 1997; North, 1990). Specifically, in China it means that institutional infrastructure in some provinces and for firms of some ownership types is more or less advanced compared to the others. The selection of the three
pillars of institutional heterogeneity in China – provincial disparities, trade barriers and uneven playing field for firms of different ownership types – is based on the analysis of the existing literature and by no means is an attempt at devising a comprehensive taxonomy of institutions and their characteristics shaping strategies of Chinese firms. The detailed description of the pillars is presented in the next section.

The pillars of institutional heterogeneity in China

Provincial disparities

Multiple studies confirm high levels of provincial disparities in China. This is attributable, firstly, to fundamental differences between provinces related to geography and natural resources endowment, isolating provinces from one another and sustaining their tendency to self-sufficiency (Boisot & Meyer, 2008; Demurger, Sachs, Woo, Bao, Chang, & Mellinger, 2002; Xu, 2011). This is also reflected in the regionally decentralized system of governance with highly centralized political and personnel controls at the national level, and decentralization of economic and administrative controls at provincial levels (Xu, 2011). It means that decision-making over economic matters largely lies within provinces. And, in general, local (provincial) governments enjoy high regulatory autonomy as long as the promulgated laws and regulations do not contravene those of the central government.

Regulatory differences between provinces have been exacerbated further with the reforms of 1978 when China started to gradually transform its socialist economy. A policy of “opening up” its coastal provinces to foreign direct investment (FDI) was one of the key measures. The idea behind choosing such unbalanced growth was that investments in coastal provinces would trickle down to inland provinces gradually pulling the rest of the economy up. This resulted in a dramatic difference of FDI into coastal and inland provinces, in the mid-1990s reaching the ratio of 90 to 10 percent.
(Cheung & Lin, 2004). Although since the 1990s various national programs have been introduced to reduce the development gap between inland and coastal provinces through encouraging investment in Central and West China, a significant difference still persists (Chen & Groenewold, 2012).

Hence, provincial disparities in China are two-fold. The first one is due to self-sufficient tendencies and relative developmental isolation of provinces from one another; and second is related to policies that stimulated unequal economic growth, especially between coastal and inland provinces.

**Trade barriers**

Another governance choice that preserves institutional heterogeneity is fiscal federalism regime. This system, which was formally established in 1994, implies that lower-tiered government must hand over a significant proportion of its income to the higher-tiered government thereby stripping the former off its revenue (Liu, Song, & Tao, 2006). At the same time, the central government sends various targets down to the local government such as annual growth and social security, which often come underfunded (Bergsten, Freeman, Lardy, & Mitchell, 2008; Liu, Song, & Tao, 2006). Hence, the local government is highly motivated to increase its tax base to fund the majority of local policies. Therefore, local governments are particularly interested in protecting local firms from undue competition and to instigate their growth. This is partly achieved through outright discrimination of firms from other provinces and thwarting acquisitions of local firms by outsiders out of fear of losing control over the targeted firms (Eberhardt, Wang, & Yu, 2013; Young 2000). The control over firms is important not only from a tax collection perspective but, not least importantly, as a way to achieve the “social” part of the central government’s targets such as keeping low unemployment rates in the jurisdiction (Bai, Lu, & Tao, 2006; Walder, 1995).

Career promotion is another important institution that fuels provincial trade barriers. Specifically, social and, particularly, economic development of the province is key in the evaluation
of provincial leaders (Jia, Kudamatsu, & Seim, 2013; Li & Zhou, 2005). Hence, the better the social
and economic indicators political leaders gain relatively to those in other provinces, the higher their
chances of promotion.

Fiscal federalism regime and career promotion considerations are the two factors of trade
barriers between provinces, which became a very salient feature of Chinese economic reality
making the difficulty of cross-province investment a widely recognized problem (Meyer & Lu,
2004).

Uneven playing field for firms of different ownership type

In China, SOEs, divided into those owned by the central (SOECGs) and local (SOELGs)
government, and POEs face very different institutional pressures creating an uneven playing field in
terms of strategies they can pursue. Since the government exerts direct control over SOEs, the key
institutional pressure on SOECGs is to conform to the national economic strategies rolled out by the
central government, whereas that of SOELGs is to fulfill the goals of the local government. Firms
of these two ownership types enjoy soft budget constraints, can expect to be bailed out by the
overseeing government, and must meet various social goals in line with the ones mentioned above.
Historically, both SOE types have been quite risk-averse, with globalization, however, things have
started to change. Entering direct competition with foreign firms, SOECGs became the bearers of
“the reputation of Chinese economic reform” where top management was selected carefully based
on their ability (Chi, Sun, & Young: 2011, 166; Peng & Heath, 1996). Moreover, consolidation and
restructuring SOECGs in the 1990s resulted in their relative financial health (Chen, Firth, & Xu
2009; Cheung 2005). In contrast, with values of “the moral and political integrity” remaining the
key performance criteria, weaker supervision and inferior management skills of the top
management, SOELGs did not achieve a similarly noticeable transformation (Chang, 2008; Yang &
Modell: 2013: 111; Yiu, Bruton, & Lu, 2005).
Institutional pressure on POEs is radically different. Moving away from the state-led socialist market, POEs became legally recognized only in the mid-1990s. However, since the government remains largely in control of the financial system, information and market opportunities in general, POEs do not enjoy unrestricted access to resources and are often discriminated against, particularly in the access to the capital market (Chen, Sun, Tang, & Wu, 2011; Ju & Zhao 2009). Furthermore, since property rights are not well protected and because law enforcement is relatively poor, POEs operate under a constant threat of confiscation (Chen et al., 2011; Feng & Wang, 2009). In light of this, it has even been proposed in literature that Chinese POEs might be more active in cross-border than cross-province acquisitions to avoid competition disadvantages in the domestic market (Boisot & Meyer, 2008; Luo & Tung, 2007). Overall, POEs have adapted to this environment by gaining more with fewer resources and seeking any possible opportunity to reduce costs of their operations (Feng & Wang, 2010; Peng, 2001).

So, the key difference between SOEs and POEs in the context of Chinese state capitalism is that state ownership helps achieve institutional support such as interpreting regulations, enforcing contracts, overcoming entry barriers, and gaining access to labor, key materials and finances, whereas POEs do not have direct access to any of this (Wang, Hong, Kafouros, & Boateng, 2012). At the same time, SOECGs and SOELGs have very different interests: the former are risk-taking, modern enterprises competing with foreign and POE firms domestically and internationally, whereas the latter are relatively inward-looking concerned with creating a steady revenue stream within the home province.

These three pillars provide a comprehensive account of the heterogeneity of the institutional context in China. They determine the choice of the three corresponding proxy variables structuring the thesis and embroidered in each of the four research papers. The relationship between institutional heterogeneity and measures used in the thesis is displayed in Figure 1:
Figure 1. The relationship between the concept of institutional heterogeneity and measurements used in the thesis; * It is captured by NERI index of marketization, more on which see in the next section “Overview of the data”

Including these three variables in each paper helps align their individual contributions with the umbrella research question. Also, this allows exploring relative significance of these variables and their interrelationships as factors of Chinese firms’ acquisition strategy. To better understand the structure of the papers please see Table 1 overleaf.

Overview of the data

Four separate datasets based on secondary data were created for each of the four papers. This was necessitated mainly by the difference in variables used in the four papers and the data availability for some variables. Some sources provided data for all papers, some, however, were used for certain papers only (to see source-paper match please see Table 2). The ZEPHYR database produced by Bureau van Dijk and CSMAR produced by GTA Information Technology Co. Ltd. and the China Accounting and Finance Research Center was key to obtaining information on firm acquisitions. ZEPHYR is a database used in acquisition studies mainly in the context of Europe, but also recently
Table 1. The structure of the research papers

<table>
<thead>
<tr>
<th>Variables:</th>
<th>PAPER 1</th>
<th>PAPER 2</th>
<th>PAPER 3</th>
<th>PAPER 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Explanatory</td>
<td>Financial resource (firm slack)</td>
<td>Ownership (SOECG, SOELG, POE)</td>
<td>Cross-province rotation of political officials</td>
<td>Domestic acquisition experience (within-province or cross-province)</td>
</tr>
<tr>
<td></td>
<td>Human resource (CEO experience outside of home province)</td>
<td>Degree of an acquiring firm’s provincial development</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Managerial political connections</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Moderating</td>
<td>Ownership (SOECG, SOELG, POE)</td>
<td>Cross-province or within-province acquisition</td>
<td>Ownership (SOE, POE)</td>
<td>The location of an acquiring firm (coastal/inland)</td>
</tr>
<tr>
<td></td>
<td>The location of an acquiring firm (coastal/inland China)</td>
<td></td>
<td>The difference in the degree of institutional development between provinces of acquiring and target firms</td>
<td></td>
</tr>
<tr>
<td>Dependent</td>
<td>Cross-province or within-province acquisition</td>
<td>Degree of relatedness of a focal acquisition</td>
<td>The firm’s acquisition intensity in a focal province</td>
<td>The choice of a cross-border acquisition</td>
</tr>
</tbody>
</table>

of China (e.g., Chen & Ghauri, 2010), whereas CSMAR is key to management studies of Chinese firms. I used ZEPHYR as a primary source of information on firm acquisitions; the information was later cross-verified and extended by CSMAR. I included several restrictions on the sample. First, all acquiring firms are listed on the Shanghai and Shenzhen stock exchanges, because firm-level information on unlisted Chinese firms is unobtainable. Second, I included only deals involving the majority ownership rights transfer, i.e. the final stake in a target firm is equal or above 51 percent. Third, all acquisitions must be completed at the time of the data collection. I selected 2002 as the
starting year for building the datasets due to the fact that detailed information on Chinese firms prior to 2002 is difficult to obtain.

The firm-level data mainly comes from the CSMAR database. In addition I used the ORBIS database also produced by Bureau van Dijk, for example, to create a variable on business group affiliation of an acquiring firm. I consulted firm annual reports obtained from the Shanghai and Shenzhen stock exchanges and corporate websites when information in the databases was missing. For province-level statistical data, such as gross regional product, market growth or the number of foreign firms, I used statistical yearbooks covering 1996 to 2014; these are produced by the National Statistical Bureau of China, which is a government agency under the State Council.

The source of information on the institutional development of provinces used in this research is the marketization index of Chinese provinces produced by the National Economic Research Institute in Beijing operating under the auspices of the Ministry of Planning and Investment. The index is a composite of five sub-indices: (1) the relationship between government and market, (2) the development of a non-state economy, (3) the level of product market development, (4) the level of the essential factor market development, and (5) the development of market intermediate organization and the legal system environment (Fan, Wang, & Zhu, 2011). It is widely used in recent China business studies as a proxy for institutional development of Chinese provinces (e.g., Li & Qian, 2013; Liu, Lu, & Chizema, 2014). The last year available for this index is 2009, so a damped-trend exponential smoothing technique was applied to produce values from 2010 to 2014.

An additional data source for Paper 3 was the China Vitae online database on Chinese leaders, which includes detailed biographies of provincial party secretaries and governors. Finally, since Paper 4 links domestic acquisitions and firm internationalization, I obtained information on firm acquisitions from Thomson Reuters’ SDC Platinum, which is a well-recognized database in international business literature.
Table 2. Data sources used in the papers

<table>
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<th>Data sources</th>
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<th>PAPER 2</th>
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<td>ZEPHYR</td>
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<td>ORBIS</td>
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<td>CSMAR</td>
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<td>Statistical yearbooks</td>
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<td>NERI index of marketization</td>
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<td>Annual reports</td>
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<td>China Vitae</td>
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<td>SDC Platinum</td>
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One of the key widely recognized limitations of relying on secondary data for conducting research in China is a high likelihood of overstatements in output and development indicators in the official statistics produced by the Chinese government and errors in financial reports issued by local firms (Rawski & Xiao, 2001; Stening & Zhang, 2007). The available studies show, however, that this issue has started to lose momentum with opening up official statistics to international scrutiny and dire consequences that “cooking the books” has on the firm, including falling of stock prices and CEO replacements (Chow, 2006; Rui, Firth, & Wu, 2011). In the light of this, notwithstanding this limitation, addressing the research question through applying quantitative modeling to the secondary data has certain advantages.

The first one is driven by the realities of conducting research in China. It has been acknowledged in prior literature that it is difficult for foreign academics to get access to local Chinese firms, which often requires the consent of the Propaganda Department of the party branch in SOEs and/or using social connections (guanxi) (Stening & Zhang, 2007; Tan & Nojonen, 2011). Even if the access to firms is established, another issue with conducting interviews or surveys in China is a cultural
tendency of Chinese people “to acquiesce to authority figures” in the sense that rather than reflect the true event, the answers are likely to be a product of respondents’ guesswork regarding what the interviewer wants to hear (Tsui, 2004: 505). Moreover, in case of investigating firm acquisition growth, this is not only a potentially sensitive topic involving business secrecy, but also, especially in case of SOEs and cross-province acquisitions, risks being heavily influenced by the Party discourse (Thøgersen & Heimer, 2006). Hence, the cost of establishing guanxi with firms and obtaining permits to access them seemed to outweigh the benefits of conducting a survey or a qualitative study, which was a key factor for setting my research focus on working with secondary data.

The second advantage of conducting quantitative analysis is the nature of the research question itself. Specifically, the investigation into the impact of institutional heterogeneity on firm acquisitions creates challenges with sampling firms of different ownership types from different provinces across China, making the study very expensive. Conducting a quantitative study on secondary data, however, not only is well fit for the task, but also gives more room for evaluating the generalizability of findings to other contexts. Although the primary task of this research is to generate context-specific knowledge, considering that other large emerging markets such as Brazil, Russia and India share the same key characteristic of severe regional institutional heterogeneity, there is clearly a potential to further investigate boundary conditions of the findings of this study (Bruno, Bytchkova, & Estrin, 2013; Daumal, 2013).

Overview of the papers


The theoretical framework of this paper is resource-based view according to which a firm is a
bundle of resources and capabilities, which can be put to use to gain competitive advantage. Using internal resources and capabilities for this purpose is, however, limited, so a firm needs to gain access to new resources to facilitate growth. One quick way to secure such access is firm acquisitions. Acquisition growth is a risky strategy because of an inherent asymmetry of information between the acquirer and the target. Hence, in the context of provincial disparities and trade barriers in China, whether a firm chooses to acquire a target in its home province or complete an even riskier transaction outside of its home province is contingent upon its resources. In this paper the focus is on human and financial resources and their impact on the choice a firm makes regarding target location.

In this paper, human resources are represented by CEO experience outside of home province (i.e. the province of a firm’s headquarters), which, I argue, in a Chinese context is likely to equate with a CEO’s social connections, whereas financial resources are proxied by organizational slack. Both of these resources make firms more risk-prone, however, with different effects on firms of different ownership types. Since POEs are efficiency maximizers, not least because they do not enjoy unrestricted access to resources, they make better use of available resources compared to SOEs. In addition, the propensity to use either type of resource should vary depending on the location of an acquiring firm. To this end, I test if the propensity of firms with CEO experience to conduct crossprovince acquisitions is less pronounced in more developed Chinese coastal provinces than relying on slack resources compared to firms in inland provinces.

These hypotheses are tested on 569 acquisition deals completed between 2002 and 2012 by listed Chinese firms in the manufacturing industry. The results of the logistic regression with robust standard errors show that CEO experience outside of home province is strongly significant, whereas organizational slack is not. Also, POEs, indeed, demonstrate a considerably stronger propensity to cross-province acquisitions when having CEO experience or slack compared to SOEs. Firm slack,
Interestingly, reduces the likelihood of SOECGs’ cross-province acquisitions. Finally, CEO experience yields stronger results for firms in coastal than in inland provinces, whereas there is no difference in using slack between coastal and inland China. These findings have several implications:

- Regardless of the notions of under-resourcefulness, among firms pursuing acquisition growth, POEs are the drivers of cross-province acquisitions in China.
- Considering the high transaction costs of crossing provinces, which, theoretically, should stall cross-province acquisitions, firms in China, especially POEs, are not deterred and find resources to overcome this.
- Contrary to the theoretical arguments suggesting that the impact of informal institutions with institutional development should be less pronounced (Peng, Wang, & Jiang, 2008), this study finds that the impact of social connections on firm strategy does not seem to wane with institutional development.
- In advancing acquisitions, organizational slack is considerably less important strategic resource than social connections.
- SOECGs are a heterogeneous group, some of which remain guided by resource hoarding and risk-averseness which characterizes firms in planned economies.
- Contrary to their immediate interests, SOELGs are likely to conduct cross-province acquisitions more when having a CEO with experience in other provinces.

_Paper 2: “Firm diversification in China: Ownership, regional development and political connections”_

Having learned the differences in deciding on cross-province acquisitions between firms of different ownership types in China in Paper 1, the second paper explores the effect of such geographical patterning of firm acquisitions on firms’ product diversification strategies. When a firm realizes the
need for an acquisition, a fundamental decision is made regarding “where” to acquire structuring the geographical (in home province or outside) and product (related or unrelated) dimensions of a potential target. Considering these two dimensions of firm acquisitions, a more detailed theoretical investigation of the interest of a local (provincial) government becomes relevant. This paper, hence, takes on a state activism perspective suggesting that in developing countries with multiple institutional voids the government is an active force impacting firms’ business strategies to attain various developmental goals.

In line with fiscal federalism ideology, the local government’s interests are geographically bounded within its jurisdiction. The local government can impact firms’ acquisition choices directly through ownership and indirectly through firm managers’ political connections. The local government has two primary concerns: social in the form of providing services to its citizens and economic by driving growth. Both of these concerns can be achieved by imposing or incentivizing local firms to diversify into unrelated industries. In this way the government can ensure that its citizens have access to social benefits through their place of work, for example, when manufacturing SOEs acquire targets in service industries. Also, internal markets created through unrelated diversification help firms circumvent multiple institutional voids of the market thereby stimulating business growth. Considering this, the idea of this paper is that SOELGs, politically connected firms and firms located in lower developed provinces are most likely to conduct unrelated acquisitions within their home provinces. This is investigated against firms of other ownership types, not politically connected, those located in higher developed provinces and acquiring outside of home province.

These ideas are tested on a sample of 377 first time acquirers in the Chinese manufacturing industry between 2002 and 2014. The ordered logistic regression model with robust standard errors provides evidence in favor of the proposed ideas. The implications of this study are as follows:
As literature on business groups suggests, firms in emerging markets engage in unrelated diversification to circumvent institutional voids; however, the state’s interests appeared to be an important factor too.

- State activism perspective in China is essentially local state activism.
- State activism maintains geographical patterning of acquisitions in China, particularly in lower developed provinces.
- Related diversification is more likely to happen when firms acquire cross-province.
- Firms seem to be more independent decision-makers when operating outside their home province rather than within.

Paper 3: “Political connections and cross-province acquisitions in China”

Paper 1 offered a firm-centric perspective on domestic acquisitions in China and Paper 2 explored it from a state-centric perspective; this paper offers a more balanced view investigating how firms and government officials both tend to exploit institutional arrangements to achieve their respective goals through cross-province acquisitions. The specific institutional arrangement in focus of this paper is cross-province rotations of provincial leaders. The rotation system is deployed by the central government to ensure the alignment of central-local government interests, to reduce corruption, disseminate successful leadership decisions and achieve provincial integration.

Social connections are a potent mechanism in navigating through institutional voids in emerging markets, and it is important for firm managers and government officials alike. Considering, first, the high risks of acquiring outside of home province due to severe information asymmetries and potential discrimination, and, second, Chinese managers being culturally and institutionally attuned to events in the political environment, firm managers are likely to see rotation of a political leader from or to their home provinces as a potential to establish social ties (guanxi), which could take the form of a referral to someone in another province who could assist with firm acquisitions in that
province. Also, a rotated political leader could “pull” certain firms from his or her former province to the new one in order to kick-start economic growth and get promoted at the next rotation round.

Specifically, in this paper the distinction is made between same-direction political rotation (a political rotation and an acquisition happen from the same province A to the same province B) and opposite-direction political rotation (a political rotation and an acquisition happen in opposite directions between provinces A and B), and their relative effects on the intensity of cross-province acquisitions are evaluated. Additionally, the theoretical section of this paper argues that opposite-direction political rotations are likely to be more pronounced when a firm conducts an acquisition in the direction from lower to higher developed provinces (an acquiring firm is located in a lower developed province compared to that of a target), and, especially, if that acquiring firm is a POE.

These hypotheses are tested on 108,000 firm/target province/year observations from 2003 to 2012. The multilevel Poisson model with fixed effects finds that opposite-direction rotation has a stronger effect on the number of cross-province acquisitions than same-direction rotation. Also, POEs seem to use opposite-direction political rotations to their benefit more than SOEs when conducting acquisitions from lower to higher developed provinces. The following points are drawn from this study:

- Political rotation is a previously unidentified dimension of political capital that may impact firm strategies in large emerging markets.
- Political rotation is a mechanism facilitating and redirecting business flows in China.
- Political rotation is strategically exploited by firm managers.
- Political rotation is an *informal* mechanism of business facilitation and not a formal one carried out through direct state ownership.
- POEs are more responsive to political rotations than SOEs when conducting cross-province acquisitions.
• Political rotations and firm political connections are unrelated factors impacting firms’ cross-province acquisitions.

*Paper 4: “Domestic and cross-border acquisitions of private firms in China: The S-curved hypothesis”*

This paper differs from the previous three in that domestic firm acquisitions are not the end strategy, rather they are viewed as antecedents of firm internationalization, i.e. cross-border acquisitions. Drawing from an organizational learning perspective suggesting a path-dependent learning pattern, this paper, first, proposes that the relationship between domestic and cross-border acquisitions is not linear but S-curved. Second, domestic acquisition experience is not homogeneous, because firms are likely to learn different skills from within-province and cross-province acquisitions. In particular, unlike within-province, through cross-province acquisitions firms may learn how to manage a firm spanning a variety of institutional contexts, which is especially valuable for cross-border acquisitions. Third, the domestic path to internationalization is different for firms located in inland and coastal provinces due to the access to the vicarious learning from foreign firms that coastal provinces provide.

These ideas are tested on a sample of 899 acquisitions completed by POE firms without any prior international experience between 2002 and 2014. The results obtained from the logistic regression with robust standard errors confirmed that there is an S-curved effect of domestic acquisition experience on choosing to acquire cross-border than domestically; and there is a higher likelihood of choosing to internationalize drawing from cross-province than within-province acquisition experience. In addition, the analysis revealed that inland firms with extensive cross-province experience in coastal provinces are more likely to acquire cross-border than domestically. Finally, firms without any domestic acquisition experience at all demonstrate the highest propensity for choosing cross-border acquisitions. These findings have several implications:
• Domestic acquisition experience is important for firm internationalization.

• Learning from experience is non-linear.

• Cross-province acquisition experience matters, so, when studying the decision to internationalize, the whole variety of institutional contexts where the firm is present through subsidiaries should be taken into account rather than the location of its headquarters only.

• For inland firms the path to internationalization is less straightforward than for coastal firms.

• Chinese firms’ internationalization provides a limitation to the path-dependent nature of organizational learning, instead, presenting evidence in favor of acquisitions as entrepreneurship approach.

Discussion

In this section the findings of each of the four papers are combined into a comprehensive discussion of how institutional heterogeneity in China shapes firms’ growth strategy.

*How does firm location in China impact acquisition growth strategy?*

The findings of this doctoral research indicate that an acquiring firm’s location (coastal or inland province; institutional distance between locations of acquiring and target firms) does not determine its decision to grow. However, it does matter on two accounts: first, it differentiates between the enablers firms use to achieve domestic growth, and, second, the location of a target firm. For example, coastal firms demonstrate a considerably stronger propensity to use their managers’ social connections to facilitate growth. Inland firms seem to be disadvantaged in this respect. This could indicate not only a culturally embedded propensity of Chinese managers to operate through guanxi, which is impervious to institutional development, but it also reflects the fact that institutionally underdeveloped locations are not attractive for well-connected managers, who are likely to seek a certain quality of life available in coastal China only. This leaves other ways of achieving growth
for inland firms, particularly POEs, for instance through the institute of political rotations, which provides a window of opportunity to create a guanxi base between the firm and political or business community in another province. Hence, in the absence of immediate resources within the firm, firms in inland provinces are bound to exploit other catalysts of acquisition growth. This finding corroborates theoretical propositions that managers in emerging markets are more flexible and risk-taking due to their experience in the context of institutional voids; hence they exhibit a considerably higher ingenuity in selecting and obtaining firm resources compared to firms from advanced markets (Cuervo-Cazurra, 2012; Madhok & Keyhani, 2012). The current study extends this line of thought by demonstrating that it is the case not only between firms from emerging and advanced markets, but also between more and less developed regions in a single, albeit heterogeneously developed, emerging market.

The findings also reveal that the location of an acquiring firm determines its geographical preferences regarding the target. Specifically, great institutional differences between acquiring and target firms deter acquisitions. This is analogous to the geographical distance preventing firm acquisitions due to greater information asymmetry and monitoring costs in the context of advanced markets (Bröckerman & Lehto, 2006; Chakrabarti & Mitchell, 2013). In China, it is not so much geographical distance that inhibits growth, but institutional distance. It means that firms in the least developed inland provinces find it difficult to acquire targets in the most developed coastal provinces, and vice versa. The reason for this pattern is related not only to increasing transaction costs associated with crossing great institutional distances (or geographical distance as in advanced markets), it is also likely that such scenarios make it difficult for an acquiring firm to find a suitable target in a province significantly different in its development. The difference in institutions translates into differences in corporate governance within firms, so, for example, an inland firm heavily relying on political connections and top-down approvals to roll out a strategy might not be
able to appreciate the more egalitarian and collaborative styles of management in coastal firms. Hence, it is very unlikely that acquisitions of firms in significantly different provinces would go through. In light of this, Chinese firms with a medium level of institutional development are likely to be instrumental as both acquirers and targets of firms in higher and lower developed provinces.

Overall, this analysis suggests that there might be no obvious heterogeneity between firms in inland and coastal provinces regarding the likelihood of engaging in acquisition growth, but the location creates heterogeneity in how firms achieve it (through which resources) and how far from the home province they choose to go.

*How does target location (within- or cross-province) impact firm growth?*

Prior studies have indicated that provincial disparities and trade barriers raise transaction costs of operating in another province compared to the home location, thereby deterring cross-province investment and cross-province acquisitions by extension, too. The findings of this doctoral research do not unequivocally support that firms pursuing acquisition growth choose not to grow cross-province. Although the studies do not provide direct investigation of cross-province transaction costs, it is possible to evaluate their effect indirectly by examining the way firms react to provincial boundaries. There is evidence, first, that the least resource-endowed firms – POEs – seem to be the drivers of cross-province acquisitions (more on this below). Second, firms are more likely to grow through related acquisitions, which are of paramount importance for the development of a firm’s expertise, when they acquire targets outside of their home province rather than within.

What the latter finding indicates is that within-province and cross-province acquisitions are likely to allow a firm to achieve two different growth targets. Within home province is where a firm engages in building internal market through unrelated acquisitions, which is subsequently used to procure resources for related growth outside of the home province. There are several interrelated
reasons why firms opt for related targets when acquiring outside of their home province. On the one hand, in home provinces firms are likely to experience pressures from the local government aiming to increase investments and provide welfare within the province through coercing or creating incentives for a firm to engage in unrelated acquisitions. On the other hand, political officials in a “foreign” province might welcome related acquisitions. Yes, there is a risk that the local government might lose control over targeted firms; however, the potential benefits of related acquisitions might offset this. It has been shown in literature that firm acquisitions can accelerate diffusion of corporate governance standards between firms in different countries (Bris, Brisley, & Cabolis, 2008). This is likely to be particularly true of related acquisitions requiring much higher integration between a parent and a subsidiary compared to unrelated acquisitions (Chakrabarti & Mitchell, 2013). So local government officials might welcome related acquisitions from outside of their province as in the short-term it increases investments, and in the long-term it raises corporate governance standards, and, perhaps, profitability of targeted firms in the province.

Hence, from the perspective of developing a firm’s competencies, it seems that costs associated with staying within the home province may be higher than costs associated with expansion to other provinces. So the currently dominant perspective, but one that is very underexplored in business and management research, that firms are deterred from investing outside of their home province due to the challenges associated with operating in a new province does not quite stand to testing. The findings suggest that if firms are deterred from entering other provinces, this is because they are dependent on the local government for growth, they cannot choose independently where and how to invest and, consequently, are likely to be bound to growing within the home province. Hence, this doctoral study offers a very different and novel view on the locational dimension of transaction costs in China.
How does a firm’s ownership type impact its growth strategy?

This doctoral research shows that firm ownership is the most significant pillar of institutional heterogeneity determining firm growth. First, the findings confirm the theoretical propositions that SOECGs and SOELGs behave differently in regard to cross-province acquisitions: the former are more open to them as they are the likely tools for the central government’s goal to restructure the national economy, whereas the latter are key to the local government’s interest to improve economic and social indicators through within-province acquisitions particularly of unrelated type.

Second, the findings reveal that SOEs and POEs have different enablers allowing them to grow. POEs, indeed, exploit their resources more efficiently exhibiting much better chances of engaging in cross-province acquisitions, for example, by using CEO experience or organizational slack. Moreover, inland province POEs seem to be surprisingly well adapted to conducting cross-province domestic acquisition growth. POEs in the least developed inland provinces are considerably more creative in finding ways to grow such as building guanxi to and through rotated political officials. Furthermore, inland POEs are more diverse in their domestic investments through acquisitions in other inland and coastal provinces. These findings, then, confirm that having no access to resources and operating in environments with significant institutional voids do not warrant suggesting that a firm does not have competitive advantages that could drive its growth (Ramamurti, 2012).

In addition, POEs do not seem to “escape” adverse institutional environment and high transaction costs of operating across provinces as proposed by international business scholars (Boisot & Meyer, 2008; Witt & Lewin, 2007). They either secure domestic presence first, such as gaining access to cheap factor markets and subsequently internationalize, or engage in acquisition growth as entrepreneurship not strategically differentiating between international and domestic opportunities (Madhok & Keyhani, 2012). This, then, paints a very different picture of POEs’ growth in China than the one stemming from their unequal status compared to SOEs. Their
strength, it seems, is partly drawn from their unequal standing in the Chinese economy.

Overall, the findings regarding the impact of institutional heterogeneity on firm acquisitions demonstrate that location and ownership determine resources that firms exploit towards growth, and their propensity to view acquisitions as entrepreneurship. Also, the effect of provincial boundaries is likely to be the opposite of what was suggested before: it is not transaction costs of crossing provincial boundaries that might be detrimental for firm growth due to the perceived adversity of host government officials towards an outsider firm, rather it is staying within its home province that is likely to inhibit a firm’s growth.

**Contributions**

*Contributions to theory*

In light of Peng and Heath’s (1996) paper arguing that domestic acquisition growth in China is not viable due to institutional voids, lack of managerial skills and independent decision-making, which partly motivated this doctoral research, the findings of the four papers propose several important alterations to how firm acquisition growth in emerging markets should be approached.

First, in the context of emerging markets, incipient formal institutions supporting market functions lead to high transaction costs of operating through the market. Firms can reduce these transaction costs by harnessing social (not always political) mechanisms that, in case of firm acquisitions, would provide funding, protect them from government intervention, and decrease the risks of information asymmetry between acquiring and target firms. Hence, it might be more insightful to investigate the impact of informal institutions on firm growth in emerging markets rather than to scrutinize the degree of inadequacy of formal institutions.

Second, in relation to nascent managerial skills and lack of managerial volition due to state dirigisme, again, research might benefit from refocusing on their substitutes as well as exploring
their universalism. In the case of China, it seems that it might yield value to view firm growth not as reallocation of excess resources and capabilities but rather to adopt acquisitions as entrepreneurship perspective examining the effect of entrepreneurial orientation (Wiklund, 1999) of firm managers on acquisitions, hence diminishing the importance of managerial skills for developing and implementing firm strategy. Also, suggesting a universal lack of independent decision-making by managers in Chinese firms might be overly simplistic, and the current research demonstrates that it does not seem to hold for POEs. Therefore, a targeted strategy research of a specific firm stratum might prove more insightful.

Finally, regarding the incorporation of institutional heterogeneity into strategy research in the context of emerging markets, this study’s contributions are two-fold. First, it shows that institutional heterogeneity is not a first-order phenomenon and can be broken down into more pillars relevant for strategy research. Secondly and more importantly, the explanatory power of institutional heterogeneity is larger when each pillar, such as the level of provincial development or firm ownership type, is taken not independently of one another but together. Hence, embracing the full extent of institutional heterogeneity in large emerging markets such as BRICS and of the interrelationship of its pillars should be more illuminating for understanding the effect of institutions on firm strategy than exploring them one by one.

**Contributions to practice**

There are several ways how this study may be of interest to business practitioners aiming to expand in China. First, the study confirms that grafting is one of the most potent managerial tools accelerating business growth. Importantly, political ties are not necessarily key to determining the success of an employee profile, rather it is a geographically diverse experience that is more valuable. Moreover, firm location determines how firms pursue their strategies, for example, what resources they use, so transferability of best practices across different locations in China may be
limited. Also, firm competition is particularly fierce because of Chinese managers’ entrepreneurial orientation guiding them to seize growth opportunities as they appear, which is further aggravated by their unorthodox competition behavior stemming from reliance on informal institutions. Finally, Central China might be a strategically beneficial location ensuring speedy nationwide growth.

For policy-makers, this study identified a number of mechanisms that can be used to achieve desired policy goals. First, for the central government willing to integrate domestic market, it seems that political rotations is one such avenue. Related to that, central government should see to the fact that POEs are exempt from fulfilling local government’s social objectives, and have a better access to resources without overinvesting in unrelated diversification within the home province. Second, for provincial governments aiming to increase local taxation bases, specifically welcoming related acquisitions by POEs from other provinces might be particularly strategic. Finally, this study has implications in that it might yield stronger results to implement more targeted policies encouraging business collaboration between East-Central and Central-West China, rather than roll out general policies supporting cross-province investments in general.

**Further research**

In addition to future research directions indicated in each of the four research papers individually (please see discussion or implications and further research sections in the papers), here I would like to highlight two further questions tangential to the current doctoral research as a whole.

First, the current study shows that prior CEO experience outside of home province enables firm growth outside of the home province. The main question, which the current doctoral study was not able to address, is whether managers with out-of-province experience are hired strategically or accidentally. By the same token, the study also identified that political rotations influence firm strategy, potentially opening new research avenues of the relationship between business and politics in large emerging markets. An important question here is: To what extent cross-province
acquisitions are unintended consequences of political rotations or whether the central government is aware of this mechanism and uses it strategically to instigate investments between provinces to reduce regional heterogeneity and create a single domestic market? The answer to this question will have significant public policy implications for governments in large emerging markets.

Second, the papers provide evidence that some of the important “classic” determinants of firm acquisition growth such as firm performance and slack resources (e.g., Iyer & Miller, 2008; Park, 2002) appeared to be not very significant in domestic acquisitions made by Chinese firms. One way to look at it is to question the level of integrity of financial reporting in China discussed earlier. Note, however, that business group affiliation matters in every paper. So the relative explanatory weakness of the “classic” variables might indicate that firms use their business group’s internal market to supply their acquisition growth thus sidestepping the books. Also, local state activism theoretically discussed and empirically probed into extends another possibility, particularly that local governments might support some acquisition deals in the form of various concessions so that financial indicators do not reflect the true resource flow between the acquiring firm and stakeholders during the acquisition process. Therefore, more research into the financial cycles within business groups in emerging markets and parameters under which local governments assist firm growth are critically required to more accurately evaluate the role of financial resources in firm growth. In addition to understanding business strategy in emerging market firms better, this will also be instructive for research in international business.

Limitations

This doctoral study bears some limitations. The most immediate one is that I was able to conduct research on listed firms only, the main reason being that background information is available only for such firms. Hence, the findings of the study are biased in a way that they are based on a small percentage of firms in China – firms, which have already been profitable and have received a
government approval to list, i.e. those that already have a certain clout to afford domestic growth (Yuan, 2015).

Related to this is the fact that in this study I have very limited information on target firms (location and industry only), because they are almost always unlisted. Hence, this circumscribed further probing into how firms in China grow by looking at the profile of firms that SOEs and POEs are targeting, such as their ownership type, performance and size. This could give an important idea of acquisition motives to discern, for example, whether it was dictated by a governmental mandate to restructure domestic economy or was guided by commercial reasons. Also, what is particularly interesting is whether any of the targets were SOELGs and whether there were cases when they were acquired by POEs from other provinces. If this were the case, it would allow obtaining further insight into the local government’s motivation to use acquisitions as a catch-up device. This would have tremendous implications regarding the constraints that firms have on domestic growth and the role of the local government in it. Also, to uncover this, a qualitative study of acquiring firms would be particularly helpful.

Classic now, a strategy tripod perspective pioneered by Peng (2006) suggests that firm resources, institutional context and industry effects should be taken into account altogether when investigating firm strategy in emerging markets. This doctoral research would have benefited from integrating industry effects on firm growth better. Although some papers in this study do control for market growth and use industry dummy variables, a more detailed cover of industrial makeup, such as Herfindhal’s index, would be beneficial. This could generate a more nuanced account of a firm’s decision to diversify as well as the role of industrial factors in prompting a firm to expand outside of its home province.

**Conclusion**

This doctoral thesis is concerned with how firms in China pursue acquisition growth. Driven by the
purpose to reconcile the lack of theoretical understanding of Chinese firms’ domestic acquisition growth and the reality which transpired through disparate studies, this research examines firm acquisitions from the perspective of institutional heterogeneity in China consisting of the three pillars: provincial disparities, trade barriers and ownership type of an acquiring firm.

The findings show that private firms are the drivers of domestic acquisition growth in China; that the location of an acquiring firm determines the resources it uses to pursue acquisition growth – including novel ones such as CEO experience outside the home province and political rotations; that trade barriers between provinces are likely to have detrimental consequences for firms remaining in their home province compared to those that expanded into other provinces. These findings demonstrate that in emerging markets informal institutions might impact firm growth more than formal ones, firm resources have multiple context-specific substitutes and the pillars of institutional heterogeneity shape firm strategy independently and together, highlighting the promising direction of studying the effect of their interrelationships on firm strategy. The findings of this research also have implications for business practitioners expanding in China and Chinese policy-makers.

References


CHAPTER 2. The Drivers of Domestic Acquisitions in People’s Republic of China: A Resource-Based Analysis

Abstract

Domestic acquisitions of firms in emerging markets have so far evaded scholarly interest. This paper contributes to closing this gap by looking into the drivers of cross-province acquisitions in China, covering 569 deals in manufacturing industry conducted between 1999 and 2012. Drawing from the resource-based view, this study looks at prior CEO experience and organizational slack as two drivers of cross-province acquisitions, and analyses the moderating effects of firm ownership types and the location of an acquiring firm. The results show that private firms having CEOs with experience outside of home province are the drivers of cross-province acquisitions in China.

Keywords: acquisitions; China; CEO experience; China; organizational slack; resource-based view; state-owned enterprises

Introduction

Acquisitions are risky and expensive (Pablo, Sitkin, & Jemison, 1996). Institutional differences and information asymmetry make this particularly true of cross-border acquisitions (Moeller & Schlingemann, 2005). With the liberalization of emerging markets, cross-border acquisitions became a hot topic in academia first studying internationalization of firms from developed economies into emerging markets. Later, this was complemented by research on acquisition strategies of firms from emerging markets internationalizing into other emerging markets and also developed economies (Wright, Filatotchev, Hoskisson, & Peng, 2005; Lv, Plechero, & Basant, 2013). While research on cross-border acquisitions thus has been prolific, domestic acquisition strategies, which represent, for example, in China over 90 percent of all acquisitions initiated between 2000 and 2010, seem to have almost completely escaped scholarly interest (Tang & Metwalli, 2012).

The current study aims to remedy this by bringing domestic acquisitions in emerging markets into the research spotlight. There are two main and intertwining reasons for putting forward this topic. The first is a severe heterogeneity of large emerging markets such as China, India and Russia, making theories developed to investigate cross-border acquisitions likely applicable to and tested in a new research context (Chen & Groenewold, 2013; Pradhan, 2011; Bruno, Bytchkova, & Estrin, 2013). The second reason is that regional heterogeneity in large emerging markets leads to high transaction costs of domestic acquisitions, therefore stalling firms from acquiring in other regions of their home countries (Boisot & Meyer, 2008). This proposition, however, remains largely conceptual because very little is known about the drivers of domestic acquisitions of firms in emerging markets and whether these firms are capable to overcome transaction costs associated with this growth strategy (Bruno, Bytchkova, & Estrin, 2013; Chi, Sun, & Young, 2011; Pan, Li, Xia, & Yu, 2010; Zeng, Douglas, & Wu, 2013).
The focus of the current study is domestic acquisitions in China. China is selected, because it provides a blend of challenging factors which significantly increases the risks of acquiring target firms across the country. First, it is a severe regional disparity in the level of socio-economic development making the largest part of the country unattractive for investments due to poor regulatory and infrastructure environment with weak local demand. Second, it is the fiscal federalism regime in which local governments must hand in a significant proportion of their income to Beijing. In this system local governments have the incentive to cultivate businesses within their fiscal jurisdiction protecting them from competition by erecting tariff and non-tariff barriers for firms outside of the focal provinces, and have very vast regulative powers in general (He, Wei, & Xie, 2008; Eberhardt, Wang, & Yu, 2013). Third, China is a state-led economy, where state-owned enterprises enjoy soft budget constraints, unlike private firms which have a restricted formal access to resources, such as human and financial (Tan, 2002).

A unique dataset of within-country acquisitions in China from 1999 to 2012 was collected to investigate the following questions: What type of firm based resources and capabilities – human or financial – increase the chances that a firm will venture a more risky growth strategy and acquire a target outside of home province? In the context of state-driven markets and local protectionism, what is the moderating role of firm ownership type in the relationship between firm resources and capabilities and cross-province acquisitions? Does the impact of human and financial resources on acquiring a firm outside of home province vary by location of an acquiring firm? Drawing from the resource-based view (RBV), this study is the first one to investigate these questions.

The study has the following contributions. First, it provides empirical findings to the propositions that firms are deterred from domestic acquisitions due to the disadvantaged access to resources, underdeveloped institutions, and high transaction costs (Luo & Tung, 2007). The findings show that these propositions might be too crude and disregard resources and capabilities
that firms use to mitigate the negative effect of institutional voids and high transaction costs. Second, it focuses on prior CEO experience outside of home province as a human resource and extends its notion to capturing a CEO’s social ties. Thus, the study uses an old concept of CEO experience, places it in a new context, and demonstrates that this concept is rather underexplored. Third, it delineates future research in Chinese business studies showing that very little is known about firm strategies of SOEs owned by central (SOECGs) and local governments (SOELGs). Fourth, it provides evidence that CEO characteristics still matter for doing business in China in coastal provinces even more so than in inland provinces, thus prompting firm CEOs to keep engaging in relationship management with businesses and governments.

**Theoretical background**

*Resource-based view and acquisitions*

The RBV proposes that a firm is a bundle of resources and capabilities – physical, financial, human and organizational – which are selected, deployed and developed to gain and maintain sustainable competitive advantage (Oliver, 1997; Barney, 1995). The difference in resources and capabilities, which are valuable, rare and difficult to imitate, determines firms’ heterogeneity in strategy. With time, however, firms might find it difficult to maintain competitive advantage using the different combinations of the same resources and capabilities over and over again. This compels firms to acquire new resources and capabilities outside of the firm (Wilkund & Shepherd, 2009; Shimizu, Hitt, Vaidyanath, & Pisano, 2004).

The most sought after resources are intangible and knowledge based, which are imperfectly mobile and difficult to obtain on the market due to information asymmetry and a high risk of opportunistic behavior by a seller (Wilkund & Shepherd, 2009; Capron & Hulland, 1999). Hence, gaining access to such resources are often done via acquisitions defined as “transactions in which
one firm buy controlling interest in another firm and the acquired business becomes a subsidiary of the acquirer’s portfolio” (Wilkund & Shepherd 2009: 195). Therefore, from the RBV perspective, the combination of current resources and capabilities determines firm acquisitions in a way that they are conducted either to exploit the advantages of resources and capabilities firm has ("capability-exploiting acquisitions"), or to obtain new resources and capabilities ("capability-seeking acquisitions") (Anand & Delios, 2002).

**Resources and selecting a target**

One of the key issues related to firm acquisition process is a target selection. This process is risky, and requires a significant investment of resources before an actual payment of a bid price. Due diligence, as an examination of the target, must provide complete information about risks and value of a target to an acquiring firm. When an acquiring firm considers an acquisition of a target in a different location, for example, outside of home province, then additional research must be done regarding local governmental regulations, potential local constraints, market and socio-demographic trends, all of which raises the costs of selecting a target. Especially important in an unfamiliar location might be the examination of a target firm’s social network to other firms and government organizations (Shimizu et al., 2004). However, this can be a sensitive topic to investigate which might be rather demanding on resources of an acquiring firm. If the latter has not carried through acquisitions before, then it lacks the knowledge and the know-how required to select a target (Meschi & Metais, 2006). This can significantly drain the stock of other available resources which might deter a risk-conscious acquiring firm from that target. Then, an acquiring firm might select a target in the home location, in our case, home province, which is relatively less risky than acquiring outside of home province or postpone the deal until it replenishes resources and capabilities needed for an acquisition.
Hypotheses

Human resources

In international business literature one of the key human resources (Barney, 1995) that impacts firm internationalization strategies is prior CEO international experience. The value of this resource is linked to the ability of CEOs to scan for opportunities and exhibit a more risk-taking attitude to firm strategy compared to CEOs without such experience (Murtha, Lenway, & Bagozzi, 1998; Bruneel, Yli-Renko, & Clarysse, 2010). In addition to cultural awareness and faster learning, another characteristic of prior international experience suggested in literature is related to a CEO’s social capital. The literature alludes to the fact that a CEO with extensive international experience might have generated a network of external ties across countries that could provide a better access to information, thereby reducing uncertainty in international acquisitions (Hermann & Datta, 2005).

In the current study, the human resource in focus is not a prior CEO international experience, but a more context-appropriate prior CEO experience outside of home province. In the Chinese context the characteristic of a prior CEO experience related to social capital seems to be particularly pertinent to its impact on the likelihood to acquire outside of home province. People in China maintain many aspects of their lives in a web of guanxi networks carrying out very few activities at arm’s-length (Park & Luo, 2001). People resort to guanxi when doing business, seeking advice and finance, and looking for career prospects (Warren, Dunfee, & Li, 2004; Yao, 2013). Guanxi networks are built for life, laden with mutual trust and exchange of favours, and can be activated at any time after lying dormant (Tsang, 1998). CEOs with experience outside of home province are more likely to have a wide guanxi network, which, as a minimum, spans provinces where they have led their professional lives before. Such CEOs are not only more open to taking risks and more familiar with different institutional regimes, but also can activate their extensive cross-country guanxi network when initiating cross-province acquisitions. Hence,
Hypothesis 1: Prior CEO experience outside of home province has a positive impact on cross-province acquisitions.

Financial resources

One of the key resources allowing a firm to build strategy is financial resources which can be broken down to debt, equity and retained earnings (Barney, 1995). Related to all three types, organizational slack as “a resource cushion that firms can use in a discretionary manner, both to counter threats […] and exploit opportunities” has long been accounted for in acquisition studies (e.g., Daniel, Lohrke, & Fornaciari, 2004: 566; Pablo, Sitkin, & Jemison, 1996). Acquisitions and organizational slack are naturally related by a concept of risk. Acquisitions are risky, but organizational slack allows for taking risky strategies, because it buffers firms in case of a negative outcome, and riskier decisions are less likely to be questioned when slack is present (Park, 2002; Tan & Peng, 2003; Lang, Stulz, & Walking, 1991). Since cross-province acquisitions in China entail higher risks ceteris paribus, then firms with more organizational slack might be more willing to acquire targets outside of home province. Interestingly, a contrasting perspective on the role of the organizational slack positing that it causes “excessive diversification, empire-building” (Tan & Peng, 2003: 1251), and may be used for CEOs’ personal goals against corporate interests (Peng, Li, Xie, & Su, 2010) might also be conducive of acquiring cross-province.

Hypothesis 2: Organizational slack has a positive impact on cross-province acquisitions.

Moderating effect of firm ownership type

In the context of Chinese state capitalism, firm ownership type is important to consider in the study of cross-province acquisitions because SOEs and private firms (POEs) are different in using their resources and capabilities. POEs became legally recognized only in the middle of the 1990s, and they are still often discriminated against, particularly in the access to the capital market (Ju & Zhao,
2009; McMillan & Woodruff, 2002; Tan, 2002). To counter this institutional disadvantage, POEs strategically build guanxi networks, because they provide an access to informal financing and can assist with obtaining other resources (Park & Luo, 2001; Ayyagari, Demirguc-Kunt, & Maksimovic, 2010). Related to this, resource scarcity compels POEs to “compete on resourcefulness” doing more with fewer resources (Peng, 2001: 103), developing more advanced corporate governance structures (Luo, Zhao, Wang, & Xi, 2011), and make more efficient investment decisions (Delios, Zhou, & Xu, 2008). Therefore, it is reasonable to conjecture that POEs will try to maximize the return on organizational slack they may have.

SOEs are very different in this respect. Firstly, they operate under soft budget constraints and have abundant resources available for execution of any firm strategy chosen. Thus, having various resource substitutes, SOEs are not compelled to utilize organizational slack and other resources and capabilities as efficiently as POEs (Ju & Zhao, 2009). Secondly, resources and capabilities of SOECGs and SOELGs might have a very limited impact on firms’ cross-province acquisition strategies, because the latter are largely shaped by the interests of their respective ultimate owners. Central government views cross-province acquisitions as a tool to restructure the national economy by converting loss-making firms into viable businesses (Cheung, 2005). Hence, SOECGs are encouraged to conduct cross-province acquisitions. Contrary to that, a very different sentiment guides interests of local governments. The fiscal federalism regime places a considerable strain on local governments to deliver social and economic targets set by the central government with taxes from firms in their jurisdictions as the main source of revenue. Thus, local governments usually oppose cross-province acquisitions as they might lose close control of firms that are acquisition targets (Meyer & Lu, 2005), or an acquisition deal outside their jurisdiction will not contribute to the local taxation base compared to within-province investment (Harlem & Schramm, 2009).
Hence, SOELGs are the least likely to deploy their resources and capabilities to acquire outside of home province. Based on this discussion,

*Hypothesis 3a: The positive impact of prior CEO experience outside of home province on cross-province acquisitions is stronger for POEs than SOECGs and SOELGs.*

*Hypothesis 3b: The positive impact of organizational slack on cross-province acquisitions is stronger for POEs than SOECGs and SOELGs.*

**Moderating effect of the location of acquiring firm**

Regional heterogeneity in China alters barriers to acquisition of firm resources and capabilities across provinces, which makes some resources and capabilities easier to obtain and deploy in a firm’s strategy than others. Chinese provinces can be largely grouped into two – coastal and inland provinces. In recent history the source of the disparity is a policy of the unbalanced growth adopted after 1978 encouraging investments into coastal provinces over the rest of the country. The difference of foreign direct investments (FDI) into coastal and inland provinces was stark, in mid-90s reaching the ratio of 90 to 10 percent (Cheung & Lin, 2004). Although various national programs have been introduced since the late 1990s to reduce the development gap between inland and coastal provinces, a significant difference still persists (Chen & Groenewold, 2012).

One of the effects of the development gap is that coastal provinces have better institutional infrastructure and quasi-market mechanisms which influence the way both POEs and SOEs access resources and build firm strategy. First, prior empirical findings suggest that social ties have more impact on firm strategy and performance in less developed environments characterized by significant uncertainty and low competition because they elevate the importance of trust in business relationships (Li, Poppo, & Zhou, 2008; Sheng, Zhou, & Li, 2011). Moreover, POEs have a substantially better access to formal financial resources in coastal provinces, which further
diminishes the importance of cultivating social ties as an alternative access to resources (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2010). Hence, the importance of social ties in attaining firm goals might be less pronounced in coastal than in inland provinces, but the role of financial resources in strategic decision-making might become more essential.

Second, being located in higher developed provinces also transforms the way SOEs develop their strategies. Prior to the start of reforms in 1978, CEOs in SOEs were risk-averse because a single mistake could mean the end of their careers (Tan & Tan, 2003). The influx of foreign MNCs to coastal provinces for many SOEs located there meant “either sink or swim in the emerging ocean of competition” (Tan & Peng, 2003: 1253). Therefore, SOEs in coastal provinces were pushed to transform, be more proactive and take risky decisions (Tan & Peng, 2003). Therefore, the role of the organizational slack differs across provinces: in inland provinces it represents hoarding cash and assets to cope with the environmental uncertainties, whereas in coastal provinces having organizational slack allows firms to develop riskier strategies in the face of high competition intensity. This discussion leads to the following hypotheses:

_Hypothesis 4a: In coastal provinces the positive impact of prior CEO experience on cross-province acquisitions is weaker than in inland provinces._

_Hypothesis 4b: In coastal provinces the positive impact of organizational slack on cross-province acquisitions is stronger than in inland provinces._

**Method**

**Data**

The data for testing the hypotheses come from various datasets and hand collected information from firms’ annual reports. Cross-verified data on acquisition deals was gathered from ZEPHYR database produced by Bureau van Dijk and CSMAR database prepared by GTA Information
Technology Co. Ltd. and the China Accounting and Finance Research Center. Additional information on acquiring firms was collected from firms’ annual reports, Bureau van Dijk’s ORBIS and CSMAR databases. The deals selected conform to the following requirements: (1) both acquiring and target firms are registered in mainland China (excluding Hong Kong and Macao); (2) an acquiring firm is listed; this condition is relaxed for target firms; (3) an acquiring firm obtains control rights in a target firm, i.e. an acquisition brings over 51 percent of shares to the acquiring firm, deals covering an acquisition of minority stakes, increase of majority stake or acquisition of assets are excluded; (4) all announced acquisitions are completed. The transfer of control rights is important, because such deals are more likely to be associated with higher risks for acquiring firms, thus requiring utilization of more resources and capabilities to complete a deal.

Only manufacturing firms were selected to test the hypotheses. Prior studies indicate that different industries might have different demands for organizational slack (Miller, Lant, Milliken, & Korn, 1996; Sharfman, Wolf, Chase, & Tansik, 1988). Besides, the Chinese national economy is tiered depending on the strategic importance of the industry and subsequent varying degrees of state intervention (Pearson, 2011). These two reasons led to the decision to limit the industrial makeup of the sample to manufacturing industry allowing for a more fine-grained control of the effect of manufacturing industry sectors by including dummy variables corresponding to two-digit Standard Industrial Classification (SIC) codes. The total sample size is 569 deals, 47 percent of which are cross-province. Drugs, chemicals and allied products, and stone, clay, glass and concrete products represent industries of a quarter of all acquiring firms in the sample.

**Dependent variable**

The dependent variable of the study is a target firm’s location. It is a dichotomous variable taking on a value of ‘1’ if a target firm is located outside of home province, i.e. the deal is cross-province, and ‘0’ if a target firm is located in home province i.e. the deal is intra-province.
Independent variables

A firm’s human resources are estimated by prior CEO experience which is coded ‘1’ if a Chairman of the Board, which is equivalent to a CEO in Chinese firms, had ever worked outside of home province, and ‘0’ if s/he never worked in a different province.

Another independent variable is financial resources of a firm, which, in line with prior studies, is proxied by unabsorbed slack (Chatterjee & Wernerfelt, 1991). Unabsorbed slack is referred to readily available resources and it is different from absorbed or recoverable slack which is resources embedded in the firm as excess costs, particularly, excess overheads, which can be tapped into, for example, in the face of financial difficulty (Singh, 1986). Considering the nature of these two types of organizational slack, it is likely that only unabsorbed slack is key for pursuing firm acquisition growth. To measure unabsorbed slack, this study uses the current ratio, which is a logarithm-transformed ratio of current assets to current liabilities taken lagged one year prior to an acquisition announcement. According to the study by Daniel et al., this measure is the most commonly used proxy of unabsorbed slack resources (2004).

Moderating variables

Firm ownership types are dummy variables representing POEs and SOELG with SOECGs being a control group. The information for these variables is based on the percentage of ownership held by the actual controller, and a list of codes denoting the nature of the actual controller is taken from CSMAR database. The list of codes is a comprehensive scheme covering 65 different types of the actual controller; these were then regrouped to obtain a classification of three firm ownership types. The Table 1 below exhibits the proportion of cross-province and intra-province acquisition deals completed by firms of different ownership types. It shows that SOELGs are the least often to have...
completed acquisitions in a province outside of home (38 percent), whereas over half (54 percent) of all deals conducted by SOECGs were cross-province.

*Table 1. The location choice of acquisitions by firm ownership type, %*

<table>
<thead>
<tr>
<th>Location choice</th>
<th>Firm ownership type</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>POEs</td>
</tr>
<tr>
<td>Not cross-province</td>
<td>49.2</td>
</tr>
<tr>
<td>Cross-province</td>
<td>50.8</td>
</tr>
<tr>
<td>Total number of deals</td>
<td>299</td>
</tr>
</tbody>
</table>

Another moderating variable used in prior studies (e.g., Ju & Zhao, 2009) is acquiring firm location which is a dummy coded ‘1’ indicating coastal location and ‘0’ – inland provinces. In line with prior studies (e.g., Qian & Smyth, 2007; Kanbur & Zhang, 1999), coastal group of provinces consists of Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Guangxi. All the rest provinces are classified as inland. Firms in coastal provinces might have a better resource endowment due to a higher proximity to the central government and a higher level of institutional development, hence are more likely to have resources to succeed in costly cross-province acquisitions than firms in inland provinces. Also, more developed markets in the coast might push firms outside of the province to realize market-seeking incentives.

*Control variables*

The classic control variables in acquisition studies are *firm age*, measured by years of operation between incorporation and the year when the focal deal was announced, *firm size* measured by a natural logarithm of the number of employees in a firm, and *firm performance* which is return on assets calculated as net income divided by total assets (Park, 2002; Ju & Zhao, 2009).

Several other variables were included to control for alternative explanations of cross-province acquisitions. CEO characteristics such as *age* and *CEO tenure* were found to have increased
proneness to risk-taking (Hermann & Datta, 2005). Therefore, both of these characteristics measured in years are included in all models. Information for these variables was taken from CSMAR database and CEO profiles in firm annual reports. Prior firm acquisition experience outside of home province could also impact the likelihood of acquiring in a different province as a consequence of firm learning process and organizational inertia (Haleblian, Kim, & Rajagopalan, 2006). Prior firm acquisition experience is denoted ‘1’ if a firm had already had subsidiaries outside of home province before launching the focal acquisition, and ‘0’ if it did not have subsidiaries outside of home province. All these control variables were lagged one year.

Environmental factors can also impact the likelihood of acquiring outside of home province. The number of cross-province acquisitions per province per year might increase the likelihood of firms to acquire as a response to mimetic isomorphism pressures (Li & Ding, 2013). Also, it might signal that local governments are willing to approve acquisitions outside of their home jurisdiction which provides a new window of opportunity for firms. Therefore, the number of cross-province acquisitions per province per year was also controlled for in the models. Fifteen manufacturing industry dummies corresponding to two-digit SIC codes (20–38) were included to control for industry effects on the likelihood of cross-province acquisitions. In addition, year dummies were included to control for unobserved environmental effects, such as the introduction of a government stimulus package in 2008 which aimed at supporting firms’ investment plans.

In the regression models the variables were not mean centered, because this procedure reduces the significance of the coefficients of correlated variables (Verbeek, 2008).

Results

Table 2 reports means, standard deviations and correlation coefficients of the independent variables. Interestingly, prior CEO experience outside of home province is not correlated with firm ownership types, whereas financial resources is positively and significantly associated with POEs ($r = 0.29, p$
Table 2. Descriptive statistics and correlation matrix

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>SD</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) POE</td>
<td>.52</td>
<td>.49</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(2) SOELG</td>
<td>.32</td>
<td>.46</td>
<td>-0.73***</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) CEO experience</td>
<td>.45</td>
<td>.49</td>
<td>0.02</td>
<td>-0.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(4) Fin. resources</td>
<td>.42</td>
<td>.86</td>
<td>0.29***</td>
<td>-0.24***</td>
<td>0.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(5) Firm age</td>
<td>10.5</td>
<td>5.4</td>
<td>-0.08*</td>
<td>0.11*</td>
<td>-0.02</td>
<td>-0.09**</td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>(6) Firm size</td>
<td>7.2</td>
<td>1.5</td>
<td>-0.32***</td>
<td>0.17***</td>
<td>0.16**</td>
<td>-0.24***</td>
<td>-0.11**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(7) Firm profitability</td>
<td>1.4</td>
<td>1.2</td>
<td>0.19***</td>
<td>-0.16**</td>
<td>0.01</td>
<td>0.25***</td>
<td>-0.16***</td>
<td>0.02</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>(8) CEO age</td>
<td>50.3</td>
<td>7.5</td>
<td>-0.11**</td>
<td>0.10**</td>
<td>-0.02</td>
<td>0.01</td>
<td>0.05</td>
<td>0.17**</td>
<td>0.04</td>
<td></td>
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</tr>
<tr>
<td>(9) CEO tenure</td>
<td>3.4</td>
<td>2.8</td>
<td>-0.09**</td>
<td>0.18</td>
<td>0.03</td>
<td>-0.05</td>
<td>0.22***</td>
<td>0.02</td>
<td>-0.06</td>
<td>0.16**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(10) Prior firm exp.</td>
<td>.63</td>
<td>.48</td>
<td>-0.09**</td>
<td>0.00</td>
<td>0.06</td>
<td>-0.04</td>
<td>-0.02</td>
<td>0.20***</td>
<td>0.00</td>
<td>0.06</td>
<td>0.07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(11) No of cross-prov.</td>
<td>2.3</td>
<td>1.3</td>
<td>-0.06</td>
<td>-0.09**</td>
<td>0.01</td>
<td>0.15**</td>
<td>-0.14**</td>
<td>0.14**</td>
<td>0.07</td>
<td>0.03</td>
<td>-0.15**</td>
<td>0.12**</td>
<td></td>
</tr>
<tr>
<td>acquisitions</td>
<td>.59</td>
<td>.49</td>
<td>0.09**</td>
<td>-0.16**</td>
<td>-0.15**</td>
<td>0.20***</td>
<td>-0.17**</td>
<td>0.07**</td>
<td>0.11**</td>
<td>0.07**</td>
<td>-0.13**</td>
<td>0.00</td>
<td>0.42***</td>
</tr>
</tbody>
</table>

Note: N = 569; * p < 0.1; ** p < 0.05; *** p < 0.001.
< 0.001) and negatively with SOELGs ($r = -0.24, p < 0.001$). Variance inflator factors (VIFs) were also calculated for the regression models averaging 5.3 which is quite large but do not exceed 10. Both the size of correlation coefficients and VIFs indicate the models have no serious issues with multicollinearity.

The hypotheses were tested using logistic regression because the dependent variable is dichotomous. The unit of analysis is an acquisition deal, and the data incorporates firms having made multiple deals over the years. To account for this unbalanced panel structure, standard errors obtained in the logistic regression were clustered by firm ID which is a common practice in similar studies (e.g., Lin, Peng, Yang, & Sun, 2009).

Hypothesis 1 postulates that prior CEO experience outside of home province has a positive direct impact on the likelihood of a cross-province acquisition. Model 1 in Table 3 shows that this hypothesis is supported ($\beta = 0.697, p < 0.05$). Model 3 demonstrates that the direct effect of organizational slack on cross-province acquisitions have no statistically significant impact, which provides no support for Hypothesis 2. Hypotheses 3a and 3b suggest that firm ownership moderates the relationship between prior CEO experience and slack. Figures 1a and 1b illustrate the difference between the moderating effects of firm ownership by taking the mean values of all other independent variables. Both Figures 1a and 1b show that POEs have the steepest positive slope compared to SOECGs and SOELGs. This confirms that POEs have the strongest effect from having prior CEO experience and slack resulting in 40 percent chance of acquiring targets outside of home province compared to below 20 percent in the absence of these resources, which supports Hypothesis 3a. Hypothesis 3b has found only partial support because SOECGs produce a surprising negative moderating effect on the relationship between slack resources and the likelihood to acquire cross-province, which goes against the postulated positive, albeit weak, influence.
Table 3. The results of the logistic regression analysis

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1 H1a</th>
<th>Model 2 H1b</th>
<th>Model 3 H2a</th>
<th>Model 4 H2b</th>
<th>Model 5 H3a</th>
<th>Model 6 H3b</th>
</tr>
</thead>
<tbody>
<tr>
<td>POE</td>
<td>.248 (.343)</td>
<td>.059 (.391)</td>
<td>.353 (.336)</td>
<td>.173 (.355)</td>
<td>.285 (.337)</td>
<td>.353 (.344)</td>
</tr>
<tr>
<td>SOELG</td>
<td>−.584 (.325)**</td>
<td>−1.164 (.418)**</td>
<td>−.517 (.313)*</td>
<td>−.629 (.313)**</td>
<td>−.568 (.320)**</td>
<td>−.568 (.320)**</td>
</tr>
<tr>
<td>Prior CEO experience</td>
<td>.697 (.210)**</td>
<td>.745 (.215)**</td>
<td></td>
<td></td>
<td>.246 (.320)</td>
<td></td>
</tr>
<tr>
<td>Financial resources</td>
<td></td>
<td>.043 (.163)</td>
<td>−.509 (.312)</td>
<td></td>
<td></td>
<td>−.155 (.216)</td>
</tr>
<tr>
<td>POE × CEO exp.</td>
<td></td>
<td></td>
<td>.482 (.336)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOELG × CEO exp.</td>
<td></td>
<td></td>
<td>.945 (.444)**</td>
<td>.659 (.352)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>POE × Fin. resources</td>
<td></td>
<td>.582 (.468)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOELG × Fin. resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coastal prov. × CEO exp.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>.766 (.335)**</td>
<td></td>
</tr>
<tr>
<td>Coastal prov. × Fin. res.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>.370 (.250)</td>
<td></td>
</tr>
<tr>
<td>Coastal province</td>
<td>−.079 (.317)</td>
<td>.095 (.331)</td>
<td>−.282 (.316)</td>
<td>−.308 (.320)</td>
<td>−.402 (.338)</td>
<td>−.408 (.330)</td>
</tr>
<tr>
<td>Firm age</td>
<td>−.003 (.023)</td>
<td>−.005 (.024)</td>
<td>−.011 (.020)</td>
<td>−.008 (.021)</td>
<td>.001 (.024)</td>
<td>−.015 (.020)</td>
</tr>
<tr>
<td>Firm size</td>
<td>.028 (.078)</td>
<td>.031 (.080)</td>
<td>.056 (.084)</td>
<td>.044 (.087)</td>
<td>.017 (.078)</td>
<td>.079 (.083)</td>
</tr>
<tr>
<td>Firm profitability</td>
<td>−.347 (.091)***</td>
<td>−.329 (.102)***</td>
<td>−.365 (.096)***</td>
<td>−.361 (.099)**</td>
<td>−.349 (.093)***</td>
<td>−.369 (.098)***</td>
</tr>
<tr>
<td>CEO age</td>
<td>.003 (.014)</td>
<td>.002 (.014)</td>
<td>.001 (.014)</td>
<td>.002 (.014)</td>
<td>.002 (.014)</td>
<td>.002 (.014)</td>
</tr>
<tr>
<td>CEO tenure</td>
<td>−.048 (.037)</td>
<td>−.051 (.038)</td>
<td>−.038 (.035)</td>
<td>−.039 (.036)</td>
<td>−.047 (.036)</td>
<td>−.041 (.036)</td>
</tr>
<tr>
<td>Prior firm exper.</td>
<td>1.088 (.222)***</td>
<td>.880 (.261)***</td>
<td>1.076 (.223)***</td>
<td>1.065 (.223)***</td>
<td>1.122 (.227)***</td>
<td>1.055 (.222)***</td>
</tr>
<tr>
<td>No of cross-prov. acq.</td>
<td>−.022 (.034)</td>
<td>−.015 (.035)</td>
<td>−.016 (.033)</td>
<td>−.015 (.033)</td>
<td>−.019 (.045)</td>
<td>−.000 (.046)</td>
</tr>
<tr>
<td>Log Likelihood</td>
<td>−331.95215</td>
<td>−319.08212</td>
<td>−333.63959</td>
<td>−331.98554</td>
<td>−330.02458</td>
<td>−331.78097</td>
</tr>
<tr>
<td>Pseudo $R^2$</td>
<td>0.1085</td>
<td>0.1231</td>
<td>0.0954</td>
<td>0.1001</td>
<td>0.1136</td>
<td>0.0988</td>
</tr>
</tbody>
</table>

Note: N = 569; * p < 0.1; ** p < 0.05; *** p < 0.001. Unstandardized coefficients are reported with robust standard errors in parentheses. SOECG is a reference category. Year and industry dummies are included in each model.
Figure 1. (a) Interaction effects between firm ownership type and prior CEO experience outside of home province; and (b) Interaction effects between firm ownership type and organizational slack

Model 5 provides the foundation for testing Hypothesis 4a positing that prior CEO experience has a weaker impact on cross-province acquisitions in coastal provinces than in inland provinces. It has been rejected as the interaction effect between prior CEO experience and coastal provinces is positive and significant ($\beta = 0.766, p < 0.05$). Model 6 shows that the interaction effect between financial resources and coastal provinces yielded a statistically insignificant result. Thus Hypothesis 4b that
slack should have a stronger influence on the likelihood of firms in coastal provinces to acquire a target outside of home province compared to inland provinces is rejected. Overall, the findings demonstrate that prior CEO experience is a much stronger predictor for firms’ strategy to acquire cross-province than slack resources.

Discussion

This study investigates how firm human and financial resources impact the likelihood of cross-province acquisitions in China compared to within-province acquisitions. In addition, it examines the moderating effects of firm ownership types and location of an acquiring firm on the relationship between firm resources and cross-province acquisitions.

The findings demonstrate that for firms pursuing acquisition growth having a CEO with prior experience outside of home province, which is a proxy of firm human resources, significantly increases the likelihood of acquiring a target outside of home province. This finding runs in parallel to research in international business showing that prior CEO international experience is an important factor impacting the likelihood of firm internationalization (Hermann & Datta, 2005). Interestingly, prior CEO experience outside of home province is a key factor improving the chances of cross-province acquisitions for all firm ownership types. In the context of resource scarcity for POEs, it was expected that having a CEO with prior experience outside of home province would boost the likelihood of conducting riskier cross-province acquisitions. In addition, this resource has a rather strong, albeit weaker than for POEs, effect on the likelihood of acquiring cross-province for SOEs too. Having this resource might seem excessive for this ownership type, because SOECGs and SOELGs operate under state mandates encouraging, in the case of the former, or
discouraging, in the case of the latter, cross-province acquisitions. Thus for SOEs the effect of CEO’s characteristics on conducting this acquisition strategy was expected to have been smaller than what the findings indicate.

Financial resources proxied by organizational slack do not have a significant direct impact on choosing cross-province acquisitions over within-province. However, the effect of organizational slack varies with different ownership types. For POEs, more slack leads to a higher likelihood of cross-province acquisitions. This goes in line with prior studies associating organizational slack with risk-taking behavior (e.g., Park, 2002; Tan, & Peng, 2003). The effect of organizational slack for SOELGs is also positive but very small, whereas its effect for SOECGs is negative, significantly reducing the likelihood of acquisitions outside of home province. Probably, SOECGs with considerable slack resources are not the agents of the central government to restructure national economy via cross-province acquisitions. Evidently, such SOECGs are less likely to have been transformed into efficient firms and still share pre-reform SOEs mentality to hoard resources “just-in-case” and exhibit risk-aversion in developing firm strategy. This indicates that SOECGs is a very heterogeneous group of firms as suggested in prior studies (Tan & Peng, 2003).

Lastly, the empirical results show that prior CEO experience outside of home province has a much more significant positive impact on cross-province acquisitions in coastal provinces than in inland provinces. At the same time, the effect of slack on cross-province acquisitions does not vary with the level of institutional development. These findings contradict the proposition that with institutional development “soft” characteristics, such as the extent of CEO’s social ties, might have less importance for doing business than “hard” characteristics of a firm such as available financial resources (e.g., Park & Luo, 2001; Li, Poppo, & Zhou, 2008). In Chinese business
environment, CEO’s characteristics remain a fundamental factor shaping a firm’s strategy.

Implications

The findings of the study have several contributions to academic research. First, this is the first study to look at domestic acquisitions in China conducted by firms of different ownership types. It shows that, of all Chinese firms pursuing acquisition growth, POEs are the drivers of cross-province acquisitions, which questions the validity of a hypothesis circulating in international business studies that POEs might be more willing to internationalize than grow in the domestic market because of their restricted access to resources and institutional deficiency (e.g., Delios, Zhou, & Xu, 2008). Future research is needed to provide direct evidence to the issue regarding cross-province versus cross-border POEs’ acquisition strategies.

Moreover, the study shows that POEs are the ones most likely making the most out of human and financial resources they have to acquire cross-province. This indicates that the proposition by Boisot and Meyer (2008) that Chinese firms might be deterred from cross-province acquisitions by higher transaction costs compared to cross-border acquisitions might not be accurate, because it does not take into consideration resources and capabilities firms have to alleviate the burden of transaction costs. Clearly, Chinese firms develop resources and capabilities necessary to overcome transaction costs associated with cross-province acquisitions.

The study has revealed a superior importance of prior CEO experience outside of home province for cross-province acquisitions. Testing this variable in a Chinese context has drawn attention to a much less studied component of prior CEO experience which is a density of CEO’s social network. Usually in empirical studies
prior CEO experience is related to risk-taking attitude, openness and understanding of new markets and cultures, however, it has never been used as a proxy of CEO’s social connections. The study demonstrates that the concept of prior CEO experience requires further investigation using various fine-grained instruments.

Another implication of this study is related to the advances in Chinese business studies. Particularly, the fact that the chances of SOELGs to acquire cross-province are boosted by prior CEO experience outside of home province and, less strongly, by organizational slack, are puzzling in the view that SOELGs are discouraged from acquiring outside of the jurisdiction. Why do some SOELGs invest resources into acquiring cross-province, and why are some local governments apparently conducive of that? One of the rare studies on cross-province acquisitions in China suggests that some SOELGs invest outside of home province as a part of an illicit scheme to increase local tax (Pan et al., 2010). In light of this, are CEOs with prior experience outside of home province used for such deals, or are they the harbingers of change in SOELGs’ strategic development? Lastly, more research is required into SOECGs because the study indicates that they are quite heterogeneous. The empirical research being done predominantly on a sample of “national champions” muddies our understanding of the variety of SOECGs in the Chinese national economy (e.g., Delios, Zhou, & Xu, 2008).

The findings also have implications for practice. CEO characteristics play a much bigger role in firm growth in China rather than financial resources. This is true not only of underdeveloped inland provinces, but is still applicable to coastal area. Therefore, it is more advisable for managers to make risky decisions when they have support of their guanxi, rather than relying on financial resources only. Next, managers of foreign companies might find it informative that Chinese firms are active
in cross-province acquisitions, thus prompting them to also invest into different Chinese provinces gaining first mover advantage.

Conclusion

The study investigates the role of human and financial resources in cross-province acquisitions in China, as well as moderating effects of firm ownership types and a location of an acquiring firm. The findings manifest that prior CEO experience outside of home province is a significant factor increasing the chances to acquire cross-province for firms of all ownership types, and POEs in particular. The role of organizational slack is less straightforward: it boosts the likelihood of POEs and SOELGs to acquire cross-province, but considerably reduces that of SOECGs. Prior CEO experience outside of home province appears to be more important for firms in coastal than in inland provinces, reiterating the remaining pertinence of CEO’s social ties on doing business in China.

References


CHAPTER 3. Firm Diversification in China: Ownership, Regional Development and Political Connections

Abstract

In this paper we examine geographical patterning of firm diversification in China. Drawing from the state activism and institutional voids perspectives, we show that local government-owned firms, firms having political connections and those located in lower developed provinces are more likely to make unrelated acquisitions within their home province compared to their acquisitions across provincial boundaries. We suggest that this is due to government attempts to promote economic development.

We test our hypotheses on 377 majority acquisition deals completed by first-time acquirers in China between 2002 and 2014. Our study contributes to the understanding of firm diversification, business-government relationship and cross-province barriers to business in China.

Keywords: diversification; acquisitions; ownership; political connections; development; China

2 With J. Arnoldi. A version of this paper is in Rewrite and Resubmit in Asia Pacific Journal of Management.
Introduction

In this paper we explore regional patterns of diversification in the acquisition strategies of Chinese firms. Such patterns exist, we argue, mainly in two forms, which, however, both are rooted in governmental economic intervention. The first of the two patterns arises from local governments pushing firms to adapt acquisition strategies in their home province which are different to their acquisition strategies in other provinces. The second pattern is due to differences in economic and institutional development, something that in turn lead local governments to intervene to different degrees, again leading to cross-provincial differences in firm acquisitions. Diversification of Chinese firms is a relatively well-studied area with several studies documenting influence of the government on diversification. However, no studies have investigated whether the fact that often it is local government that exerts the influence translates into a geographical patterning.

Firm acquisitions and conglomerate diversification resulting from unrelated acquisitions are fundamental firm growth strategies, not least in a growth-driven market like China where firms seek to obtain new knowledge, resources and access to new markets. Diversification of Chinese firms has been extensively analyzed in the context of the formation of large diversified conglomerates or business groups, which are prevalent in China (Fan, Wong, & Zhang, 2013; Keister, 2007; Sutherland & Lutao, 2012). This body of literature comprises discussions both of the causes of the formation of such diversified business groups and performance effects of business group affiliation. While early studies of the latter type and longitudinal studies report performance benefits of business group affiliation in early stages of the Chinese economic reform process (Keister, 2007, 1998), later studies find no or even negative effects of such affiliation (He, Mao, Rui, & Zha, 2013). State-owned groups are an
exception in that they continue to perform well (Guest & Sutherland, 2010; Ma, Yao, & Xi, 2006, Yu, Ees, & Lensink, 2009). Also, studies that focus specifically on the degree of diversification (as opposed to diversified business group affiliation) report mixed results, some arguing for a U-shaped relationship between diversification and performance (Li & Rwegasira, 2008) and one study finding positive performance effects (Lin & Su, 2008).

Research in the area has first and foremost argued that diversification is a response to institutional voids and underdeveloped factor markets and scarce factor resources (Fan, Jin, & Zheng, 2009; Keister, 2004; Liu, Zheng, & Zhu, 2010). Diversification, studies suggest, can help firms mitigate some of those just mentioned problems by creating “internal markets” (Li & Rwegasira, 2010) and in part impose hierarchical control mechanisms on internal transfers, thus reducing transactions costs.

Studies have repeatedly pointed to ownership type and ownership concentration as determinants of diversification. Zhang and Li (2006) find that local government-owned firms (SOELGs) exhibit an inverse U-shaped relationship between ownership concentration and diversification while no such relationship exists for private (POEs) or central government-owned firms (SOECGs). Zhao (2010) finds that state-owned (SOE) business groups exhibit relatively higher degrees of diversification while ownership concentration (irrespective of ownership type) reduces diversification (see also Jiang, 2008). Also providing evidence of agency problems and political rent seeking, Du, Lu and Tao (2015) argue that POEs are expropriated by government officials who, however, in return provide access to new markets, which causes the firms to diversify into these markets. Research generally finds that political connections and political capital increase the likelihood of diversification (Hu & Shi, 2009; Li, He, Lan, & Yiu, 2012; Zhang, Su, Sun, Zhang, & Shen, 2015). Because
political connections is an indicator of influence but not outright control rights, such findings indicate that the government has an influence on diversification beyond direct political control.

Some scholars promote a “state activism view” arguing that the Chinese government actively influences firms to diversify with the aim of creating positive externalities in order to stimulate economic growth and provide welfare (Lee & Jin, 2009; Zhao, 2010: 1103; Zhou & Delios, 2012). Such scholars argue that the government encourages diversification because diversified groups can share scarce resources such as technological knowhow and provide welfare services to their employees (Zhao, 2010; Zhou & Delios, 2012). Formation of SOE diversified groups has primarily happened through mergers and acquisitions and local governments have been particularly active in instigating these (Lee & Jin, 2009).

The main reason for the active stance of local governments towards firm diversification lies in the decentralization of the Chinese government, where the central government sets economic and social targets for local governments, and the delivery on those targets is one of the key factors in promoting or demoting provincial leaders (Jing & McDermott, 2012; Liu, Song, & Tao, 2006). Therefore, local governments are focused on the transformation of the economy within their jurisdiction instigating a yardstick competition between local governments. The main point here is that a local government will seek to promote economic growth within a given province not beyond it. One can also expect the intensity of local government intervention to depend on economic development with the highest intensity of intervention happening in the least developed provinces. Such geographical implications of political activism have not been explored by existing literature, which is a gap that our study attempts to fill.
We show that the choices between related and unrelated acquisitions in China exhibit geographical patterns, specifically hinging on differences between home and “foreign” province acquisitions. Our attention is focused on first-time acquirers for two reasons. Firstly, studies indicate that acquisitions are heavily path dependent (e.g., Collins, Holcomb, Certo, & Hitt, 2009). Transferred to a Chinese context, that would make firms having already conducted cross-province acquisitions more likely to repeat such cross-province acquisitions, and more likely to repeat acquisitions in that specific foreign province. Secondly, once firms have established a presence outside of home province, the “foreign” provincial government potentially gains leverage over the firm, in which case the firm is subjected to pressures from more than one local government. To avoid these biases our study concerns first-time acquirers.

Our study makes several contributions. Firstly, our findings contribute to a body of literature on acquisition strategies and diversification of Chinese firms. Secondly, our study is a contribution to the burgeoning literature on how government influences business in China. Thirdly, but not least important, our study contributes to a small body of literature looking at provincial differences and barriers in the Chinese market.

**Theoretical background and hypotheses**

The brief literature review above shows that the main conceptual approaches to the study of diversification of Chinese firms are agency problems, government expropriation, institutional voids, and state activism. In what follows, we will mainly focus on state activism while also drawing on the institutional voids thesis. Our theorizing hinges on two different concepts, namely positive externalities and social reciprocity. Proponents of the state activism argument have suggested that historically
the Chinese government has ensured that business groups were formed in order to create positive externalities. This happened first and foremost to ensure economic growth (Keister, 1998) thus rendering diversification and conglomerate building a “catch up-device” used by the government to develop the economy (Lee & Jin, 2009; Seo, Lee & Wang, 2010). But the political motives behind diversification may also be to provide jobs and services for employees and even citizens outside the firms (Zhao, 2010; Zhou & Delios, 2012). Zhou and Delios, for example, argue that especially SOEs are expected to act as “mini societies” that provide welfare services to its employees (2012: 779). This can be achieved by diversifying into service industries. Another factor is that the government seeks to have SOEs retain excess labor by spinning off or acquiring firms in unrelated industries (Zhao, 2010; Zhou & Delios, 2012). Thus, in summation, we expect government, both central and local, to actively intervene in firm strategy encouraging them to diversify with the aim of creating positive externalities that can help mitigate institutional voids, drive economic growth and arguably also create various other social benefits.

State activism as just described covers the influence exerted by both central and local (in our study provincial) government. However, state activism differs in a crucial aspect when comparing local and central governments. By definition the geographical extension of local government is limited while the central government’s sphere of responsibility is the whole of China. Therefore, as mentioned above, any local government attempting to make firms diversify to ensure economic growth or to create other welfare services will concentrate on firms diversifying within its home province. Local governments will most likely (be able to) exert pressure to diversify on firms owned and controlled by themselves (Lin & Su, 2008: 406). We therefore expect SOELGs to show a propensity to engage in unrelated acquisitions when they
acquire in their domestic provinces relative to SOECGs and, even more so, to POE firms. That does not necessarily mean that SOELGs are prevented from making cross-province acquisitions, but such acquisitions are not politically motivated to the same degree, and the propensity to pursue unrelated acquisitions is therefore not dominant in those cases.

So far we have hypothesized reasons why governments may impose unrelated acquisitions on SOEs through directing their strategic decisions. But the government may also incentivize SOEs into diversification and, thus, make unrelated acquisitions. This is done by creating business opportunities for SOEs offering them extensive support in terms of access to finances, permits and licenses (Hu & Shi, 2009; Lin & Milhaupt, 2013). Access to excess resources then, we argue, conditions SOEs’ growth strategy to enter unrelated industries. In line with existing literature, we therefore would expect SOE firms to conduct more unrelated acquisitions than POEs, and more specifically, we would expect SOELGs to engage in more unrelated acquisitions only in that geographical realm in which the local government is able to provide support and create opportunities for these firms, that is, in the home province.

In summation, we expect local governments’ bounded sphere of influence to impact on the pattern of acquisitions. Specifically, both the pressure from the local government and the creation of incentives for SOELGs to diversify occur in the context of home province acquisitions. This leads us to our first hypothesis:

*Hypothesis 1: Chinese SOELGs tend to conduct more unrelated acquisitions within their home provinces than outside, a tendency which is stronger than that for SOECGs and POEs.*
If diversification is being used by a government as a catch-up device, then the degree of governmental pressure on firms to achieve economic and political objectives can be expected to depend on the degree of catching-up needed, that is, the level of economic and social development of the province. Thus we expect government intervention to be stronger in provinces that are less developed. As a result, firms in less developed provinces will be subjected to more coercive pressure to diversify compared to more developed provinces. Moreover, the coercive pressure is often exercised by local governments, in which case the pressure will only be in relation to home province acquisitions. Hence we formulate the following hypothesis:

**Hypothesis 2:** Chinese firms in less developed provinces tend to conduct more unrelated acquisitions within their home provinces than outside, a tendency which is stronger than that for firms in more developed provinces.

Hypothesis 1 was concerned with the effects of ownership type building on the proposition that governments use ownership to exert influence over firms via involvement in strategic decision-making or creation of incentives. Institutional theory and research on political connections suggest that political coercion also can happen by other means (Dillard, Rigsby, & Goodman, 2004), for example, through network ties (Zhou & Delios, 2012). This has given rise to research on political connections continuously debating the positive and negative consequences for firms with such connections, one negative consequence being the dependence on and obligations to comply with the political connections (Luo, Huang & Wang, 2012). In other words, because such ties build on reciprocity, firms that have managerial (guanxi) connections to political stakeholders are under pressure to fulfill expectations of those stakeholders. This is supported by existing research, which
shows that political connections increase propensity for diversification (Li et al., 2012; Zhang et al., 2015). Moreover, similar to what is the case for SOEs through direct ownership, one of the benefits that POEs with strong political connections gain from such connections is permissions, licenses and contracts that allow them access to new and lucrative markets. This, at the same time, causes firms with close political connections to diversify (Du et al., 2015). As most political ties are to local government officials (Arnoldi & Villadsen, 2015) and because local governments in general are active trying to influence the strategic decisions of firms (Li & Ding, 2013), we expect the two types of influence outlined here – compliance with the expectations and access to resources – to result in a skewed relationship between home and “foreign” province-unrelated acquisitions with a higher likelihood of the former:

**Hypothesis 3:** Chinese firms with managerial political connections tend to conduct more unrelated acquisitions within their home provinces than outside, a tendency which is stronger than for firms without managerial political connections.

**Method**

**Data**

To test our hypotheses we used data on firm acquisitions completed in China between 2002 and 2014; the data was generated from the ZEPHYR database produced by Bureau van Dijk. The majority of information on acquiring firms was gathered from the China Stock Market & Accounting Research (CSMAR) database produced jointly by GTA Information Technology Co. Ltd. and the China Accounting and Finance Research Center. We selected acquiring firms listed on the Shanghai and Shenzhen
Stock Exchanges operating in the manufacturing industry that fall between codes 20 and 39 in the Standard Industry Classification (SIC). We decided to limit the sample of firms to the manufacturing industry for two main reasons. The first is that natural resources, real estate and finance sectors are not only heavily regulated but are subjects of great state intervention (Chen, Sun, Tang, & Wu, 2011). In addition to this, many studies on business groups in China focus on the investigation of the conglomerate diversification by firms in manufacturing industry only (e.g., Carney, Shapiro, & Tang, 2009; Lee & Jin 2009; Ma & Lu, 2005). Therefore, our results would be comparable to and inform studies on the formation of business groups in China.

In terms of the deal characteristics, we applied restrictions on the stakes acquired. Specifically, our data only comprises acquisition deals involving the transfer of majority ownership rights, i.e. the final ownership stake in a target firm is over 51 percent. Also, we selected only those acquiring firms that conducted their first majority domestic acquisition in the observed period. As mentioned in the Introduction, this was done to exclude path dependent acquisitions, which render an interplay of firm-government interests unidentifiable and decrease the uncertainty associated with multiple, and often conflicting, forces shaping firm growth strategies that arise with multiple and geographically dispersed acquisitions. If a firm conducted multiple domestic acquisitions across years, then only the first deal is included in the sample. When a firm announced and completed a number of majority domestic acquisitions in the same year, then all of these deals are included. The final sample consists of 377 acquisition deals made by 328 firms.
Dependent variable

Firm diversification is our dependent variable. We built an initial measure of firm diversification drawing on Wang and Zajac (2007). In particular, a firm diversification was coded ‘1’ if the first digit of a four-digit SIC code of a target firm was a) different from that of acquiring firm and b) the difference would fall beyond the 20-39 scope of codes denoting manufacturing industry. The code ‘1’ thus represents unrelated diversification of an acquiring firm. Next, ‘0.75’ was assigned to cases where the first digits of two firms’ SIC codes are either 2 or 3; ‘0.5’ is where the first two digits of the two firms’ SIC codes are the same, and ‘0.25’ where three digits are the same. Finally, ‘0’ is assigned to a deal where four digits in the SIC codes of the acquiring and target firms are different representing related diversification. Our sample has 113 unrelated diversification and 116 related diversification deals, with the remaining 34 percent being represented by deals varying from ‘somewhat related to somewhat unrelated’ deals. Considering the small size of subsamples by the level of diversification, we use a recoded version of the original firm diversification in the statistical analysis, where ‘1’ is related diversification, ‘2’ is ‘somewhat related/unrelated’ diversification and ‘3’ – unrelated diversification deals.

Independent variables

Target location is a dichotomous independent variable coded ‘1’ when the acquiring and target firms are located in different provinces, or an acquisition deal is cross-province, alternatively it is coded ‘0’ when both firms are located in the same province, or the deal is within-province. Forty-three percent of acquisition deals in the sample is cross-province.
Firm ownership is captured in our study by three ownership types: privately-owned (POEs), central state-owned (SOECGs) and local state-owned (SOELGs) firms. Eighty percent of SOELGs are firms owned by Provincial Bureaus and Municipal Departments of State Assets Administration Committee. The data on firm ownership type is based on the percentage of ownership held by the ultimate owner taken from a comprehensive list of codes contained in the CSMAR database. The distribution of firm diversification deals across the firms of the three ownership types is presented in Table 1.

Table 1. The level of diversification by firm ownership type

<table>
<thead>
<tr>
<th>Level of diversification</th>
<th>POE</th>
<th>SOECG</th>
<th>SOELG</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 (related)</td>
<td>28.1</td>
<td>42.2</td>
<td>29.9</td>
</tr>
<tr>
<td>0.25</td>
<td>38.9</td>
<td>28.9</td>
<td>27.0</td>
</tr>
<tr>
<td>0.5</td>
<td>32.9</td>
<td>28.9</td>
<td>43.1</td>
</tr>
<tr>
<td>1 (unrelated)</td>
<td>249</td>
<td>45</td>
<td>83</td>
</tr>
<tr>
<td>Total deals</td>
<td>249</td>
<td>45</td>
<td>83</td>
</tr>
</tbody>
</table>

The next independent variable, the level of provincial development where an acquiring firm is located, we proxied by the Marketization index of Chinese provinces produced by the National Economic Research Institute, Beijing, China. This index is composed of five sub-indices: (1) the relationship between government and market, (2) the development of a non-state economy, (3) the level of product market development, (4) the level of the essential factor market development, and (5) the development of market intermediate organization and the legal system environment (Fan, Wang, & Zhu, 2011). The higher the Marketization index value, the higher the level of provincial development. The values of this index are available for 1997 to 2009; however, since the last year of our observed period is 2014, we used a damped-
trend exponential smoothing technique to obtain the missing values (Gardner, 2006). This variable is included in the model with one year lag prior to a focal deal.

*Managerial political connections* is also a dichotomous independent variable defined as the connections of a top manager, whose role in Chinese firms is carried by the chairman of the board, to the government. In line with prior studies, it is coded ‘1’ if a top manager of a firm is or was an official of the central or local government, industry bureau or military, otherwise it is ‘0’ (Li, He, Lan, & Yiu, 2012).

*Control variables*

To control for alternative explanations of firm diversification, we included several additional variables. It has been theoretically discussed and empirically tested in prior studies that higher *firm performance* prior to a focal acquisition increases the chance of related diversification as, due to the path-dependent nature of learning, firms will be likely to maintain a high degree of similarity between prior and future firm strategies (Chen & Yu, 2012; Park, 2002). In the current study *firm performance* is return on assets (ROA) calculated as net income divided by total assets taken one year prior to the focal acquisition (Chen & Yu, 2012). Unlike *firm performance*, *organizational slack* tends to encourage firms’ risk-taking behavior, which is likely to lead to unrelated diversification (Park, 2002). Here we define *organizational slack* as unabsorbed slack resources calculated as a logarithm-transformed ratio of current assets to current liabilities one year prior to a focal acquisition (Chatterjee & Wernerfelt, 1991; Daniel, Lohrke, & Fornaciari, 2004). Another variable that might increase a firm’s propensity to conduct an unrelated acquisition is a firm’s *business group affiliation*. Firms belonging to a business group are known to coordinate their investment decisions; also their advantage in emerging markets stems from the creation of internal market (Keister, 1998). Hence, we expect that *business group*
affiliation would increase a firm’s propensity to conduct unrelated diversification. We identified business group affiliation from an ORBIS database produced by Bureau van Dijk, which provides historical data on firms’ direct and ultimate owners. We identified a business group as a firm’s ultimate owner if it owns at least five other firms partly or wholly (Wang, Yi, Kafouros, & Yan, 2015).

Firm age is expected to positively relate to unrelated acquisitions as young firms are likely to have fewer resources and lower experience; entering unrelated industries is thus too resource-draining for them (Bernardo & Chowdhry, 2002). Firm age is defined as the difference between one year prior to the focal acquisition and the year of a firm’s establishment. Firm size, on the other hand, we would expect to have a negative relationship with unrelated diversification. This is due to the fact that larger firms tend to have more bureaucratized and inflexible internal structures prohibiting risk-taking decisions leading to organizational change such as unrelated diversification (Park, 2002). Firm size we define as a logarithm-transformed number of employees one year prior to a focal acquisition. Lastly, we also controlled for ownership concentration of an acquiring firm defined as a percentage owned by an ultimate owner one year prior to an acquisition. Admittedly, this variable pertains to POEs more than SOEs. We expect that ownership concentration will negatively affect a firm’s propensity to conduct unrelated diversification, because firms with high ownership concentration are likely to focus more on performance-generating activities and, hence, will be more risk-averse (Amihud & Lev, 1999).

We also controlled for unobserved industry effects by including two-digit SIC codes of acquiring firms in every model following Goranova, Alessandri, Brandes and Dharwadkar (2007). Industry effects in our study are represented by 13 manufacturing sub-industries. In particular, the top two-digit sub-industries in the sample are
chemicals and allied products constituting a quarter of all deals, followed by electronic and electrical equipment, excluding computer equipment (22 percent). In addition, we controlled for the effect of economic cycles on the propensity to conduct unrelated acquisitions by including Gross Regional Product (GRP) growth in the year preceding a focal deal (Chen & Yu, 2012). Specifically, we expect that the lower GRP growth might prompt firms to diversify (Park, 2002). Finally, since our sample spans 13 years, year dummies are included in every model.

Model

The dependent variable in our study is firm diversification which takes three values representing three levels of diversification, namely ‘1’ (related diversification), ‘2’ (somewhat related/unrelated diversification) and ‘3’ (unrelated diversification). Since these values imply a certain order and since we are unable to estimate intervals between the values, the dependent variable is measured on an ordinal scale. Hence, to test our hypotheses we use ordered logistic regression. Our sample is unbalanced data pooled across years with several observations per firm, which violates the assumption of independence of observations. To correct for that, we estimate robust standard errors clustered by a firm’s identification number.

Results

The descriptive statistics and correlation coefficients are presented in Table 2. Target location is negatively related to firm diversification ($r = -0.11$, $p < 0.05$), which is also what our theoretical conceptualization suggests, i.e. firms with home province acquisitions are more likely to diversify. None of the other independent variables have a significant correlation with firm diversification. Firm performance is negatively related ($r = -0.14$, $p < 0.05$) to the dependent variable, which corroborates findings of
prior studies. Firm slack, however, also demonstrates a negative correlation \( r = -0.11, p < 0.05 \) with the dependent variable, meaning that having organizational slack does not make firms more prone to risk-taking. This might also suggest that the link between firm diversification and risk is different than the one proposed in the context of advanced economies. It is conceivable that related acquisitions are riskier for firms in China because of their lower managerial skills (Peng, 2012) and this is detrimental to a successful integration of the target firm – a task much more likely to be pertinent to related than unrelated acquisitions (Chakrabarti & Mitchell, 2013).

Furthermore, there is a positive correlation \( r = 0.14, p < 0.05 \) between business group affiliation and firm diversification, which corresponds to what we expected. Overall, the highest correlation coefficient we observe is between POE and SOECG firm ownership types \( r = -0.51, p < 0.01 \) as these two are the “opposite” dummy variables, followed by a second highest correlated coefficient \( r = 0.34, p < 0.01 \) which is between the level of provincial development and POE firm ownership. The latter can be interpreted as there being more POEs in higher than in lower developed provinces.

In addition to the inspection of the correlation matrix, we calculated variance inflation factors (VIF) for each of the variables. The conventional rule of thumb suggests that VIFs below 10 are an indicator of no serious multicollinearity issues (Silver, 1997). In our case, all VIFs are below 1.58, suggesting no multicollinearity problems in our data.

The results of our hypotheses are presented in Table 2. Note that in ordered logit models there are no intercept terms. Instead, M-1 cut-off parameters are estimated where M is the number of orders or levels in the dependent variable. In our case we have two cut-off parameters which are then used to estimate the probability that the
Table 2. Descriptive statistics and correlations

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>SD</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Firm diversification</td>
<td>2.11</td>
<td>.93</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2. Target location</td>
<td>.43</td>
<td>.49</td>
<td>-0.11*</td>
<td></td>
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<tr>
<td>3. POE</td>
<td>.66</td>
<td>.47</td>
<td>-0.00</td>
<td>0.19**</td>
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<tr>
<td>4. SOECG</td>
<td>.11</td>
<td>.32</td>
<td>-0.04</td>
<td>0.04</td>
<td>-0.51**</td>
<td></td>
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</tr>
<tr>
<td>5. The level of provincial</td>
<td>9.42</td>
<td>2.44</td>
<td>-0.01</td>
<td>-0.07</td>
<td>0.34**</td>
<td>-0.23**</td>
<td></td>
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<tr>
<td>6. Managerial political</td>
<td>.28</td>
<td>.45</td>
<td>0.02</td>
<td>-0.02</td>
<td>-0.01</td>
<td>0.03</td>
<td>0.01</td>
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<tr>
<td>connections</td>
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<tr>
<td>7. Firm performance</td>
<td>5.98</td>
<td>6.61</td>
<td>-0.14*</td>
<td>0.09</td>
<td>0.37**</td>
<td>-0.20*</td>
<td>0.18*</td>
<td>0.02</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>8. Firm slack</td>
<td>3.42</td>
<td>4.08</td>
<td>-0.11*</td>
<td>0.08</td>
<td>0.31**</td>
<td>-0.13*</td>
<td>0.13*</td>
<td>-0.03</td>
<td>0.45**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Business group affiliation</td>
<td>.74</td>
<td>.43</td>
<td>0.14*</td>
<td>-0.12*</td>
<td>-0.25**</td>
<td>0.13*</td>
<td>-0.18*</td>
<td>-0.06</td>
<td>-0.12*</td>
<td>-0.07</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Firm age</td>
<td>11.61</td>
<td>5.35</td>
<td>0.03</td>
<td>-0.08*</td>
<td>-0.26**</td>
<td>0.16*</td>
<td>0.00</td>
<td>-0.07</td>
<td>-0.19*</td>
<td>-0.14</td>
<td>0.11*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Firm size</td>
<td>4.90</td>
<td>4.25</td>
<td>0.03</td>
<td>-0.11*</td>
<td>-0.26**</td>
<td>0.05</td>
<td>-0.25**</td>
<td>-0.02</td>
<td>-0.14*</td>
<td>-0.19*</td>
<td>0.09</td>
<td>-0.05</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Ownership concentration</td>
<td>34.87</td>
<td>17.01</td>
<td>0.04</td>
<td>-0.02</td>
<td>0.01</td>
<td>0.12</td>
<td>0.09*</td>
<td>0.19**</td>
<td>0.10*</td>
<td>0.04</td>
<td>-0.12*</td>
<td>-0.05</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. GRP growth</td>
<td>26.57</td>
<td>18.41</td>
<td>0.06</td>
<td>0.01</td>
<td>-0.01</td>
<td>0.05</td>
<td>0.00</td>
<td>0.02</td>
<td>0.07</td>
<td>-0.03</td>
<td>-0.09</td>
<td>-0.11*</td>
<td>0.11*</td>
<td>0.03</td>
</tr>
</tbody>
</table>

\( N = 377; * p < 0.05, ** p < 0.01. \)
dependent variable will take on a particular value. If we calculate each outcome of our
dependent variable for each case using beta coefficients derived from the regression,
then if that outcome falls below the cut-off point 1, the acquisition deal is related; if it
falls between the cut-off points 1 and 2, then the deal is “somewhat related/unrelated”.
Finally, if the outcome for a particular firm is higher than the cut-off point 2, then the
acquisition deal is unrelated.

Model 1 contains only control variables, Model 2 adds main effects of the
independent variables, Models 3 to 5 test hypotheses 1-3 respectively, and Model 6 is
a full model containing all interaction effects all at once. Overall, based on the log-
likelihood ratio test, Model 6 offers a statistically significant improvement in
explanatory power over Model 1 ($p < 0.05$), although still amounting to only just over
10 percent of variance in the dependent variable. The findings in Model 1 show that
only business group affiliation is statistically significant ($\beta = 0.59, p < 0.05$) meaning
that the probability of a firm with business group affiliation conducting an unrelated
deal is 0.53 percent, whereas without such affiliation it declines to 0.38 percent. This
variable remains statistically significant in all models. At the same time, the
comparison of the standardized coefficients of business group affiliation and those of
the interaction effects of key independent variables (see Model 6) demonstrates that
the former is lower than all except a standardized coefficient of an interaction term
between target location and the level of provincial development. Hence, statistically
speaking, three out of four proposed interaction effects produce a stronger impact on
the dependent variable than business group affiliation. An additional analysis revealed
that the effect of business group affiliation on firm diversification is not moderated by
target location or any other independent variable. This might suggest that being part
of a business group and replicating the logic of business groups by diversifying into
Table 3. The results of the ordered logistic regression; firm diversification is the dependent variable

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3 (H1)</th>
<th>Model 4 (H2)</th>
<th>Model 5 (H3)</th>
<th>Model 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm performance</td>
<td>–.02 (.03)</td>
<td>–.03 (.03)</td>
<td>–.03 (.03)</td>
<td>–.03 (.03)</td>
<td>–.03 (.02)</td>
<td>–.03 (.03)</td>
</tr>
<tr>
<td>Firm slack</td>
<td>–.04 (.04)</td>
<td>–.05 (.04)</td>
<td>–.04 (.04)</td>
<td>–.05 (.03)</td>
<td>–.04 (.03)</td>
<td>–.04 (.04)</td>
</tr>
<tr>
<td>Business group affiliation</td>
<td>.59 (.29)**</td>
<td>.64 (.30)**</td>
<td>.64 (.30)**</td>
<td>.65 (.30)**</td>
<td>.58 (.27)**</td>
<td>.63 (.30)**</td>
</tr>
<tr>
<td>Firm age</td>
<td>–.03 (.03)</td>
<td>–.02 (.03)</td>
<td>.02 (.03)</td>
<td>–.01 (.03)</td>
<td>–.01 (.03)</td>
<td>–.02 (.03)</td>
</tr>
<tr>
<td>Firm size</td>
<td>.03 (.03)</td>
<td>.03 (.03)</td>
<td>–.01 (.03)</td>
<td>.02 (.02)</td>
<td>.03 (.05)</td>
<td>.02 (.03)</td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>–.01 (.01)</td>
<td>–.01 (.01)</td>
<td>–.00 (.01)</td>
<td>–.01 (.01)</td>
<td>–.00 (.01)</td>
<td>–.00 (.01)</td>
</tr>
<tr>
<td>GRP growth</td>
<td>–.00 (.01)</td>
<td>–.00 (.01)</td>
<td>–.00 (.01)</td>
<td>–.00 (.01)</td>
<td>.00 (.01)</td>
<td>.00 (.01)</td>
</tr>
<tr>
<td>Target location</td>
<td>–.31 (.27)</td>
<td>–1.9 (.72)**</td>
<td>–2.41 (1.03)**</td>
<td>–.03 (.27)</td>
<td>–2.31 (1.10)**</td>
<td></td>
</tr>
<tr>
<td>POE</td>
<td>.39 (.39)</td>
<td>–.00 (.45)</td>
<td>.44 (.40)</td>
<td>.35 (.34)</td>
<td>.03 (.46)</td>
<td></td>
</tr>
<tr>
<td>SOECD</td>
<td>–.49 (.47)</td>
<td>–.84 (.55)</td>
<td>–.44 (.48)</td>
<td>–.54 (.42)</td>
<td>–.91 (.55)</td>
<td></td>
</tr>
<tr>
<td>The level of provincial development</td>
<td>–.02 (.06)</td>
<td>–.02 (.06)</td>
<td>–.10 (.10)</td>
<td>–.03 (.05)</td>
<td>–.06 (.08)</td>
<td></td>
</tr>
<tr>
<td>Managerial political connections</td>
<td>–.00 (.29)</td>
<td>.05 (.29)</td>
<td>.03 (.30)</td>
<td>.45 (.34)</td>
<td>.48 (.39)</td>
<td></td>
</tr>
<tr>
<td>Target location * POE</td>
<td></td>
<td></td>
<td>1.84 (.77)**</td>
<td></td>
<td>1.6 (.80)**</td>
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<tr>
<td>Target location * SOECD</td>
<td></td>
<td></td>
<td>1.77 (.08)**</td>
<td></td>
<td>1.8 (.08)**</td>
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</tr>
<tr>
<td>Target location * provincial</td>
<td></td>
<td></td>
<td>.23 (.09)**</td>
<td></td>
<td>.08 (.11)</td>
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<tr>
<td>development</td>
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<td></td>
</tr>
<tr>
<td>Target location * political</td>
<td></td>
<td></td>
<td></td>
<td>–1.10 (.54)**</td>
<td>–1.04 (.62)*</td>
<td></td>
</tr>
<tr>
<td>connections</td>
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<tr>
<td>Pseudo R2</td>
<td>0.082</td>
<td>0.090</td>
<td>0.099</td>
<td>0.095</td>
<td>0.096</td>
<td>0.105</td>
</tr>
</tbody>
</table>

N = 377; robust standard errors in parentheses; industry and year dummies included in all models. * p < 0.1, ** p < 0.05, *** p < 0.01.
new businesses is a powerful alternative explanation to our proposed hypotheses which, however, does not provide insight into the geographical scope of such strategy or variation across other important firm characteristics.

Model 2 demonstrates that none of the independent variables have a significant effect on firm diversification. Model 3 presents interaction effects between target location and two firm ownership types, holding SOELGs as a control group. Beta coefficients on both interaction effects are statistically significant ($\beta = 1.84, p < 0.01$, and $\beta = 1.77, p < 0.05$), revealing that a diversification strategy of POEs and SOECGs is different from SOELGs when controlling for target location. To aid an understanding of the effect of interaction terms on the dependent variable, we plot them in Figure 1. Note that ordered logistic regression calculates the probability of each firm to reach each of the levels/orders of the dependent variable. Hence, there are separate interaction plots predicting a likelihood of conducting related, “somewhat related/unrelated” and unrelated acquisitions. However, since our main theoretical focus is on unrelated acquisitions and to save space, we present only interaction plots for this value of the dependent variable. Figure 1 shows that SOELGs are considerably more likely to acquire unrelated targets when an acquisition takes place in the home province: 60 percent versus just over 20 percent when a target is located in another province. Hence, Hypothesis 1 is supported.

Next, Model 4 tests Hypothesis 2 suggesting that firms located in lower developed provinces are more likely to conduct unrelated acquisitions when acquiring within the home province. An interaction effect is positive and significant ($\beta = 0.23, p < 0.05$), however, the total beta coefficient on target location is negative ($\beta = -2.18$); on the level of provincial development it is positive, but considerably smaller than that of the former ($\beta = 0.13$). As depicted in Figure 2, the diversification strategy of firms
located in lower developed provinces varies significantly depending on the target location. In particular, the lower the level of provincial development where an acquiring firm is located, the higher the likelihood of unrelated diversification if a target is located in the home province. Thus, Hypothesis 2 is also supported.

Figure 1. An interaction effect of firm ownership types and target location on the likelihood of unrelated diversification

Figure 2. An interaction effect of the level of provincial development and target location on the likelihood of unrelated diversification
Hypothesis 3, which suggests that politically connected firms are more likely to conduct unrelated diversification if acquiring in their home province, is tested in Model 5. The beta coefficient on an interaction term between target location and managerial political connections is negative and significant ($\beta = -1.10$, $p < 0.05$). An interaction plot in Figure 3 shows that firms with politically connected CEOs are about 10 percent more likely to conduct unrelated diversification when acquiring within their home jurisdiction than when crossing provincial borders. This lends support to Hypothesis 3.

![Figure 3. An interaction effect of managerial political connections and target location on the likelihood of unrelated diversification](image)

Robustness checks

In this paper we propose that a firm diversification decision is largely predicated on whether an acquisition target is in acquiring firm’s home province or not. However, there might be systematic differences between firms acquiring targets outside their home province or staying within their home province borders. To account for a potential endogeneity bias, we apply a Heckman two-stage procedure (Heckman, 1979). In the first stage, a probit regression is run to estimate the likelihood of an
acquiring firm conducting a deal within its home province (coded ‘0’) or outside it (coded ‘1’). In the estimation of this selection equation, we include several instrumental variables which are expected to be significantly related to the dichotomous within-province/cross-province dependent variable and do not significantly impact the firm diversification variable in the main regression model. Specifically, we introduce two new independent variables: the top manager’s prior experience outside of home province and the number of listed firms in a province engaging in cross-province acquisitions over the course of three years prior to the focal acquisition. In line with prior studies, we expect that top managers’ prior experience outside of the home province should be positively related to the likelihood of cross-province acquisitions due to a wider guanxi network that such top managers are likely to possess as well as their openness to risk-taking (Muratova, 2015). Similarly, we expect that with low information transparency and a perception of severe trade barriers between provinces, firms are likely to monitor the behavior of their rivals; and the higher the number of firms overcoming cross-province barriers in the vicinity, the more likely a focal firm will be actively considering cross-province growth as a strategic option. The values for top managers’ prior studies and/or work-related experience outside their home province are coded from the CSMAR database, whereas the values for the second independent variable are calculated from the ZEPHYR database. In addition to these independent variables, to run the selection equation, we included organizational slack, performance, ownership type, industry and year dummies. Since there are multiple observations per firm, we generated robust standard errors clustered by a firm’s identification number.

The values derived from the selection equation serve as a basis to calculate Mill’s lambda and we use this variable as an additional regressor in the main ordered logistic
regression to control for selection bias. In all the models (1 through 6), Mill’s lambda was not statistically significant, suggesting there was no endogeneity bias related to firms’ different ability to conduct cross-province acquisitions. Also, the main results of the regression models remained unchanged.

In addition, we conducted a regression analysis on an original scale of the dependent variable varying from ‘0’ (related diversification) to ‘1’ (unrelated diversification). We treated the five-ordered dependent variable as quasi-numerical and ran a series of least-squares linear regressions reflecting Models 1 through 6. Of all interaction effects analyzed in the models, only an interaction effect between managerial political connections and target location was insignificant, albeit with the same sign. Hence, we would conclude that our findings are quite robust to metric changes of the dependent variable.

**Discussion**

The results of our study show that ownership significantly impacts Chinese firms’ diversification strategies so that the likelihood of SOELGs conducting unrelated acquisitions within their home province is considerably higher compared to cross-province acquisition. Moreover, we show that the differences between home province acquisitions compared to “foreign” province hinges on the degree of market development. Finally, we show that managerial political connections tend to lead to more home province, unrelated acquisitions.

Our results, first of all, contribute to the literature on how (state) ownership affects the strategic behavior of Chinese firms, a literature where SOELGs already have been shown to differ (Yi & Xi, 2006). Also, our results on political connections extend the contribution to the literature on political ties, a body of literature where performance
effects, so far, have dominated as dependent variable but where other effects of ties are starting to attract attention (e.g., Li et al., 2012). Our study generally shows a great deal of political influence on firm strategy.

While our study contributes to the literature on how, particularly local, state ownership affects firm strategy, the more important contribution lies in the theoretical implications. As shown in the literature review, diversification studies have often argued that Chinese firms diversify largely in response to institutional voids. By diversifying, the firms hope to reduce transaction costs and also to reduce the risk of arbitrary political interventions. However, our results showing differences between within and cross-province acquisition strategies and a moderating effect of provincial development indicate that diversification is due to government coercion, something which happens because the local government attempts to generate economic and social development in its jurisdiction. Thus, an institutional void perspective is not irrelevant, but the theoretical explanation of firm diversification should not only focus on how firms respond to these voids. The explanation should at least also include an account of how local governments try to foster economic development in response to such voids.

We thus find that our results support a state activism view of firm diversification. This also means that ownership must be attributed great importance as a factor determining firm diversification strategy. We believe that our study makes important contributions by showing how any analysis of the impact of state ownership must differentiate between local and central government control and not least by showing how Chinese state activism often is local state activism, with resulting local geographical patterns to firms’ strategies.
In our hypothesis development and interpretation of results, we concentrated on within-province factors affecting firms’ acquisitions. At least implicitly, we thus a) suggest that cross-province acquisition strategies are less influenced by government and b) that firms, therefore, are freer to make decisions based solely on economic considerations, which will entail more related cross-province acquisitions compared to within-province. These two assumptions may be overly simplistic constituting limitations of our research, and certainly have important implications for future studies.

Dealing with a) first, assuming that firms acquire targets across province unhindered and unaffected by government may indeed be misleading. On the one hand, there is evidence of firm discrimination exerted by host governments aiming to protect home-grown businesses (e.g., Eberhardt, Zheng, & Yu, 2013). On the other hand, local governments are particularly keen to attract outside investment into their province to boost the local economy (e.g., Yu, Zhou, & Zhu 2013). So there is a certain degree of government intervention that conditions “foreign” province firms’ acquisitions. Hence, it is likely that there is a more multifaceted interplay of state activism within and across provinces, something which impacts firms’ diversification decisions in regard to location, in a more complex fashion than the one proposed in the paper. The analysis of such interplay, while beyond the scope of this research, could be a fruitful, yet daunting, avenue for further research.

The other aspect b) concerns the implicit assumption in our theorizing that firms, if not coerced by government and not faced by institutional voids, would favor related acquisitions over unrelated. It has been the mainstream view in the strategy literature that related diversification is less risky compared to unrelated diversification, because the latter involves firms entering industries they do not have first-hand experience in
(e.g., Park, 2002). However, there is another – less prominent – perspective suggesting that related diversification might, in fact, be more risky, because it requires closer post-acquisition integration of a target into the existing business activities whereas unrelated firms largely remain stand-alone business units (e.g., Chakrabarti & Mitchell, 2013). Hence, an understanding of which of these two perspectives is more valid in the context of emerging markets and, likely, suboptimal managerial skills, is an important factor to consider before making the above-mentioned assumption.

The latter point, of course, is also important in relation to a question of firm costs. Specifically, does government coercion of firms to pursue unrelated acquisitions within their home province through ownership or political connections, constitute a political cost for these firms? On the one hand, there is evidence showing that state ownership or political ties result in suboptimal firm efficiency (e.g., Baek, Min, & Ryu, 2006; Chen, Zheng, Song, & Wu, 2011; Du & Girma, 2010). On the other hand, in a context of institutional voids and dynamic market changes, firms might not have a long-term growth strategy. Therefore being coerced into unrelated diversification should not necessarily be perceived as a cost but rather as an opportunity. Indeed, as was mentioned at the outset of the paper, the findings on performance effects of firm diversification are not conclusive, and, as Chen and Yu (2012) argue, firms pursuing unrelated diversification in emerging markets can reap quick benefits from such deals. Besides, for POEs in particular, being coerced into unrelated diversification might be the only available growth trajectory which maintains a balanced win-win relationship with the local government (Shi, Markóczy, & Stan, 2014; Du & Girma 2010). Hence, the lack of Chinese firms’ “free” choice of growth strategy cannot necessarily be
construed as a cost. To shed more light on this matter, a further analysis into the types of growth strategy of Chinese firms in the domestic market is in order.

Conclusion

We conclude that local government intervention creates a geographical patterning of the acquisitions conducted by Chinese firms owned by the local government or connected to provincial political leaders. That patterning manifests itself by a higher likelihood of unrelated home province acquisitions compared to cross-province. Such a patterning may be suboptimal for such firms and it shows that there are many facets of the relationship between government and business in China. These facets, we argue, have still not been fully explored by strategy research on Chinese firms.

References


CHAPTER 4. Political Rotations and Cross-Province Acquisitions in China

Abstract

We show that regional political rotations affect the intensity of cross-province acquisitions made by Chinese firms. We suggest the reason is that cross-province political rotations constitute opportunities for firm managers to establish political ties in a target province, ties that can ensure political support helpful in mitigating the risks of cross-province acquisitions. Moreover, we demonstrate that rotations both in the same direction as the acquisition (from acquiring firm province to target firm province) and the opposite direction (target to province) have an effect. Finally, we find that private firms located in lower developed provinces show a high propensity to make acquisitions in higher developed provinces if a political official is rotated from the higher developed to the lower developed province. The study has practical implications for management in relation to understanding a firm’s external environment and political stakeholders; also it reveals a new way for the Chinese government to build an integrated domestic market.

Keywords: China; acquisitions; political rotations; local government

3 With J. Arnoldi, X. Chen and J. Scholderer. A version of the paper is in Rewrite and Resubmit in Management and Organization Review.
Introduction

The interplay between government and business remains an underexplored area in strategy studies both in developed and developing markets. One reason is that the impact of government on business strategy takes many forms, making it difficult to identify the specific mechanisms of the relationship between government and business (Ring, Bigley, D’Aunno, & Khanna, 2005). Chinese state capitalism, however, provides a fertile ground for researching this topic, particularly when looking into how government affects business strategies through soft budget constraints, resource allocation, political appointment of top managers and control over their future career promotions, imposition of social goals, and various regulative incentives and constraints (e.g., Chen, Firth, & Xu, 2009; Delios, Zhou, & Xu, 2008; Du & Girma, 2010; Lin, 2011; Peng, 2000).

This paper adds to this area of study by examining cross-province rotations of high-ranked politicians as a factor influencing cross-province acquisitions in China. Political rotation across provinces in China has, so far, largely been a subject of political science and economics studies. These studies have focused on the antecedents of political rotations, seeking knowledge about the characteristics and mechanisms behind the decentralization of the Chinese state and its impact on the Chinese economy (Jia, Kudamatsu & Seim, 2013; Li & Zhou, 2005; Lin, 2011; Persson & Zhuravskaya, 2008; Shih, Adolph, & Liu, 2012; Su, Tao, Xi, & Li, 2012; Wu, 2010; Zhang & Gao, 2008). Political rotations have, however, never been the focus of business strategy studies. Therefore, this paper is the first to offer insight into the intricate interplay between cross-province political rotations and firms’ business strategies in China.
The main question explored here is: How do cross-province political rotations affect cross-province acquisitions? By gaining access to new capabilities, resources or markets, firm acquisition is a quick way to achieve firm growth. On the flip side, however, acquisitions are associated with significant risks, such as acquisition premiums, and a challenging post-acquisition integration stage, which is likely to lead to lower performance of an acquiring firm (King, Dalton, Daily, & Covin, 2004; Pablo, Sirkin, & Jemison, 1996; Vermeulen & Barkema, 2001). Most such risks are rooted in lack of information on the target and its environment, lacking familiarity with and experience in new markets, and complexities of organizational change (Barkema & Schijven, 2008; Chakrabarti & Mitchell, 2013; Pablo et al., 1996). In China, risks associated with firm acquisitions are aggravated further by the pervasiveness of institutional voids, dramatic institutional disparities between provinces, and province-level trade barriers. Besides, the regulation of mergers and acquisitions in China is quite opaque, providing ample opportunity for government intervention (Nee, Opper, & Wong, 2007). Thus, cross-province firm acquisitions are rife with institutional uncertainty. Such uncertainty will make managers seek political support, for example through political (guanxi) ties (Luo, Huang, & Wang, 2012; Shi, Markóczy, & Stan, 2014), and generally it will lead managers to conduct environmental scanning more (especially of the firm’s political environment) (Ebrahimi, 2000). This leads us to argue that Chinese managers are likely to notice political rotations between provinces and see such rotations as potential opportunities for establishing political (guanxi) ties into a new province, which in turn can be a basis for political support. We show that regional political rotations is a factor that contributes to the intensity of cross-province acquisitions. Moreover, we find that rotations both in the same direction as the acquisition (from acquiring firm province
to target firm province) and opposite-direction rotations have effects. Finally, we explore the moderating effects of ownership finding that it is a factor only in combination with difference in institutional development between provinces, so that private firms (henceforth POEs) located in lower developed provinces show a stronger propensity to make acquisitions in higher developed provinces if a political leader is rotated from the higher developed to the lower developed province.

Our study contributes to the literature on the development of business strategy in China, government-business relations, and to the literature on regional diversity in China. We wish to highlight two specific contributions. First, our results suggest a mechanism by which politics in China shapes firm growth strategy. Second, the results suggest that firms’ dependence on political support ultimately constrains the geographical scope of the firms’ activities, meaning that provincial divides are upheld. Our results also show that the Chinese government can use rotation of government leaders as a tool for integrating the Chinese economy and breaking down such divides.

**Research setting**

The unique institutional context of China has been aptly described as a regionally decentralized authoritarian system with highly centralized political and personnel controls at the national level, and decentralized economic and administrative controls at the regional/provincial level (Xu, 2011). The government in China is multi-tiered with central government at the top and provincial, municipal, county and township governments at lower levels. The central government directly controls appointments of provincial leaders, the two highest ranking of which are provincial governor and provincial Communist party secretary. A provincial governor is mainly tasked with
economic growth targets and a provincial party secretary is, among other things, set to oversee personnel matters and to ensure compliance with central government policies. While on paper provincial governors are appointed by the People’s Congress, in practice both provincial leadership posts are appointed by the Communist party, with the provincial party secretary ranking higher than the governor (Yao & Zhang, 2015; Li, 2011). Even though political loyalty remains a factor in career promotion, economic performance is key in the evaluation of provincial leaders (Jia et al., 2013; Li & Zhou, 2005). Provincial leaders have about five years to achieve economic results as demanded by the central government, results on which their career prospects hinge (Li, 2011). The system has been criticized for leading to short-termism, which is particularly challenging since often newly appointed provincial leaders are not familiar with the local context (Zhang & Gao, 2008). The rotation system was put in place in the 1990s. It was deployed as a measure of personnel control to ensure the alignment of central-local government interests; to reduce corruption and fraction formation between party cadres; to disseminate successful experiments with institutional development across provinces; and to create provincial integration (Ke, 2015; Xu, 2011; Zhang & Gao, 2008).

**Theoretical background and hypotheses**

Drawing on social capital theory and institutional theory, research on emerging markets in general and China in particular shows that managerial (guanxi) ties to political stakeholders are highly important for firms operating in environments with institutional voids (Luo & Chen, 1997; Luo, Huang & Wang, 2012; Park & Luo, 2001; Peng & Luo, 2000). Institutional voids, the literature suggests, increase uncertainty. Voids create information asymmetries due to lack of market
intermediaries; make contract enforcement and arbitration less reliable; reduce factor market efficiency; and increase political risk because state and market are separated less distinctly. Under such conditions firms need and seek political support – support which often is secured through managerial ties or other types of personal relations. Research also shows that political ties influence Chinese firms’ strategic behavior, for example so that firms with political ties diversify (Li, He, Lan, & Yiu, 2012; Zhang, Su, Sun, Zhang, & Shen, 2015) or invest more (Su, Fung, & Yau, 2013). Moreover, research on environmental scanning, which is the acquisition of information on the events and trends in an organization’s external environment, shows that managers scan their political environment more when operating in environments with institutional voids (Ebrahimi, 2000).

There is no doubt that institutional voids also create uncertainty for Chinese firms when contemplating acquisitions. Poorly developed institutions and factor markets impede the target valuation process and increase uncertainty associated with this business strategy (Peng & Heath, 1996; Xu, Zhou, & Phan, 2010). In general, reliable information about firms and industries is lacking (Duncan, 1972; Lukas, Tan, Tomas, & Hult, 2001; May, Stewart Jr., & Sweo, 2000; Tan & Tan, 2005). Some of that uncertainty may be mitigated through political ties and political support springing from such ties. Corporate information in China is often controlled by the (local) government and is often only accessible through guanxi ties (Xu et al., 2010). Also uncertainty when it comes to protection of property rights, contract enforcement, and especially access to factor resources can be reduced through local government support (Wu, Li, & Li, 2013). For foreign province firms making acquisitions, these problems can be especially dire because of local protectionism (Eberhardt, Zheng, & Yu, 2013). Local governments often set up trade barriers for out-of-province firms and even seek
to localize financial services (Tenev, Zhang & Brefort, 2002). Non-local acquiring firms risk being treated as hostile (Peng, Luo, & Sun, 1999). Thus, for foreign province firms the need for political support is acute.

These considerations lead us to the assumption that any market expansion strategy into a foreign target province would entail, or be preceded by, both careful scanning of the political environment of that foreign province and attempts to expand political (and other) guanxi ties into the foreign province in order to mitigate some of the above uncertainties (Qian, Cao, & Takeuchi, 2013). By the same token, managers will be more willing to embark on foreign province acquisitions if or when they have established, or at least can see the possibility of establishing, political (and other) ties. This assumption is indirectly supported by research which shows that political ties are associated with trade extension into foreign provinces (Lu, 2011).

We suggest that when contemplating a foreign province acquisition a firm will scan the political environment of the target province looking to establish political ties; the firm will a) notice political rotation and b) see rotation as an opportunity to establish political ties in the target province. Identifying a political leader that moves/has moved to or from a province in which a potential target firm is located, does not, of course, by default mean that the potential acquiring firm can establish guanxi ties to, or otherwise obtain support from, that leader. However, we firstly assume that local government leaders will try to assist firms from “their” province whenever possible because economic performance is important for provincial leaders. Thus, a local government leader might put in a word or refer firm managers to political officials or other stakeholders in the target province to whom the leader is connected. Secondly, firm managers will use initial ties to a local leader as a point of referral or “guanxi base” (Chen & Chen, 2004) for establishing further political ties.
“Guanxi base” refers to the fact that normally guanxi ties are based on the existence of some shared background (same home town or home province, same alma mater, mutual acquaintances, etc.). When establishing ties to current political leaders in the target province with previous tenure in the acquiring firms’ province, that previous tenure – the mutual connection to the acquiring firm’s province – can be used as a guanxi base. Also, the previous tenure may make a mutual acquaintance likely – one which can be used as a further guanxi base.

We need to emphasize that while we talk about political rotations (as events), leaders with previous tenure either in the target or acquisition province are potential targets for firms seeking political support at any point in time during their tenure, not only at the time right after their rotation. Moreover, so far focus has been on how firms observe (scan) and potentially use political rotations (rotated leaders) when contemplating foreign province acquisitions. For such firms, political rotations and rotated leaders both from the target province and to the acquirer’s province would constitute opportunities. Or in the terminology which we will use henceforth, both same-direction (same as direction of acquisition – leader going from acquirer’s province to target’s province) and opposite-direction rotations constitute opportunities (we also talk about same-direction and opposite-direction leaders in the following section).

However, rotations may also lead to cross-province acquisitions due to initiatives taken by the rotated leaders, not due to initiatives taken by firms. A rotated leader may “pull” specific firms from the previous province, firms with which the leader has developed close ties and/or which have helped the leader achieve economic and political goals. The reason for this might be that the leader feels a need for business allies in the new province, or perhaps the leader wants to replicate initiatives that were
successful in the previous province and which involved (these) specific firms, or because reciprocity norms entailed in guanxi ties create a pressure to offer such firms opportunities also in the new province. As political rotation is an under-explored topic, only little evidence of government leaders “pulling” firms with them across provinces exists. But there is plenty of evidence of how local government leaders develop strong and long lasting ties with business leaders (Krug & Hendriscke, 2008; Li, Meng, Wang, & Zhou, 2008; Li & Zhang, 2007; Lu, 2011; Shi, et al., 2014; Wank, 2001; Zhu & Chung, 2014). Moreover, Du, Lu and Tao (2015) provide detailed case descriptions of how such close relations endure also when political leaders are rotated to other provinces. Nevertheless such “pulling” will only involve a relatively small group of firms with whom the rotated government leader has close ties. As a result, we would expect political rotation to have a relatively modest effect on acquisitions if the effect of rotation was due to “pulling” only – simply because political rotation in that case would constitute opportunities only for a small group of firms (those with whom the leader has close and strong ties).

More importantly, if the link between political rotations and acquisitions consists only of government leaders “pulling” firms with them, the link would only relate to same-direction political rotations. However, our theoretical argumentation as outlined above afford grounds for expecting that the relation at any rate is due also to firms seeking opportunities to secure political support. If that is the case, then political rotations in both directions impact foreign province acquisitions. Thus we formulate our first hypothesis:

*Hypothesis 1: Both same-direction and opposite-direction cross-province political rotations are positively related to cross-province acquisition intensity.*
For firms seeking to establish a guanxi base in a target province or even just seeking knowledge about the target province, at least recent same-direction political rotations may be less useful than opposite-direction ones. This is due to recently rotated same-direction leaders having relatively scarce knowledge of, and social ties in, the target province compared to opposite-direction leaders who in all likelihood have had a five or ten-year tenure in the target province. As a result opposite-direction leaders both have deep knowledge of, and a strong social network in, the target province. Of course, the same-direction leader’s knowledge and social network will increase with time. But while the same-direction leader’s potential as a guanxi base thus will appreciate over time, the former’s potential as a guanxi base will, given the longevity of guanxi ties (Kipnis, 2002), not depreciate at a corresponding rate. Thus, overall, an opposite-direction political rotation should have a greater effect than a same-direction one. Thus we formulate the following hypothesis:

_Hypothesis 2: Opposite-direction cross-province political rotations exhibit a stronger relation with cross-province acquisition intensity than do same-direction cross-province political rotations._

Opposite-direction political rotations may be particularly valuable for firms from lower developed provinces that attempt to acquire in higher developed provinces for three reasons. Firstly, it may be assumed that firms from lower developed provinces contemplating higher developed province acquisitions have strategic motives similar to Chinese firms contemplating international acquisitions in developed countries (Child & Rodrigues, 2005; Farrell & Xiaohua, 2011). That is, they try to obtain strategic assets rather than seek to exploit competitive advantage. Such strategic assets could be technologies, know-how or other “locally embedded assets” (Farrell &
These assets may include well-protected assets, that is, the target province local government may want to protect them from foreign province acquisitions. Secondly, but a logical extension of the previous point, in the eyes of the target province’s local government, firms from lower developed provinces likely to carry lower legitimacy compared to firms from higher developed foreign provinces. Firms from lower developed provinces are less likely to be perceived as conducive to local economic growth through positive spillovers effects related to technological know-how, high corporate governance standards, etc. Such lack of legitimacy would make the target province local government reluctant to approve an acquisition or, if approved, lead to arbitrary discrimination. Thirdly, firms from lower developed provinces are likely to be accustomed to a business environment where government influence is pervasive due to a poor separation of state and market and severe institutional voids. Thus, the mind-set of lower developed province firm managers is likely to be that political support always must be sought after. Moreover, such managers can be expected to be more accustomed to, and again attributing greater value to, guanxi building. Thus, such managers will scan the political environment with even greater care, seek to exploit any chance of a referral or recommendation to establish ties in the target province, and attribute greater value to the possibility of gaining political support in the target province.

Based on these three reasons we envisage that political rotations will present greater opportunities for lower developed province firms wishing to acquire in higher developed provinces. As for target province protection of locally-embedded assets, rotation in both directions may be equally valuable, but for the two other theoretical arguments, opposite-direction seems more valuable. The support of a former target province leader now working in the acquiring firm’s province but with a good
reputation and strong ties in the higher developed target province will help the acquiring firm gain legitimacy and establish ties and therefore be (or perceived to be) more valuable. Thus:

**Hypothesis 3:** The effect of opposite-direction political rotations on foreign province acquisitions intensity is particularly strong when it concerns firms from lower developed provinces aiming to acquire in higher developed provinces.

We further propose that the above is particularly pertinent for POEs. POEs in China generally are resource constrained and have low legitimacy and government support (Du et al., 2015). Being resource constrained, Chinese POEs have adapted by becoming more ingenious, gaining more with fewer resources and seeking to exploit any possible opportunity (Peng, 2001). Hence, POEs facing a high level of environmental uncertainty can be expected to “strategize” and scan the environment for every potential resource they can use to attain their business goals (Oliver, 1991; Xu et al., 2010). POEs from lower developed provinces, we suggest, have the lowest legitimacy, have less government support than state-owned firms (SOEs) from the same provinces at the same time being more minded towards, and better at, exploiting strategic opportunities such as political rotations. Thus:

**Hypothesis 4:** For POEs from lower developed provinces the effect of opposite-direction political rotations on cross-province acquisition intensity is particularly strong when POEs are aiming to acquire in higher developed provinces.
Method

Data

The sample covers acquisition deals between provinces in mainland China completed by firms listed on the Shanghai and Shenzhen stock exchanges between 2003 and 2012. The primary source of cross-province acquisition deals is Bureau van Dijk’s ZEPHYR database, which further was cross-verified and extended by drawing from the China Stock Market & Accounting Research (CSMAR) database produced by the GTA Information Technology Co. Ltd. and the China Accounting and Finance Research Center, which covers firm information on publicly traded firms. The firm-level data comes from CSMAR; if the information was not available in the database, we searched for it in annual reports. The key acquisition deal information used in the analysis is an acquiring firm’s headquarters location, i.e. home province, and a target firm’s location, i.e. host province. Only deals involving the transfer of controlling rights, i.e. the final stake in a target firm being equal to or above 51 percent, were included. This restriction was levied to ensure that deals are substantial enough to observe the effect of political rotation on the number of cross-province acquisitions.

The number of firms in the sample is 358. Considering that China has a total of 31 provinces, municipalities, or autonomous regions, we created a sample of all possible firm-target province combinations in each year from 2003 to 2012, meaning that there are 30 provinces (in each year) where a given firm could potentially acquire a target. The total sample size is 108,000 firm-target province-year observations.

Dependent variable

In this study we use the number of cross-province acquisitions completed by firms in each year between 2003 and 2012 as dependent variable. The number of deals varies
between 0 and 2 for each year-dyad, non-zero observations account for 432 deals (0.4 percent of the sample).

Independent variables

The key independent variable of this study is political rotation between provinces. The data for this variable come from the China Vitae database on Chinese leaders, which includes detailed biographies of provincial party secretaries and governors, and which was used in prior studies (e.g., Jia et al., 2013). In this study we focus on provincial rotation of the political elite such as party secretaries and deputy secretaries, provincial governors and deputy provincial governors (Persson & Zhuravskaya, 2008; Zang, 1991). Leaders of various ministries are on the same bureaucratic level as provincial leaders, therefore, the movement of provincial leaders between their respective provinces and ministeries in Beijing is considered as political rotation (Wu, 2010). Several notes should be made on what we do not consider as a political rotation, which, arguably, demonstrates the stringency of the measurement. First, promotions are not coded as political rotation as long as the official did not change provinces whilst being promoted. Only promotions between deputy and higher positions were considered, i.e. promotions of officials from the lower hierarchical levels to deputy level positions, even whilst changing provinces, are not counted as political rotations. Second, similarly, demotions below deputy levels are not taken into consideration, even if the official moved across provinces. Third, retirements of the top officials, even when they involve changing provinces, are not considered as political rotation. In general, the nature of the rotation, e.g. promotion or demotion, is beyond the scope of this paper. Fourth, biography of officials, i.e. provinces of their birth, schooling and work prior to attaining deputy secretary or deputy governor
position, are not considered in the measurement. Fifth, rotations of officials across provinces prior to 2003 are not considered.

The total number of provincial deputy secretaries, deputy governors, secretaries and governors who changed provinces moving to equivalent or higher positions between 2003 and 2012 is 57. Sixty-six percent of these officials were subject to only one rotation (rotation between two provinces), and the rest were rotated between more than two provinces. The maximum number of rotations that were completed by one official is three. For example, Hu Chunhua was rotated at top provincial ranks between Tibet, Hebei, Inner Mongolia and Guangdong (three rotations). The total number of political rotations in the given time frame is 74.

The political rotation variable is directional having two different measures for same-direction political rotation and opposite-direction political rotation. Same-direction political rotation is assigned ‘1’ when a provincial leader has moved in the same direction as a completed acquisition. However, if a firm located in Shanghai acquires a firm in Anhui, but a political rotation occurs from Anhui to Shanghai, then opposite-direction political rotation is coded for. Both same and opposite-direction political rotation are assigned ‘1’ in the year where an individual moved between two provinces, and the value stays ‘1’ as long as that individual remained in one of the four top administrative positions in a province of the provincial dyad. We do not observe a year lag between political rotation variables and a firm acquisition, because prior studies demonstrate that the investment flow may follow political rotation quite rapidly as political leaders’ interest in instigating economic growth is short term (Cao, Julio, Leng, & Zhou, 2015). We do, however, test for lagged effects as part of our robustness checks, but do not find this to alter our results.
Moderating variables

The first moderating variable of the study is firm ownership, which is coded ‘1’ if an acquiring firm is a POE and ‘0’ if it is a SOE. The information for this variable is taken from CSMAR. The 65 different categories of actual controller in CSMAR were regrouped to obtain a classification of POE and SOE firm ownership types. Fifty-six percent of the sample firms are POEs that conducted 221 cross-province acquisitions. The remaining SOEs completed 211 cross-province acquisitions.

Another moderating variable in our study is the difference in the levels of development of acquiring and target provinces, which we identify as marketization index difference between acquiring and target provinces; their values are produced by the National Economic Research Institute, Beijing, China (Fan, Wang, & Zhu, 2011). The values of this index are available for 1997 to 2009, so the values between 2010 and 2012 have been obtained by applying a damped-trend exponential smoothing technique, which is considered to be the superior forecasting method (Gardner, 2006). The lowest value of the total index is 0.29 for Tibet in 2006 and the highest is 13.9 for Jiangsu in 2012. Values below zero mean that the marketization index of an acquiring province in a given year was smaller than that of a target – which is the case, for example, if firms from inland provinces acquire targets in coastal provinces.

Control variables

When accounting for alternative explanations for the number of cross-province acquisitions, we selected several firm-level control variables. First, we control for firm acquisitions in a target province, which we coded as ‘1’ if a firm has majority-owned subsidiaries in a target province prior to the focal acquisition and ‘0’ if it does not have any subsidiaries in a target province. Firm acquisition in a target province indicates a “foothold” in a focal target province, which should reduce a firm’s need
for political support. This is in line with studies in international business suggesting that acquisition experience in a foreign country increases the chance of further acquisitions in that country (Collins, Holcomb, Certo, & Hitt, 2009). We also include *top manager’s experience* in the target province, which is coded ‘1’ if a chairman of the board, whose role in most respects is equivalent to that of a CEO in Western companies, was born, studied at higher education institutions, or worked in a focal province, otherwise it is ‘0’. The international business literature on managerial experience usually incorporates only study and work experience in the target setting (Hermann & Datta, 2002; Takeuchi, Tesluk, Yun, & Lepak, 2005). However, due to the high importance of family guanxi ties in China (Chen, Chen, & Huang, 2013), we added origin of birth. Also we control for *top manager’s political connections* which is defined as a manager’s connections to the government. In line with prior studies (Li et al., 2012), this variable is equal to ‘1’ if a chairman of the board is or was an official of the central government, local government, an industry bureau or the military, otherwise it is set at ‘0’. *Top manager’s political connections* may reduce the likelihood of a firm’s growth strategy being dependent on political rotation. In sum, these three firm-level variables could provide bases for conducting cross-province acquisitions that would lessen the need for firms having to rely on political rotation.

Two additional firm-level control variables are included – *firm performance* and *firm size* – both of which are likely to increase the intensity of cross-province acquisitions conducted since they indicate a firm resource endowment (Lu, Liu, Filatotchev, & Wright, 2014). *Firm performance* one year prior to a focal acquisition is proxied by a logarithm-transformed return on assets (ROA) defined as net income divided by total assets, which is a common accounting measure of performance widely used in studies on firm acquisitions (e.g., Zollo & Singh 2004). *Firm size* was
calculated as a logarithm-transformed value of a number of firm employees one year prior to a focal deal (Liang, Lu, & Wang, 2012).

Finally, we control for *market size difference* between home and host province defined as a logarithm-transformed absolute difference in Gross Regional Product (GRP) levels between two provinces in a dyad (Tsang & Yip, 2007). According to prior studies, large market size is attractive for acquirers, consequently instigating acquisitions from lower to higher developed countries (Ellis, 2008). In China, conducting business in lower developed provinces might be advantageous due to lax taxation, cheaper labor and more accessible land (KPMG, 2012). In light of the Chinese government using acquisitions to restructure its economy and advance personal or local gains, SOE firms can be significantly underpriced, thereby increasing their attractiveness as targets. This makes acquisitions from larger to smaller markets more plausible (Tsang & Yip, 2007). The data for this variable were taken from China Statistical Yearbooks 2004–2013. Similarly to the *marketization index difference* between home and host provinces, *market size difference* varies between negative and positive values, where: negative values indicate that an acquiring province have a smaller market size compared to that of a target province, and vice versa in case of positive values.

We also control for industry using Standard Industrial Classification (SIC) codes with 64 percent of the sample being manufacturing firms, followed by 14 percent of firms in finance, real estate and insurance, 12 percent of firms operating in transportation and public utilities industry, and 6 percent of firms in mining. The remaining four percent are equally distributed across other industries. The industry variables are included in all models.
**Analytical approach**

Our data have a hierarchical structure; years of observation \((j = 1, \ldots, 10)\) are nested under all possible combinations of acquiring firms \((k = 1, \ldots, 358)\) and potential target provinces \((l = 1, \ldots, 31)\) in turn are nested under the acquiring provinces \((m = 1, \ldots, 30)\). The dependent variable in our paper is the number of acquisitions per firm per target province per year. Since the response variable is nonnegative and discrete, and its sample mean equals its variance \((M = s^2 = 0.0040)\), we specified a Poisson response distribution and a logarithmic link function. To analyze the data we use a generalized linear mixed model (GLMM), which is a flexible and powerful framework for the analysis of non-Gaussian panel data.

Since the theoretically relevant characteristics of acquiring firms, acquiring provinces and target provinces are explicitly measured and specified as fixed effects, inclusion of random intercepts on these levels would duplicate the fixed effects and render them unidentifiable. Hence, we follow a marginal approach and specify a model that includes a compound-symmetric covariance structure of the residuals. The observation clusters defining the compound-symmetric residual covariance structure are the ten observation years for each combination of firm and target province. All models were estimated using residual pseudo-likelihood (Wolfinger & O’Connell, 1993), a technique that reduces the bias in the estimation of covariance parameters relative to maximum likelihood. Standard errors and degrees of freedom for fixed effects were corrected using the Kenward and Roger’s approximation (2009).

**Results**

Descriptive statistics and a correlation matrix are presented in Table 1. The values display statistically significant correlations between several of our independent
variables and the number of cross-province acquisitions all with the expected signs. In particular, firm acquisitions and top manager’s experience in a target province are positively related to cross-province acquisitions in the same province, and both market size and marketization size differences are negatively related to the dependent variable, suggesting that a majority of cross-province acquisitions are from lower to higher marketization provinces. Same-direction and opposite-direction political rotation are both positively related to the independent variable; the latter one displays a stronger correlation coefficient ($r = 0.01$ versus $r = 0.02$). Specifically, same-direction and opposite-direction political rotation variables demonstrate positive and significant correlation coefficients ($r = 0.22, p < 0.05$). This indicates that for some provincial dyads political rotation occurs in both directions simultaneously (in the same direction as firm acquisitions and in the opposite direction as acquisitions). There is also a highly positive and significant ($r = 0.76, p < 0.01$) relationship between market size difference and marketization index difference, suggesting that the level of economic development and the level of institutional development go hand in hand. To test the implications of this, we ran robustness checks excluding market size difference due to its high correlation with marketization index difference. The results are unchanged (see also below).

The results of our regression models are presented in Table 2. Model 1 is a null model with control variables only, in Model 2 we add our independent variables same-direction and opposite-direction political rotations, Model 3 tests interaction effects between same and opposite-direction rotation and Marketization index difference, and Model 4 is a full model with a triple interaction term as well as additional interaction effects between several firm-level variables and political rotation variables.
<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Mean</th>
<th>S.D.</th>
<th>1.</th>
<th>2.</th>
<th>3.</th>
<th>4.</th>
<th>5.</th>
<th>6.</th>
<th>7.</th>
<th>8.</th>
<th>9.</th>
<th>10.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of acquisitions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm performance</td>
<td>7.82</td>
<td>0.05</td>
<td>-0.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm size</td>
<td>7.39</td>
<td>1.74</td>
<td>0.00</td>
<td>-0.06**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top manager’s political connections</td>
<td>0.18</td>
<td>0.38</td>
<td>0.00</td>
<td>0.05**</td>
<td>0.01*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top manager’s experience in a target province</td>
<td>0.03</td>
<td>0.17</td>
<td>0.01**</td>
<td>-0.00</td>
<td>-0.02**</td>
<td>0.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm acquisitions in a target province</td>
<td>0.17</td>
<td>0.32</td>
<td>0.03**</td>
<td>0.02**</td>
<td>0.06**</td>
<td>0.04**</td>
<td>0.18**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market size difference</td>
<td>0.59</td>
<td>1.26</td>
<td>-0.03**</td>
<td>0.05**</td>
<td>0.04**</td>
<td>-0.00</td>
<td>-0.00</td>
<td>-0.00</td>
<td>-0.02</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketization index (MI) difference</td>
<td>1.60</td>
<td>2.94</td>
<td>-0.02**</td>
<td>0.05**</td>
<td>0.01**</td>
<td>-0.03**</td>
<td>-0.01**</td>
<td>-0.02**</td>
<td>0.76**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ownership type</td>
<td>0.55</td>
<td>0.50</td>
<td>-0.00</td>
<td>0.08**</td>
<td>-0.14*</td>
<td>-0.00</td>
<td>0.01*</td>
<td>-0.05**</td>
<td>0.07</td>
<td>0.07**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same-direction political rotation</td>
<td>0.14</td>
<td>0.35</td>
<td>0.01**</td>
<td>0.01*</td>
<td>0.02**</td>
<td>0.00</td>
<td>0.03**</td>
<td>0.03**</td>
<td>-0.06**</td>
<td>-0.02**</td>
<td>-0.03**</td>
<td></td>
</tr>
<tr>
<td>Opposite-direction political rotation</td>
<td>0.11</td>
<td>0.32</td>
<td>0.02**</td>
<td>-0.02</td>
<td>0.07*</td>
<td>0.00</td>
<td>-0.00</td>
<td>0.02**</td>
<td>-0.13**</td>
<td>-0.11**</td>
<td>-0.06**</td>
<td>0.22**</td>
</tr>
</tbody>
</table>

Notes: N = 108,000; * p < 0.05, ** p < 0.01.
The findings of the null model demonstrate that top manager’s experience in a target province (β = 0.42, p < 0.05) and firm acquisitions in a target province (β = 1.00, p < 0.001) both are positively and significantly related to the dependent variable. In fact, the latter variable has the largest standardized coefficient (β = 105.11) of all independent variables included in Models 1 to 4. Market size difference (β = -0.23, p < 0.001) and marketization index difference (β = -0.08, p < 0.01) seem to reduce the number of cross-province acquisitions. This means that there are fewer acquisitions between acquiring firms located in higher developed provinces and target firms in lower developed provinces, suggesting that there might be fewer target firms of interest in the latter provinces.

We test Hypothesis 1 that same-direction and opposite-direction political rotation leads to higher cross-province acquisition intensity and Hypothesis 2 specifying that opposite-direction political rotation is a stronger predictor of cross-province acquisitions in Model 2. Both same and opposite-direction political rotation variables are statistically significant at p < 0.05 and p < 0.001 respectively, offering a confirmation of Hypothesis 1. The comparison of standardized coefficients for these two variables demonstrates that opposite-direction political rotation has a larger impact on the number of cross-province acquisitions than same-direction political rotation. Specifically, having opposite-direction political rotation yields 1.58 more acquisitions between the dyad of provinces per year compared to those without political rotation; the corresponding figure for same-direction political rotation is 1.32. Hence, we find support for Hypothesis 2.

Model 3 includes two sets of interaction effects testing hypothesis 3 that the effect of opposite-direction political rotation is stronger than that of same-direction political rotation when acquisitions run from lower developed acquiring provinces to higher
Table 2. The results of the generalized poisson mixed model regression, the number of acquisitions is the dependent variable

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Model 1</th>
<th>Model 2 (H1, H2)</th>
<th>Model 3 (H3)</th>
<th>Model 4 (H4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm performance</td>
<td>-0.18</td>
<td>-0.18</td>
<td>-0.18</td>
<td>-0.19</td>
</tr>
<tr>
<td></td>
<td>(-2.94)</td>
<td>(-3.07)</td>
<td>(-3.05)</td>
<td>(-3.09)</td>
</tr>
<tr>
<td>Firm size</td>
<td>0.04</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td></td>
<td>(21.87)</td>
<td>(17.03)</td>
<td>(17.28)</td>
<td>(14.74)</td>
</tr>
<tr>
<td>Top manager’s political connections</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.00</td>
</tr>
<tr>
<td></td>
<td>(1.51)</td>
<td>(1.19)</td>
<td>(1.06)</td>
<td>(0.22)</td>
</tr>
<tr>
<td>Top manager’s experience in a target province</td>
<td>0.42</td>
<td>0.41</td>
<td>0.41</td>
<td>0.28</td>
</tr>
<tr>
<td></td>
<td>(23.03)</td>
<td>(22.62)</td>
<td>(22.81)</td>
<td>(15.22)</td>
</tr>
<tr>
<td>Firm acquisitions in a target province</td>
<td>1.00</td>
<td>0.99</td>
<td>0.99</td>
<td>1.12</td>
</tr>
<tr>
<td></td>
<td>(105.11)***</td>
<td>(103.70)***</td>
<td>(103.75)***</td>
<td>(117.54)***</td>
</tr>
<tr>
<td>Market size difference</td>
<td>-0.23</td>
<td>-0.20</td>
<td>-0.20</td>
<td>-0.20</td>
</tr>
<tr>
<td></td>
<td>(-96.86)***</td>
<td>(-82.15)***</td>
<td>(-83.41)***</td>
<td>(-83.14)***</td>
</tr>
<tr>
<td>MI difference</td>
<td>-0.08</td>
<td>0.09</td>
<td>-0.08</td>
<td>-0.08</td>
</tr>
<tr>
<td></td>
<td>(-80.93)**</td>
<td>(-91.26)***</td>
<td>(-75.68)***</td>
<td>(-76.12)***</td>
</tr>
<tr>
<td>Ownership type</td>
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<td>0.03</td>
<td>0.03</td>
<td>0.01</td>
</tr>
<tr>
<td></td>
<td>(3.26)</td>
<td>(4.83)</td>
<td>(4.11)</td>
<td>(2.03)</td>
</tr>
<tr>
<td>Same-direction political rotation (H1, H2)</td>
<td>0.28</td>
<td>0.32</td>
<td>0.29</td>
<td>(33.58)</td>
</tr>
<tr>
<td></td>
<td>(32.12)*</td>
<td>(36.36)*</td>
<td>(33.58)**</td>
<td></td>
</tr>
<tr>
<td>Opposite-direction political rotation (H1, H2)</td>
<td>0.46</td>
<td>0.46</td>
<td>0.61</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(47.78)***</td>
<td>(47.76)***</td>
<td>(33.58)**</td>
<td></td>
</tr>
<tr>
<td>Same-direction rotation*MI (H3)</td>
<td>-0.06</td>
<td>-0.05</td>
<td>-0.06</td>
<td>-0.05</td>
</tr>
<tr>
<td></td>
<td>(21.50)</td>
<td>(63.40)</td>
<td>(18.75)</td>
<td></td>
</tr>
<tr>
<td>Opposite-direction rotation*MI (H3)</td>
<td>-0.04</td>
<td>-0.04</td>
<td>-0.24</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-13.41)</td>
<td>(-20.85)</td>
<td>(-51.53)**</td>
<td></td>
</tr>
<tr>
<td>Same-direction*firm ownership</td>
<td>0.25</td>
<td>-0.28</td>
<td>-0.43</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(21.38)</td>
<td>(-22.25)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opposite-direction*firm ownership</td>
<td>-0.28</td>
<td>-0.28</td>
<td>-0.28</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-20.85)</td>
<td>(-22.25)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same-direction*Top manager’s political connections</td>
<td>-0.26</td>
<td>0.26</td>
<td>0.26</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(11.82)</td>
<td>(11.82)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opposite-direction*Top manager’s political connections</td>
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<td>0.13</td>
<td>0.13</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(3.30)</td>
<td>(3.30)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same-direction*Top manager’s experience</td>
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<td>0.38</td>
<td>0.38</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(7.10)</td>
<td>(7.10)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opposite-direction*Top manager’s experience</td>
<td>-0.11</td>
<td>-0.11</td>
<td>-0.11</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-5.10)</td>
<td>(-5.10)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same-direction*Firm acquisitions</td>
<td>-0.55</td>
<td>-0.55</td>
<td>-0.55</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-22.13)</td>
<td>(-22.13)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opposite-direction*Firm acquisitions</td>
<td>-0.06</td>
<td>-0.06</td>
<td>-0.06</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-35.92)</td>
<td>(-35.92)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ownership*MI</td>
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<td>-0.55</td>
<td>-0.55</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-22.13)</td>
<td>(-22.13)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same-direction rotation<em>ownership</em>MI</td>
<td>-0.04</td>
<td>-0.04</td>
<td>-0.04</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-10.19)</td>
<td>(-10.19)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opposite-direction rot.<em>ownership</em>MI (H4)</td>
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<td>-0.24</td>
<td>-0.24</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-51.53)**</td>
<td>(-51.53)**</td>
<td></td>
<td></td>
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<td>Generalized chi-square</td>
<td>107553</td>
<td>104872</td>
<td>104590</td>
<td>104949</td>
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<tr>
<td>~2 Residual Log Pseudo-Likelihood</td>
<td>915603</td>
<td>926397</td>
<td>934991</td>
<td>939243</td>
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</tbody>
</table>

Notes: N = 108,000; * p < 0.05, ** p < 0.01, *** p < 0.001. Unstandardized coefficients are reported with standardized coefficients in parenthesis. Each model includes year and industry dummies.
developed target provinces. The results are not statistically significant; thus we do not find support for Hypothesis 3.

Hypothesis 4 that the effect of opposite-direction political rotation is stronger for POEs located in lower developed provinces and acquiring firms in higher developed provinces, is tested in Model 4. To do this, we test a triple interaction effect between opposite-direction political rotation, ownership type and marketization index difference; we find that its impact on the number of cross-province acquisitions is negative and statistically significant ($\beta = -0.24, \ p < 0.01$). This interaction effect is plotted in figure 1 keeping all other independent variables at their mean levels.

Figure 1. The interaction effect for Hypothesis 4. The solid lines indicate the least-squares means and the dotted lines the lower and upper bounds of the 95 percent confidence intervals

As the plot illustrates, there is a significant spike in the number of cross-province acquisitions for POEs approximately between −7 and −12.5 difference in
marketization indices between acquiring and target provinces. Contrasting these *marketization index differences* with marketization indices of different Chinese provinces enables us to identify that the spike is represented by acquisitions such as, for example, between acquiring firms located in Tibet, Yunnan, Shanxi and other least developed provinces of West China and target provinces of East China like Jiangsu and Zhejiang. Overall, this finding supports Hypothesis 4.

In addition to the triple interaction effect in focus, Model 4 also contains beta coefficients for a triple interaction effect between *same-direction political rotation*, *ownership type* and *marketization index difference* as well as *same* and *opposite-direction political rotation* and firm-level variables such as *top manager’s political connections*, *top manager’s experience* in a target province, *firm acquisitions* in a target province – none of which are significant. We present these interaction effects to highlight the strength of our finding that *opposite-direction political rotation* increases the number of POE acquisitions from lower to higher developed provinces.

Several robustness checks were made. We investigated whether the high correlation between *market size* and *marketization index differences* has implications for the significance of the latter as it could have been boosted by a suppression effect or partially masked by a mediation effect of *market size difference*. The specification of the model with omitted market size difference revealed that the *marketization index difference* variable increased considerably in absolute size (by 80 percent), which did not qualitatively affect the statistical test results.

Another aspect of our analysis that could have been questioned was the inclusion of contemporaneous measurements of *market size* and *marketization index differences*, which we considered in the context of Chinese state capitalism to be relatively stable year-on-year, as opposed to lagged measurements. To examine how
sensitive our results were to this, we replaced contemporaneous measures with one-year lagged measures in the specification of Model 4 and re-estimated the model parameters. The results of our analysis remained unaffected.

**Discussion**

This study examined the relationship between cross-province political rotations and cross-province acquisitions providing a conceptualization of the way(s) in which cross-province political rotation acts as a catalyst for cross-province acquisitions in China. The main argument is that Chinese firms respond to rotations because they potentially can help create managerial ties to key political stakeholders in the target province and thus help the firm secure political support in that target province. However, rotation may also, we proposed, be a catalyst because government leaders “pull” with them firms from their old province to the new. To disentangle these two conceptualized effects of a political rotation in a provincial dyad on the number of cross-province acquisitions, we empirically distinguished between same-direction and opposite-direction political rotations. The result is that while we cannot rule out the “pulling” effect of political rotations, we can rule out that political rotation is a catalyst *only* because rotating leaders pull firms with them. In other words, firms actively seek to exploit political rotations strategically; they are not just passively dragged along by rotating leaders.

By showing that opposite-direction rotation to a greater degree acts as a catalyst for acquisitions (Hypothesis 2), we further support our theoretical argument that political rotation is an opportunity to establish political ties to political stakeholders in the target province (ties being *informal* means of support in the target province). If a firm were to rely on a political leader’s formal executive power as the means of
support, then same-direction rotation would be the main catalyst as opposite-direction rotated leaders no longer have any formal political power in the target province. Therefore, any influence wielded by former provincial leaders must be of a more informal nature – for example by putting in a good word for a foreign province acquiring firm and/or referring the firm’s managers to a close political ally in the target province, giving the manager the opportunity to create guanxi ties to that official.

Our analyses did not uncover any moderating effect of institutional distance on firms’ willingness or capability to utilize political rotations for acquisitions. However, when we included ownership as a factor, we found that POEs are more responsive to political rotations (and again, only opposite-direction rotations) when they have to go from lower to higher developed provinces. A reason why this only applies to POEs could be that they are less resource endowed than SOEs. In particular, they are less endowed compared to SOEs when it comes to political resources and thus have no “substitute resources” (Newbert, 2007: 139) for reducing transaction costs associated with cross-province acquisitions through political support.

Our findings also show that political rotation is a factor impacting cross-province acquisitions independent of top manager’s political connections. Specifically, by conducting additional analyses to test for moderating and mediating effects between top managers’ political connections, political rotations, and firm acquisitions, we did not find any significant evidence of any such relationships. This means that political connections, in our study defined as a top manager’s previous government experience, do not hold the same potential for political support as political rotations do. The reason, we believe, is simple. Political connections offer generic (potential) political support while political rotations offer specific (potential) political support in the target
province. Or more sharply formulated, political support often has geographical boundaries.

By focusing on cross-province political rotations and acquisitions, our study addresses two calls from very different strands of strategy research. One call is for more light on the interplay between government and business (Ring et al., 2005) and another is for a focus on the unique characteristics of Chinese management (Barney & Zhang, 2009). We find our results to be important in regard to both of these. As for the latter, our findings indicate that firms actively scan for, and seek to exploit, political rotations. Our ability to rule out the “pulling effect” being the sole effect is in this regard significant. As for the former, we contribute very specifically to the literature on political rotations and their economic implications. Our results both show that provincial borders are (perceived or real) barriers of entry for Chinese firms and that political ties are (perceived or real) resources for firms to negotiate these barriers. Issues concerning regional disparities and trade barriers across China’s provinces are, we argue, a somewhat ignored topic in the management literature, and our study takes a small step to remedy that.

In addition to the above, we contribute to the literature on political ties by empirically testing an additional dimension of political capital that firms in China can draw from. Finally, our findings indirectly contribute to the international business literature, namely that domestic firm growth in China is inhibited by institutional voids. Our findings suggest that POEs in China, being resource disadvantaged, are keen to exploit opportunities as “remote” as political rotations to enter more developed provinces with stronger market institutions. Hence, even though we do not test an escape motive for internationalization of Chinese firms proposed by Witt and Lewin (2007) and Boisot and Meyer (2008) directly, we do provide tangential
evidence that POEs are resilient in reducing uncertainties to fuel an “escape” from lower developed to higher developed provinces in China (Liang et al., 2012).

**Limitations and implications for future research**

The nature of this study is exploratory and has its limitations. In particular, we hypothesized that firms use political rotations to establish guanxi ties with target province political stakeholders – for example by getting a referral from the rotated leaders to these stakeholders. However, we have not empirically tested the theoretical assumptions that link political rotations with political support. Future studies deploying a survey methodology or semi-structured interviews could help confirm our theories. Another limitation of the paper is that we were unable to investigate the time trend of the impact of political rotations on cross-province acquisitions. The reason for this is that the multilevel panel structure of our data yielded very few positive cross-province acquisition events, thereby distorting the potential analysis of the time trend. This multilevel panel structure of the data, on the other hand, makes it possible to control for firm-level effects while investigating the impact of a macro-level political rotation on cross-province acquisitions.

Not all provinces in China have an equal offering of target firms meaning that some provinces have more potential targets than others, therefore target munificence of provinces might impact our results. It is of course also possible that qualitative characteristics of potential target firms, e.g. ownership and industry, might vary within and between provinces. However, such fine-grained analysis falls outside the scope of this study. Lastly, in this study we have followed Persson and Zhuravskaya’s (2008) definition of political leadership that comprises deputy governors and deputy party chiefs, whereas other studies exclude the deputy level from their analysis of
political rotation (Cao et al., 2015; Li & Zhou, 2005). Considering such variation of the analysis level of political rotations, future research should aim to uncover at which government level rotations have the greatest effect on firm strategies.

**Conclusion**

We conclude that political rotations do affect cross province acquisitions. Thus, political rotations can play a role in the economic integration of China’s province. However, that does not exclude the possibility that the political rotation system simultaneously has other political or economic effects that help maintain provincial barriers. More important for management studies, we find clear evidence that the effect of rotations at least partly is due to firms actively seeking to exploit rotations. We find no direct evidence that institutional disparities between provinces accentuate the effects of rotations but we do find evidence that rotations opposite to the direction of (intended) acquisitions are especially effectual for private firms from lower developed provinces.

**References**


CHAPTER 5. Domestic and Cross-Border Acquisitions of Private Firms in China: The S-Curved Hypothesis

Abstract

Drawing on organizational learning theory I propose an S-curved relationship between domestic and cross-border firm acquisitions in China. I further argue that domestic acquisition experience in China is heterogeneous with different knowledge generated through within- and cross-province acquisitions. I test these ideas on a sample of 899 acquisitions conducted by Chinese private firms between 2002 and 2014. I find a resounding confirmation of a non-linear effect between domestic and cross-border acquisitions, and demonstrate that firms located in coastal and inland China have different paths to internationalization. The study contributes to the analysis of the effect of a firm’s institutional environment on its internationalization, and indicates a limitation of a path-dependent view of organizational learning in the context of emerging markets.

Keywords: domestic acquisitions; internationalization; cross-border acquisitions; China; private firms
Introduction

How do firms from emerging economies (EE) internationalize having relatively little internationalization experience has become pivotal in international business literature in the past decade. In the attempt to solve this conundrum various factors have been explored such as home country government support (Hong, Wang, & Kafouros, 2014; Lu, Liu, & Wang, 2010; Lu, Liu, Wright, & Filatotchev, 2014), the quality of home institutions (Liu, Lu, & Chizema, 2014; Luo & Wang, 2012; Meyer, Estrin, Bhaumik, & Peng, 2009; Rabbiosi, Elia, & Bertoni, 2012; Stoian, 2013; Sun, Peng, Lee, & Tan, 2015; Wu & Chen, 2014), top management international experience (Cui, Li, & Li, 2011; Lu, Liu, Filatotchev, & Wright, 2014), and firms’ experience with joint ventures and alliances (Hong & Lee, 2015; Zheng, Khavull, & Crockett, 2012). Against the backdrop of this extant research, as first argued by Peng (2012) and reinforced by Lebedev, Peng, Xie and Stevens (2014), studies of cross-border acquisition behavior of EE firms rest on a lack of understanding of their domestic acquisition experience, which is partly a cause for conflicting findings on internationalization of EE firms.

This paper is among the first to explore the missing link between domestic and cross-border acquisitions of EE firms in the specific context of China. I integrate literature on organizational learning (Levitt & March, 1988; Zahra & George, 2002), with the focus on prior acquisition experience (Collins, Holcomb, Certo, & Hitt, 2009; Nadolska & Barkema, 2007), and institutional theory (Peng, Wang, & Jiang, 2008; Witt & Lewin, 2007) to model a firm’s decision to conduct cross-border acquisitions as a function of its domestic acquisition experience. Hence, the main research question of this study is: What is the relationship between domestic acquisition experience of Chinese firms and a decision to pursue a cross-border acquisition over a domestic acquisition? To answer this question I focus the analysis on private Chinese firms that completed their first cross-border acquisition during the period from 2002 to 2014.
The study makes several contributions to the fields of strategic management and international business. First, I propose and test an S-curved relationship between domestic acquisition experience and cross-border acquisitions, which departs from prior studies fitting linear models and receiving inconclusive results on the nature of the relationship (Collins et al. 2009; Dikova & Sahib, 2013; Muehlfeld, Sahib, & Witteloostuijn, 2012; Nadolska & Barkema, 2007). Using a different methodology I confirm the findings by Lu et al. (2014) that domestic acquisition experience by EE firms matter for their decision to internationalize. Second, by theoretically and empirically embedding organizational learning theory in the institutional context of EE, this study goes further and demonstrates that domestic acquisition experience of EE firms is heterogeneous in a way that it varies by two factors: 1) whether the provincial borders have been crossed (whether a target firm is located within home province or outside of home province of an acquiring firm) and 2) the institutional distance covered in an acquisition (whether a target firm is located in a higher or lower developed province relative to the province of an acquiring firm). This experiential heterogeneity results in a different effect that domestic acquisition experience has on a firm’s internationalization. Not all types of domestic acquisition experience are equally important, which represents an extension of research concerned with the effect of organizational learning on subsequent business strategies in the context of mergers and acquisitions.

Third, by showing that firms from higher developed – coastal – provinces are likely to internationalize with more experience generated from lower developed – inland – provinces, whilst firms from inland provinces tend to establish wider presence across coastal provinces before internationalizing, I am able to identify different paths to internationalization of firms operating in different institutional settings. This has certain implications for empirical studies built on recent theoretical developments within the springboard and institutional escape perspectives (Luo & Tung, 2007; Witt & Lewin, 2007). One of the propositions they share is that firms internationalize as a
response to adverse institutional environment in home location. This has engendered a multitude of empirical studies looking at a firm’s location as a factor of internationalization (e.g., Ding, 2009; Liu, Lu, & Chizema, 2014; Luo & Wang, 2012; Wu & Chen, 2014). The path to internationalization found in this paper questions the methodological appropriateness of these studies, because a firm with cross-province acquisitions operates across different institutional contexts within home country, so accounting for institutions only of the location of its headquarters is insufficient, creating a distorted picture of the relationship between institutional context and internationalization of EE firms.

The paper starts with an overview of organizational learning theory which is used for building the S-curved hypothesis. This is followed by the introduction of the two types of domestic experience drawing from the institutional theory, and the argumentation for the interaction term between the direction of cross-province acquisition experience and firm location. Then, methods, results and additional tests lead to a detailed discussion of the hypothesized and additional findings, followed by the limitations of this study and a conclusion.

**Theory and Hypotheses Development**

Research in organizational learning views a firm’s behavior as a function of its experience (Argote & Miron-Spektor, 2011; Fiol & Lyles, 1985). Organizational learning is a path-dependent and cumulative process, where a firm’s ability to assess new information, assimilate it and apply to new ends – a process which is often termed absorptive capacity – is contingent upon the firm’s prior knowledge (Cohen & Levinthal, 1990; Todorova & Durisin, 2007; Zahra & George, 2002). This means that the more experience with a particular routine or task a firm has, the more likely that routine or task will be refined and repeated in the future (Amburgey, Kelly, & Barnett, 1993; Halebian, Kim, & Rajagopalan, 2006). In the context of firm acquisitions, empirical studies both in advanced and emerging markets confirm that prior acquisition experience positively impacts the
likelihood of subsequent acquisitions (Alessandri, Cerrato, & Depperu, 2014; Haleblian et al., 2006; Peng & Fang, 2010). Indeed, considering that firm acquisition is a complex strategy entailing a high level of risk due to information asymmetry between target and acquiring firms, repeated acquisitions can help generate valuable templates of how to select targets and conduct a post-acquisition integration of the two firms (Capron & Shen, 2007; Haleblian et al., 2006). The further application of these templates leads to their refinement and potentially more successful outcomes.

Cross-border acquisitions are considerably more complex than domestic acquisitions (Basuil & Datta, 2015; Contractor, Kundu, & Hsu, 2003). The reason for this is a greater degree of uncertainty and higher information asymmetry incorporating both apparent and subtle institutional and cultural differences between countries which must be factored in during the due diligence process. Hence, misapplication of acquisition routines developed in a domestic context is a likely possibility. For example, Barkema (2006) describes how a Dutch retail chain “Ahold” wrongly identified the potential for synergy with its acquired US target by disregarding differences in incentive structures, and failed in China, not least due to ignoring local customers’ preferences for “wet markets” to buy fresh vegetables. The higher complexity can partly account for the sparseness of studies on the relationship between domestic and cross-border acquisitions compared to domestic-to-domestic and international-to-international. Three studies found a positive impact of prior domestic acquisition experience on cross-border acquisitions (Collins et al., 2009; Lu et al., 2014; Nadolska & Barkema, 2001), whereas one did not find any relationship between these two strategies (Muehlfeld et al., 2012). In addition to this, Nadolska and Barkema (2001) found a U-shaped relationship between prior domestic acquisition experience and success of cross-border acquisitions, and Dikova and Sahib (2013) found no effect of domestic experience on cross-border acquisition performance – both of which reflect the difficulty firms experience when trying to apply their domestic acquisition routines to foreign contexts.
In light of the inconsistency of the results on the relationship between domestic acquisition experience and cross-border acquisitions, I extend the, predominantly linear, view of the effect of prior experience on subsequent firm behavior by theoretically and empirically accounting for two specific points in the process of firm learning. These are the beginning and the advanced stages of the application of a routine. The introduction of these two points in addition to the linear trend conceptualized and identified in prior studies requires modeling a generic S-curved (sigmoid) relationship between prior experience (prior domestic acquisition experience in this case) and a subsequent firm behavior (completion of a cross-border acquisition).

A staged model of the effect of prior domestic acquisition experience on cross-border acquisitions

Figure 1. A staged model of prior domestic acquisition experience on cross-border acquisitions

Building firm knowledge is a cumulative process. When pursuing a new strategy, a firm is likely to suffer from dissimilarity between prior knowledge and new procedures. Inability to draw
connections between prior knowledge and new information inhibits organizational learning, so that the generation of usable routines for future applications is hindered (Cohen & Levinthal, 1990; Hayward, 2002; Muehlfeld et al., 2012). March, Sproull and Tamuz (1991) discuss that when having experience with one or few cases, a firm might not be able to overcome the noise of dissimilarity. If a firm tries to build a certain template of action at this stage, the noise will increase a risk of erroneous generalizations. In case of firm acquisitions, adding subsidiaries increases coordination and governance costs dramatically. This point has been addressed in extant research on firm internationalization, and diversification in general, demonstrating negative performance effects at early stages (Contractor et al., 2003; Hayward, 2002; Lu & Beamish, 2004; Thomas & Eden, 2004; Tsai, 2014; Zhang & Rajagopalan, 2010). With increasing organizational complexity, firm’s limited resources will likely to be directed at reducing the implications of this complexity at the expense of other firm activities such as extracting learning points and creating organizational routines for future acquisition strategies. Considering higher complexity and inherent risks of cross-border acquisitions, firms with minimal domestic acquisition experience are not likely to be able to generate acquisition templates to be readily applied to more uncertain foreign contexts. In other words, at Stage 1 a negative slope of prior domestic experience on the likelihood to internationalize should be expected.

When a firm reaches a medium level of acquisition experience, i.e. it would have several acquired subsidiaries, its ability to create and refine action routines from past experiences improves. There are two factors allowing that. First, firm acquisitions have a delayed positive effect on the acquiring firm’s business operations due to the challenges of achieving synergy post-acquisition (Barkema & Schijven, 2008). It means that having several subsidiaries will allow the firm to enjoy efficiencies of scale and, thereby, higher performance (Contractor et al., 2003). Second, after the initial shake-up stage of business expansion, the firm is likely to learn how to manage
organizational complexity. Hence, the benefits of each additional acquisition would outweigh the costs. Achieving the benefits of acquisition growth and better corporate governance together liberate resources needed for systematic organizational learning. Specifically, a firm can engage in deliberate learning from past acquisition experiences (Argote & Todorova, 2007; Zollo & Winter, 2002). Research suggests that deliberate learning can help accelerating organizational learning involving strategies with high causal ambiguity (Levitt & March, 1988). Acquisitions are exactly this type of firm strategy when it is not clear which actions or a combination of actions lead to which results. Deliberate learning, as a controlled learning process incorporating collective discussions, implicit knowledge articulation and codification, can help firms create better routines from a variety of past acquisition events (Zollo & Winter, 2002). Hence, the stage of a medium level of acquisition experience is where organizational learning process can be the most efficient and effective. This, then, would allow firms to venture cross-border as a way to utilize excess knowledge and financial resources, resulting in a positive slope between domestic acquisition experience and cross-border acquisitions.

The third – advanced – stage of domestic acquisition experience is rooted in a path-dependent nature of organizational learning. Any repeated strategy bears a risk of leading to a competency trap when a positive feedback with that strategy reduces a chance of selecting a different strategy (Levitt & March, 1988; Zahra & George, 2002). There are several factors contributing to this process. First of all, any new strategy requires significant investment in learning compared to repeating the old one (Greve, 2003). Also, firm managers might choose the old strategy because it simplifies information processing (Amburgey & Miner, 1992). In case of acquisition growth, repetition of this strategy increases a firm’s complexity so it becomes “overstretched” which “taxes a firm’s absorptive capacity” (Levinthal & March, 1993; Teece, Rumelt, Dosi, & Winter, 1994; Vermeulen & Barkema, 2002). So with the increasing number of acquisitions, a risk of mistakes due to
inappropriate application of routines to different contexts increases exponentially, whilst simultaneously compromising managerial capacity to deal with organizational complexity. Hence, at this stage a firm will not likely to find resources or managerial will to internationalize, leading to a negative slope between domestic acquisition experience and cross-border acquisitions.

Hypothesis 1: There is an S-curved relationship between domestic acquisition experience and the choice of a cross-border acquisition: a negative slope at low and high levels of domestic acquisition experience and a positive slope at a medium level of domestic acquisition experience.

Within-province and cross-province firm acquisitions

In the context of China, domestic acquisition experience is heterogeneous, varying, first of all, by the geographical location of a target firm, that is whether a target is located in the same province as an acquiring firm (or an acquisition is within-province), or a target is located in a different province from that of an acquiring firm (or an acquisition is cross-province). China is a regionally decentralized state with relatively closed provinces that historically aimed to be self-sufficient, and some of them still maintaining their unique cultural identities (Ke, 2015; Tse, 2010). Formal institutions such as laws and regulations also vary dramatically across provinces because local governments have considerable legislative powers in their jurisdictions (He, Wei, & Xie, 2008; Huang, 2003; Liu, Song, & Tao, 2006). The pronounced sub-national variability of institutional contexts in China prompted Boisot and Meyer (2008) to suggest that transaction costs of acquiring cross-province might exceed the costs of internationalization, and led Lu et al. (2014) to propose that firms acquiring targets across different provinces are likely to encounter liability of foreignness akin to the one firms experience in internationalization.
There are important differences between experiences of within- and cross-province domestic acquisitions. First, within- and cross-province acquisitions differ in the type of knowledge they convey. Specifically, within-province acquisition experience contributes to a firm’s procedural knowledge of “how to screen, select, take over, and integrate” target firms, something which was equated with domestic acquisition experience in prior studies (Kogut & Zander, 1992; Nadolska & Barkema, 2001: 1174). In addition to the procedural knowledge, however, cross-province acquisitions carry insights into how to overcome and manage a firm across a variety of institutional contexts. Hence, compared to within-province acquisition experience, cross-province acquisition experience should result in a higher likelihood of cross-border acquisitions.

Second, within- and cross-province acquisitions vary by the learning process involved in each of the two strategies. Due to underdeveloped market institutions, reliance on social networks for resources and information is key to business success in EE (Khanna & Palepu, 1997; Li, Poppo, & Zhou, 2008). Hence, when a firm repeats its business strategy, firm acquisitions in this case, it is done through the established social network (Acquaah, 2007). One of the characteristics of social networks, which has been alluded to in the Chinese context too, is their decreasing power with geographical distance (Hedström, 2004; Li et al., 2008; Lu et al., 2014; Peng, 2003). In brief, then, within-province acquisitions are likely to be conducted within the established social network (or, in other words, in a more stable knowledge environment), whereas cross-province acquisitions are carried out through weaker or even outside of the usual social network (or in a changing knowledge environment). The stability of knowledge environment is an important concept in organizational learning literature as it begets a different relationship between a firm and knowledge. In stable environments the relationship is likely to be that of exploitation or refining and deepening of the current knowledge stock, whereas in changing environments it is of exploration involving seeking new knowledge through risk-taking and initiative (March, 1991). Considering that cross-border
acquisitions require major efforts of knowledge exploration, cross-province acquisitions is a better springboard to internationalization than within-province acquisitions.

Gathering these two points regarding the difference between within- and cross-province acquisitions together, I propose the next hypothesis as follows:

**Hypothesis 2: Cross-province acquisition experience results in a higher likelihood of choosing a cross-border acquisition than within-province acquisition experience.**

**The effect of cross-province acquisitions based on the location of acquiring and target firms**

Although in China institutional differences between all provinces are quite stark, coastal-inland is a watershed divide distinguishing high developed coastal provinces from low developed inland provinces (Fan, Kanbur, & Zhang, 2011; Lemoine, Poncet, & Unal, 2015). Coastal provinces benefited from the opening up to foreign markets since the launch of economic reforms in 1978, achieving better contract enforcement, lower degree of government intervention, superior infrastructure, and hosting a considerably larger proportion of private and foreign firms compared to inland provinces (Du, Lu, & Tao, 2008; Li, 2004). Considering this, I make two propositions. First, firms are likely to generate more knowledge not just from any cross-province acquisitions, but from acquisitions in significantly different provinces which allow for the heterogeneity of acquisition experience leading to better learning. Second, operating in coastal provinces is a source of indirect learning mainly, but not exclusively, from foreign firms, strengthening a firm’s ability to recognize, interpret and navigate through institutional complexity.

Considering the first proposition, the requirement of knowledge exploration is likely to be greater when inland firms acquire targets in coastal provinces than in other inland provinces, and the reverse is applicable to coastal firms. This is because of different institutional logics existing in inland and coastal provinces that shape what is deemed appropriate organizational behavior
(Thornton & Ocasio, 1999). Some of the differences in institutional logics between inland and coastal provinces are the stronger role of networks in running business and the possibility of bargaining with government officials in case of the former (Fliqstein & Zhang, 2010; Krug & Hendrischke, 2008). Hence, when, for example, coastal firms acquire targets in other coastal provinces, although this will enable them to gain knowledge of operating under different formal institutions and experience a certain degree of cultural variation, they will likely not encounter the kind of shift in the dominant institutional logics as they would in case they entered inland provinces. It is very likely that operating in environments dominated by different institutional logics is exactly the degree of heterogeneity of experience that is indispensable for subsequent internationalization (Argote & Miron-Spektor, 2011).

Regarding the second proposition, indirect organizational learning is a powerful way to learn in addition to experiential learning (Huber, 1991). Vicarious learning is one of the indirect learning mechanisms that entails observing other organizations, their administrative practices, technologies and strategies, and using this knowledge to inform a firm’s decisions (Argote & Miron-Spektor, 2011; Kim & Miner, 2007; Levinthal & March, 1993). Considering institutional differences between coastal and inland China noted above, coastal provinces provide ample opportunities for learning about and from foreign firms. Prior research on multinational corporations (MNCs) has demonstrated that they, to a large extent, carry an imprint of the headquarters’ institutional environment, be it in form of employee management or business partner selection (Chung, Gibbons, & Schoch, 2006; Lampel & Shamsie, 2000). Also, foreign firms often consult local governments in institution building through policies and best practices, thereby exporting institutional forms from advanced markets (Child & Tsai, 2005; Child & Tse, 2001). Hence, Chinese firms can learn to read cultural and institutional cues though spatial proximity to foreign firms without having a formal contract with them (Meyer, 2004). In case of cross-border acquisitions, being located or having
experience in coastal provinces is advantageous for firms not only because they are likely to become more informed of business opportunities in foreign countries through connecting with market intermediaries or foreign firms directly, but, more importantly, being exposed to more diverse cultural and institutional environment reduces the cost of cross-border acquisitions associated with being impercipient of cultural and institutional dissimilarities. Since such indirect learning is not readily available for inland firms, they are likely to benefit from acquisitions of targets located in coastal China more than from cross-province acquisitions in other inland provinces. This is different for acquiring firms located in coastal provinces, because they already have access to indirect learning, so they are not likely to benefit from cross-province acquisitions in other coastal provinces as much as inland firms.

Combining the two propositions, I hypothesize the following:

**Hypothesis 3a:** Firms from inland China are more likely to pursue cross-border acquisitions when having prior cross-province acquisition experience in coastal provinces.

**Hypothesis 3b:** Firms from coastal China have a higher likelihood of conducting cross-border acquisitions when having prior cross-province acquisition experience in inland provinces.

**Method**

**Data**

Domestic, particularly cross-province, and cross-border acquisition experience in China varies by firm ownership type. Since mid-1990s, in line with the decision to liberalize its planned economy, the Chinese government engaged heavily in restructuring state-owned firms to increase their competitiveness and speed up the country’s economic development by supporting “pillar” and high-tech industries which resulted in waves of cross-province mergers and acquisitions (Chan, 2009; Chang, 2008; Jefferson & Su, 2006; Lee & Jin, 2009;). In addition, consolidation of state-owned
firms has been driven by another – non-economic – rationale such as maintaining low unemployment levels and keeping social unrest at bay, shaping the domestic growth of state-owned firms (Delios, Zhou, & Xu, 2008; Du & Boateng, 2015; Shieh, 1999). Moreover, state-owned firms also experience a significant institutional “push” exerted by the Chinese government in line with “going out” policy and, therefore, exhibiting a very different pattern of cross-border acquisitions compared to that of private firms (Wei, Clegg, & Ma, 2015). In contrast to this, private firms started to be recognized as a part of the economy only in late 1990s, and they are still restricted in the access to factor markets (Li et al., 2008; Ralston, Terpstra-Tong, Terpstra, Wang, & Egri, 2006).

When conducting acquisitions private firms are driven by commercial objectives and, as proposed by prior studies, seek to internationalize as a way to escape growth-limiting underdeveloped market institutions (Peng, 2001; Wei et al., 2015; Witt & Lewin, 2008). This brief overview shows that domestic and cross-border acquisition experience of state-owned firms is very different from private firms and is rather distorted as their behavior is driven by the place in the government’s economic and development plans, rather than by firm learning process. This consideration guided the decision to focus on acquisitions of private firms only.

I collected the data on firms that completed acquisitions between 2002 and 2014 from the SDC Platinum database which is considered to be an authoritative source of merger and acquisition data and is often used in international business studies, including those focusing on China (e.g., Collins et al., 2009; Gaur, Malhotra, & Zhu, 2013). I applied several limitations on these data. Based on the standard industry classification (SIC) codes, I included firms operating in all industries except financial because it is subject to stringent government regulation in China (Lien, Piesse, Strange, & Filatotchev, 2005; Lu et al., 2014). Then, I included only deals involving the transfer of majority ownership rights, i.e. the percentage of final shares is limited to 51 percent and above. This has been done to ensure that the deal is significant enough for an acquiring firm and is more likely to
capture the effect of firm learning. Finally, I included only firms listed in the Shanghai and Shenzhen Stock Exchanges since data on unlisted firms is rarely available. I used firm stock exchange ticker to identify firm ownership from CSMAR dataset produced by GTA Information Technology Co. Ltd. and the China Accounting and Finance Research Center. At this stage the dataset covered 1,902 unique deals of completed acquisitions both within China (domestic) and outside (cross-border), with the latter comprising 14 percent of the sample.

I derived data on prior acquisition experience from firm annual reports one year prior to the focal acquisition. I obtained firm annual reports from the Shanghai and Shenzhen Stock Exchanges and corporate websites. I excluded firms that did not provide detailed information on their subsidiaries. Also, since the focus is on the decision to acquire cross-border for the first time, I excluded firms that indicated they already had subsidiaries outside of China, including Hong Kong, prior to the focal acquisition. When a firm conducted several cross-border deals in the examined timeframe, only the first one was included in the sample. One year lag was applied to all independent variables. The final dataset consists of 468 firms conducting 903 acquisition deals, with 10 percent being cross-border deals.

Dependent variable

I measured the dependent variable, *acquisition destination*, by creating a dummy, with the value of ‘1’ if the focal acquisition is cross-border and ‘0’ if the focal acquisition is domestic.

Independent variables

To measure acquisition experience I used the absolute numbers of completed majority acquisitions prior to the focal one in line with prior studies (e.g., Halebian & Finkelstein, 1999). In this study I used two disaggregated measures of experience – *within-province acquisition experience* and *cross-province acquisition experience* – and one aggregated measure of *domestic acquisition experience*,
which is the sum of within- and cross-province acquisition experiences. Within-province acquisition experience is a number of majority-owned subsidiaries prior to the focal acquisition located in the province of an acquiring firm. Cross-province acquisition experience is a number of majority-owned subsidiaries located outside of the province of an acquiring firm. I focus on majority-owned subsidiaries because minority-owned subsidiaries are unlikely to generate meaningful learning outcomes as usually they are less risky, require lower resource commitment and do not demand the same level of control (Contractor, Lahiri, Elango, & Kundu, 2014). The total domestic acquisition experience varies between 0 and 90 acquisition deals. Within-province acquisition experience varies between 0 and 71, and cross-province acquisition experience varies between 0 and 40; 5 percent of firms in the sample do not have any subsidiaries at all. I also further disaggregated cross-province acquisition experience to cross-province acquisition experience in coastal provinces and cross-province acquisition experience in inland provinces, which are the number of majority cross-province subsidiaries a firm has in coastal and inland provinces respectively. A further variable was computed from the latter two as a weighted difference in the number of cross-province subsidiaries in coastal and inland provinces:

\[
Scope\ of\ cross-province\ experience = \frac{N\ of\ coastal\ subsidiaries - N\ of\ inland\ subsidiaries}{N\ of\ cross-province\ subsidiaries}
\]

This variable reflects the scope of cross-province acquisition experience generated by a firm in either coastal or inland provinces. The positive values mean a firm has more subsidiaries in coastal provinces than inland, whereas the negative values mean the opposite. The larger the absolute value of this variable, the more weight this particular cross-province experience bears in the total cross-province experience.

A moderating variable included in the analysis is location of an acquiring firm, where ‘1’ represents coastal provinces, and ‘0’ represents inland provinces. The basis for this variable is marketization index of Chinese provinces produced by the National Economic Research Institute in
Beijing. This index is a composite of five sub-indices: (1) the relationship between government and market, (2) the development of a non-state economy, (3) the level of product market development, (4) the level of the essential factor market development, and (5) the development of market intermediate organization and the legal system environment (Fan, Wang, & Zhu, 2011). The values of this index are available for 1997 to 2009, so the values for the last available year were extrapolated to 2013. Provinces with values above the mean for all years were classified as higher developed or coastal which are Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Shandong and Fujian. The rest of the provinces are classified as lower developed or inland.

Control variables

Prior research indicated that firm internationalization requires a high resource endowment (Lu et al., 2014). Consequently, I include several variables to control for this effect. First, is firm performance prior to the focal acquisition. It was proxied by a logarithm-transformed return on assets (ROA) defined as net income divided by total assets. This is an accounting measure of performance which has been widely used in studies on firm acquisitions (e.g., Zollo & Singh, 2004). Second, I control for firm unabsorbed slack resources defined as a ratio of current assets to current liabilities (Daniel, Lohrke, & Fornaciari, 2004). In addition to this, I also control for business group affiliation of an acquiring firm. This is an important parameter, which is likely to have significant implications for a firm’s resource endowment, as affiliated firms coordinate investment decisions (Keister, 1998), and could serve as conduits for information dissemination about new business opportunities (Luo & Chung, 2005). I identified business group affiliation from an ORBIS database (Bureau van Dijk) which provides historical data on a firm’s direct and ultimate owners from 2003 onwards. I identified a business group as a firm’s ultimate owner, if it owns at least 5 other firms partly or wholly (Wang, Kafouros, & Yan, 2015). The final firm-level control variable as a proxy of a firm’s resource endowment is a firm’s political connections defined as top manager’s connections with
government. This variable is dichotomous and in line with prior studies is equal ‘1’ if a top manager’s is or was an official of the central or local government, an industry bureau or the military, otherwise it was set to ‘0’ (Li, He, Lan, & Yiu, 2012). This variable is important to account for as private firms with politically connected top manager are likely to have a better access to resources than those without such connections. All of these variables of firm resource endowment are likely to have a positive impact on the decision to acquire cross-border than pursue domestic acquisition growth.

Considering literature on born-globals, which proposes that high-technology firms internationalize soon after inception regardless of the lack of knowledge required to do this, I control for the firm’s R&D intensity. I measure it as a ratio of R&D expenses to annual sales in a year prior to the focal acquisition (Chen, Huang, & Lin, 2012; Zhou & Wu, 2014). I expect that higher R&D intensity would lead to a higher propensity to internationalize. Next, extant literature suggests that international experience of a top management team (TMT) is positively related to a firm’s decision to acquire cross-border (Cui et al., 2011; Lu et al., 2014; Reuber & Fischer, 1997). Hence, I also added TMT international experience variable which is dichotomous with ‘1’ indicating if any TMT member listed in “Profile of Directors and Senior Managers” of firm’s annual reports worked or studied abroad, and ‘0’ indicating the absence of such cases.

I also controlled for firm age as it increases a firm’s knowledge and experience, so, depending on the pattern of a firm’s experience, it might lead to a higher propensity to internationalize (Wang, Hong, Kafouros, & Boateng, 2012). Contrary to this, however, greater age also could lead to a competency trap (Schwens & Kabst, 2009). Age was calculated as a difference of one year prior to the focal acquisition and a year of firm establishment. In addition, I controlled for firm size which is also likely to increase a firm’s decision to internationalize, and was calculated as a logarithm-transformed value of a number of firm employees one year prior to the focal deal (Liang, Lu, &
Wang, 2012). In addition to these firm-level variables, I also controlled for a province-level *market size growth* which, if comparably small, could push firms to conduct cross-border acquisitions instead of growing domestically. I measured *market size growth* as a percentage difference of gross regional product (GRP) values of a firm’s home province one and two years prior to the focal acquisition (Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007; Collins et al., 2009). Finally, I also included year dummies and two-digit SIC codes in all models.

**Model**

I estimated binary logistic regression model as the dependent variable *acquisition destination* is dichotomous. Since there are multiple observations per firm, the panel is unbalanced and the independence of observations is violated. To address this issue, I ran models with standard errors clustered by firm ID. This approach to modeling data is commonly adopted in similar studies (e.g., Collins et al., 2009; Muehlfeld et al., 2012). Prior studies have found that the number of firms from higher developed provinces that internationalize is higher than that from lower developed provinces (e.g., Wu & Chen, 2014). One of the possible ways to account for this is to fit a three level hierarchical model where acquisition deals are nested within firms, and the latter are nested within provinces. I have tested the level 3 intraclass correlation coefficient (ICC) which appeared to be significantly smaller than 0.05 (*p* < 0.001). This is considered to be a low correlation coefficient in international business studies (Peterson, Arregle, & Martin, 2012). Based on this, I did not find sufficient evidence that there was significant variance in the likelihood to acquire cross-border attributable to the difference in provinces. Hence, I decided against running a multilevel model to test the hypotheses.

Finally, I inspected the data for outliers and, based on Pregibon’s delta-beta influential statistic, which is an equivalent to Cook’s distance in linear regression models, I excluded 4 observations with over 70 subsidiaries (Long & Freese, 2005). Hence, the final sample is 899 acquisition deals
varying between 0 and 56 acquisitions. To reduce the issues of multicollinearity of quadratic and cubic terms, the independent variables have been standardized in all regression models.

**Results**

The means, standard deviations and correlation values of all variable are presented in Table 1. There is a negative, but small, relationship between *domestic acquisition experience* ($r = -0.063, p < 0.05$) and *within-province acquisition experience* ($r = -0.074, p < 0.05$), on the one hand, and cross-border *acquisition destination*, on the other. Also, the sub-types of *domestic acquisition experience* have a high degree of correlation ($r > 0.600$) with the total measure of *domestic acquisition experience*. All other correlation coefficients are below $r = 0.200$. To further investigate the multicollinearity issues, I computed variance inflation factor (VIF) values. As anticipated, VIF of the total *domestic acquisition experience* is 13.85, *within-province acquisition experience* is 7.26 and that of *cross-province acquisition experience* is 10.26 – all of which are above 10 which is the highest acceptable cut-off value in regression models (Neter, Wasserman, & Kutner, 1996). However, when *domestic acquisition experience* is taken out of the model, all VIFs fall below 10, however, *cross-province acquisition experience* remains quite high (VIF = 7.35). Hence, to avoid multicollinearity problems caused by the total and disaggregated acquisition experiences, I avoid including these variables in the same model.

Table 2 contains the results of the logistic regressions testing hypotheses proposed in the study. Model 1 is a null model with control variables only, showing that none of them significantly impact the choice of a cross-border acquisition over a domestic acquisition except *TMT international experience*. Model 2 has a main effect of *domestic acquisition experience* added which appeared to have no impact on the dependent variable. Model 3 tests Hypothesis 1 proposing an S-curved relationship between *domestic acquisition experience* and the choice of a cross-border acquisition. The signs of a statistically significant cubic term of *domestic acquisition experience* reveal two
Table 1. Descriptive statistics and correlations

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>SD</th>
<th>1</th>
<th>2</th>
<th>3</th>
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<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cross-border acq.</td>
<td>0.101</td>
<td>0.293</td>
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<tr>
<td>2. Domestic acq.exp.</td>
<td>7.058</td>
<td>7.205</td>
<td>−0.063</td>
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</tr>
<tr>
<td>3. Within-province acq. Exp.</td>
<td>4.239</td>
<td>4.850</td>
<td>−0.074</td>
<td>0.836</td>
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<tr>
<td>4. Cross-province acq. Exp.</td>
<td>2.799</td>
<td>4.170</td>
<td>−0.022</td>
<td>0.749</td>
<td>0.365</td>
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<tr>
<td>5. Scope of cross-prov. exp.</td>
<td>−0.108</td>
<td>0.785</td>
<td>−0.021</td>
<td>−0.007</td>
<td>0.010</td>
<td>−0.059</td>
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<tr>
<td>6. Location</td>
<td>0.620</td>
<td>0.485</td>
<td>0.028</td>
<td>−0.018</td>
<td>−0.089</td>
<td>0.062</td>
<td>−0.020</td>
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<tr>
<td>7. Performance</td>
<td>1.398</td>
<td>0.041</td>
<td>0.026</td>
<td>0.004</td>
<td>0.014</td>
<td>−0.010</td>
<td>−0.010</td>
<td>0.055</td>
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<tr>
<td>8. Slack</td>
<td>3.453</td>
<td>4.999</td>
<td>−0.062</td>
<td>−0.096</td>
<td>−0.107</td>
<td>−0.050</td>
<td>−0.019</td>
<td>0.063</td>
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<tr>
<td>9. Business group affiliation</td>
<td>0.760</td>
<td>0.426</td>
<td>0.049</td>
<td>0.072</td>
<td>0.133</td>
<td>0.005</td>
<td>0.003</td>
<td>−0.176</td>
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<tr>
<td>10. Political connections</td>
<td>0.420</td>
<td>0.493</td>
<td>0.013</td>
<td>0.069</td>
<td>0.070</td>
<td>0.029</td>
<td>0.001</td>
<td>−0.044</td>
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<tr>
<td>11. Age</td>
<td>12.165</td>
<td>5.260</td>
<td>−0.061</td>
<td>0.083</td>
<td>0.104</td>
<td>0.048</td>
<td>0.043</td>
<td>−0.047</td>
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<tr>
<td>12. Size</td>
<td>7.141</td>
<td>1.290</td>
<td>0.032</td>
<td>0.200</td>
<td>0.217</td>
<td>0.125</td>
<td>0.057</td>
<td>0.004</td>
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<tr>
<td>13. R&amp;D</td>
<td>1.775</td>
<td>3.516</td>
<td>−0.009</td>
<td>−0.158</td>
<td>−0.147</td>
<td>−0.116</td>
<td>−0.062</td>
<td>0.145</td>
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<tr>
<td>14. International exp.</td>
<td>0.099</td>
<td>0.299</td>
<td>0.055</td>
<td>0.047</td>
<td>−0.043</td>
<td>0.139</td>
<td>0.030</td>
<td>0.145</td>
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<tr>
<td>15. Market size growth</td>
<td>37.909</td>
<td>22.794</td>
<td>−0.007</td>
<td>0.091</td>
<td>0.118</td>
<td>0.033</td>
<td>0.039</td>
<td>−0.272</td>
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</table>

Note: N = 899; Correlations with an absolute value equal or larger than 0.063 are significant at 0.05 level.
negative slopes (linear and cubic) and one positive (quadratic), which provide evidence supporting Hypothesis 1. The coefficient of a first negative slope is the largest, suggesting a steep decline once the number of subsidiaries starts to grow, followed by a gradual growth; and the smallest coefficient is for the cubic term, reflecting a slight decline. To understand the character of the cubic term better, I have plotted it in Figure 2. It shows that the highest likelihood of choosing cross-border acquisitions occurs when a firm does not have any domestic acquisition experience at all, followed by a steep decline in the likelihood to conduct a cross-border deal than domestic from about 45 percent to just 10 percent when the number of subsidiaries is between 1 and 8. The gradual raise in the likelihood of choosing internationalization over domestic growth happens over the course of having between 9 and 23 subsidiaries. After that the likelihood of acquisition destination being cross-border is decreasing, and stops vacillating after about 35 subsidiaries having a near zero chance of conducting cross-border acquisitions. The long tail of near zero chance is likely to be responsible for the small absolute value of the cubic coefficient.

I use a disaggregated domestic acquisition experience into within- and cross-province to test Hypothesis 2, proposing that cross-province acquisition experience leads to a higher likelihood of choosing cross-border acquisitions than within-province. Model 4 and Model 5 contain sigmoid terms of within- and cross-province acquisition experience respectively. Model 4 shows that the cubic value of within-province acquisition experience is insignificant, meaning that there is a U-shaped relationship between this type of acquisition experience and choosing cross-border acquisitions with no variation of the effect when a firm has a large number of within-province subsidiaries. Interestingly, values in Model 5 also show that in the case of cross-province acquisition experience only quadratic and cubic terms are significant, i.e. there is a more pronounced reversed U-shaped model, suggesting an almost flat effect at the initial stages of generating cross-province experience.
Table 2. The results of the logistic regression analysis

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3 (H1)</th>
<th>Model 4 (H2)</th>
<th>Model 5 (H2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm performance</td>
<td>3.009 (2.385)</td>
<td>2.222 (2.259)</td>
<td>2.700 (2.392)</td>
<td>3.494 (2.399)</td>
<td>2.623 (2.432)</td>
</tr>
<tr>
<td>Firm slack</td>
<td>-0.088 (0.067)</td>
<td>-0.082 (0.063)</td>
<td>-0.096 (0.067)</td>
<td>-0.099 (0.067)</td>
<td>-0.085 (0.066)</td>
</tr>
<tr>
<td>Business group affiliation</td>
<td>0.539 (0.333)</td>
<td>0.509 (0.325)</td>
<td>0.615 (0.322) †</td>
<td>0.667 (0.317)**</td>
<td>0.536 (0.343)</td>
</tr>
<tr>
<td>Firm political connections</td>
<td>0.021 (0.286)</td>
<td>0.001 (0.291)</td>
<td>0.035 (0.292)</td>
<td>0.091 (0.296)</td>
<td>-0.026 (0.293)</td>
</tr>
<tr>
<td>Firm age</td>
<td>-0.046 (0.031)</td>
<td>-0.026 (0.028)</td>
<td>-0.022 (0.028)</td>
<td>-0.032 (0.028)</td>
<td>-0.041 (0.031)</td>
</tr>
<tr>
<td>Firm size</td>
<td>0.003 (0.155)</td>
<td>0.098 (0.157)</td>
<td>0.104 (0.159)</td>
<td>0.129 (0.161)</td>
<td>0.017 (0.157)</td>
</tr>
<tr>
<td>Firm R&amp;D intensity</td>
<td>0.002 (0.087)</td>
<td>-0.008 (0.097)</td>
<td>-0.008 (0.064)</td>
<td>-0.010 (0.073)</td>
<td>-0.003 (0.072)</td>
</tr>
<tr>
<td>TMT international experience</td>
<td>0.751 (0.366)**</td>
<td>0.771 (0.370)**</td>
<td>0.653 (0.342) †</td>
<td>0.541 (0.355)</td>
<td>0.731 (0.355)**</td>
</tr>
<tr>
<td>Market size growth</td>
<td>-0.004 (0.007)</td>
<td>-0.003 (0.005)</td>
<td>-0.005 (0.007)</td>
<td>-0.001 (0.007)</td>
<td>-0.005 (0.007)</td>
</tr>
<tr>
<td>Domestic acquisition experience</td>
<td>-0.039 (0.031)</td>
<td>-0.056 (0.042)**</td>
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<tr>
<td>Domestic acquisition experience squared</td>
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<tr>
<td>Domestic acquisition experience</td>
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<tr>
<td>Domestic acquisition experience</td>
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<tr>
<td>Within-province acquisition</td>
<td>-0.239 (0.068)**</td>
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<tr>
<td>experience</td>
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<tr>
<td>Within-province acquisition</td>
<td>0.036 (0.012)**</td>
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<tr>
<td>experience squared</td>
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<tr>
<td>Within-province acquisition</td>
<td>-0.001 (0.000)†</td>
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<tr>
<td>experience tripled</td>
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<tr>
<td>Cross-province acquisition</td>
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<tr>
<td>experience</td>
<td>-0.103 (0.069)</td>
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<tr>
<td>Cross-province acquisition</td>
<td>0.030 (0.013)**</td>
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<tr>
<td>experience squared</td>
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<tr>
<td>Cross-province acquisition</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>experience tripled</td>
<td>-0.001 (0.001)**</td>
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</tr>
<tr>
<td>Pseudo R square</td>
<td>0.064</td>
<td>0.071</td>
<td>0.107</td>
<td>0.111</td>
<td>0.070</td>
</tr>
<tr>
<td>Log-likelihood</td>
<td>-264.80998</td>
<td>-262.71517</td>
<td>-252.62646</td>
<td>-251.80095</td>
<td>-263.31495</td>
</tr>
</tbody>
</table>

*Note: N = 899; robust standard errors in parentheses; industry and year dummies included in all models. † p < 0.1, ** p < 0.05, *** p < 0.001.*
These disaggregated values give a better understanding of the total effect of domestic acquisition experience on the likelihood of choosing internationalization over domestic growth. It seems that on the first stage the negative slope is driven by the growth of within-province acquisition experience, the positive slope is driven by the effects of learning from both within- and cross-province experiences, and the negative slope on the third stage is caused by the diminishing returns from cross-province acquisition experience. In other words, at the initial stage, the effect of cross-province acquisitions picks up slowly with almost immediate effect of within-province acquisitions, followed by a faster exhaustion of within-province acquisition experience compared to cross-province. This corresponds with the fact that cross-province acquisitions are more complex compared to within-province, hence it is more resource-consuming to yield knowledge returns from them. Since the measurement of within- and cross-province acquisition experience is the same, it is possible to test Hypothesis 2 comparing the strength of the effect of these two variables on acquisition destination by the total beta values. The beta value for within-province acquisition
experience is −0.204, whereas the one for cross-province acquisition experience is −0.074. Thus, the relative effect of cross-province acquisition experience on the likelihood of choosing a cross-border acquisition is higher than that of within-province. Specifically, the average predicted probability of choosing a cross-border acquisition in the model with within-province acquisition experience is 0.057, whereas it is 0.112 in the model with cross-province acquisition experience. These findings point in favor of Hypothesis 2; hence, it is confirmed.

Table 3. The results of the logistic regression analysis

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 6</th>
<th>Model 7 (H3.1, H3.2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm slack</td>
<td>−0.059 (0.075)</td>
<td>−0.029 (0.062)</td>
</tr>
<tr>
<td>Business group affiliation</td>
<td>1.014 (0.586) †</td>
<td>1.257 (0.611)**</td>
</tr>
<tr>
<td>Firm political connections</td>
<td>0.155 (0.398)</td>
<td>0.148 (0.379)</td>
</tr>
<tr>
<td>Firm age</td>
<td>−0.001 (0.042)</td>
<td>−0.021 (0.039)</td>
</tr>
<tr>
<td>Firm size</td>
<td>0.120 (0.181)</td>
<td>0.185 (0.149)</td>
</tr>
<tr>
<td>Firm R&amp;D intensity</td>
<td>−0.024 (0.066)</td>
<td>−0.033 (0.073)</td>
</tr>
<tr>
<td>TMT international experience</td>
<td>0.209 (0.592)</td>
<td>0.352 (0.575)</td>
</tr>
<tr>
<td>Market size growth</td>
<td>0.006 (0.011)</td>
<td>0.001 (0.006)</td>
</tr>
<tr>
<td>Location</td>
<td>−0.401 (0.407)</td>
<td>0.008 (0.390)</td>
</tr>
<tr>
<td>Scope of cross-province acquisition</td>
<td>−0.016 (0.210)</td>
<td>0.344 (0.319)</td>
</tr>
<tr>
<td>Scope of cross-province acquisition squared</td>
<td>0.430 (0.214)**</td>
<td>1.037 (0.428)**</td>
</tr>
<tr>
<td>Scope of cross-province acquisition *Location</td>
<td>−0.690 (0.448)</td>
<td></td>
</tr>
<tr>
<td>Scope of cross-province acquisition squared *Location</td>
<td>−1.133 (0.052)**</td>
<td></td>
</tr>
<tr>
<td>Pseudo R square</td>
<td>0.092</td>
<td>0.112</td>
</tr>
<tr>
<td>Log-likelihood</td>
<td>−139.37815</td>
<td>−136.30786</td>
</tr>
</tbody>
</table>

Note: N = 503; robust standard errors in parentheses; industry and year dummies included in all models. † p < 0.1, ** p < 0.05, *** p < 0.001.

Hypothesis 3a suggests that firms located in inland provinces benefit more in terms of cross-border acquisitions from conducting cross-province acquisitions in coastal provinces and Hypothesis 3b proposes that firms from coastal provinces benefit more from acquisitions in inland provinces. These are tested in Models 6 and 7. I run the analyses to test these hypotheses on a subsample of firms that have cross-province acquisition experience, which results in the sample size being reduced to 503 observations. In comparison to previous models, I introduce two new
independent variables – location of an acquiring firm and the scope of cross-province acquisitions. Assuming that a firm generates experience from acquiring both in inland and coastal provinces, thereby resulting in different propensity to internationalize, I expect a nonlinear effect of this variable on the likelihood of cross-border acquisitions. To this end, I fit a squared term of the scope of cross-province acquisitions. Model 6 shows the main effects of location and the scope of cross-province acquisitions. The results are such that the former is not significant, whereas the squared term of the latter one indicates a U-shaped relationship with cross-border acquisitions. Model 7 includes the interaction term between the firm location and the scope of cross-province acquisition experience, which has a U-shaped impact on the dependent variable.

To facilitate the interpretation of the interaction effect, I plotted it in Figure 3. It illustrates that firms located in inland provinces, indeed, have a higher likelihood of acquiring cross-border than domestically, when they have prior cross-province experience in coastal provinces. This is followed

![Figure 3. The effect of the scope of cross-province acquisition experience in coastal and inland provinces on the choice of cross-border acquisitions](image-url)

Figure 3. The effect of the scope of cross-province acquisition experience in coastal and inland provinces on the choice of cross-border acquisitions
by experience generated in other inland provinces. The lowest likelihood of choosing internationalization occurs when inland firms have a slightly more pronounced *cross-province experience* in other inland provinces. Interestingly, unlike those in inland, firms located in coastal provinces have an almost linear trend, showing that they are much more likely to internationalize when the large scope of their experience is generated in inland provinces. They reach the minimum likelihood of choosing cross-border acquisitions when having an extensive prior presence in other coastal provinces. Overall, based on these results, Hypothesis 3a and 3b are also confirmed.

Additional tests

To further explore some of the findings, I have conducted several additional analyses. First, I wanted to see if the first negative slope in S-curved term is driven by born-globals (or early internationalizers). First, I conducted analysis of variance of *R&D intensity* conditional on having prior *domestic acquisition experience*. The test with unequal variances showed there is no difference in *R&D intensity* between firms that have or do not have *domestic acquisition experience*. Considering this, second, I decided to probe into this matter by excluding from the sample early internationalizers and run the models again. In line with prior studies I define early internaitonalizers as those that conducted a cross-border acquisition within 3 years of a firm’s inception (Freeman, Hutchings, & Chetty, 2012; Zhou, Barnes, & Lu, 2010; Zhou & Wu, 2014). In the sample there are only 6 early internationalizers, two of which has prior *domestic acquisition experience*. Upon exclusion of these observations, the findings of the statistical analysis remained unchanged.

One of the possible incoherencies between the theoretical framework of the paper and its empirical representation lies in the fact that I test the effect of *cross-province acquisition experience* on a number of cross-province acquisitions, rather than on the number of provinces a focal firm has subsidiaries in. Accounting for this, I recalculated all models with the latter version of cross-
province variable, which has a very high correlation coefficient with the number of cross-province acquisitions \((r = 0.828, p < 0.05)\). All results remained unchanged.

To explore the effect of state support in firm internationalization that could reduce the impact of firm learning generated through domestic acquisitions, I have constructed a variable identifying local government’s policy supporting “going out” of private firms based on hand collected provincial policies offering firm support to internationalize from the local government websites and news articles available in online media outlets. This variable equals ‘1’ for those provinces where “going out” regulations mentioned assistance for private firms specifically for the first year onwards, it is ‘0’ in those provinces where not a single regulation promulgated between 2001 and 2013 stressed helping private firms as a separate class of firms. The direct effect of “going out” policy for private firms appeared to be insignificant in all models, as well as the interaction terms of this variable with firm age and the number of domestic subsidiaries.

Next, recent studies have established the importance of controlling for internationalization behavior of other firms in a focal firm’s decision to internationalize as a way to reduce uncertainty associated with this strategy (Li & Ding, 2013; Lu et al., 2014). To this end, I have introduced a new variable capturing the degree of firm internationalization in the province. It is measured as a total number of cross-border acquisitions that had been completed by all listed firms located in a focal province three years prior to the focal acquisition. This variable appeared to be highly significant in all models, positively impacting the likelihood of choosing cross-border acquisitions over domestic. When this variable is controlled for, the effect of all types of domestic acquisition experience on cross-border acquisitions increases significantly. This provides evidence that vicarious learning from other local (not foreign) firms also matter in a firm’s decision to acquire cross-border.
To evaluate how well a dichotomous firm *location* variable captures presence of foreign firms in the province, and so allowing it to be the proxy for vicarious learning opportunities from foreign firms, I computed a one year-lagged logarithm-transformed number of foreign firms in a province. The correlation coefficient between *location* and the number of foreign firms in the province is very high ($r = 0.805, p < 0.05$). Additionally, I included numerical values of marketization index instead of a dichotomous firm *location* variable. Its correlation coefficient with the number of foreign firms remained high ($r = 0.864, p < 0.05$). These results suggest that firm *location* is a good indicator of vicarious learning from foreign firms.

**Discussion**

A scant research in international business proposes a linear effect of prior domestic acquisition experience on firm internationalization with findings varying from positive to non-significant. In this paper I propose an S-curved relationship, which found a resounding confirmation. In addition to this, I suggest that in large EE domestic acquisition experience is heterogeneous. Specifically, in China this heterogeneity represents itself in within- and cross-province acquisitions. The latter offers advantages for an acquiring firm in a way that it not only learns how to conduct acquisitions, but also how to manage institutional differences between home and host locations. Finally, I show that the effect of prior cross-province experience on cross-border acquisitions varies with firm location and where the majority of its cross-province experience comes from. In particular, firms from inland provinces are considerably more likely to conduct cross-border acquisitions if they have significant cross-province acquisition experience in coastal China. In the case of coastal firms, the highest likelihood of choosing cross-border acquisitions occurs when they have the majority of its cross-province acquisition experience generated in inland China.

In recent studies of firm internationalization, the focus has gradually been shifting from the analysis of firm internationalization experience impacting subsequent international strategies to
finding other factors of firm internationalization. Firm experience in international joint ventures (Hong & Lee, 2015), alliances (Zheng et al., 2012) and top management’s domestic mindset (Nadkarni & Perez, 2007) have been named among indirect factors affecting a firm’s propensity to internationalize. The current study, however, questions an implicit consensus in international business research community that all is known about the relationship between firm domestic acquisition experience and its subsequent internationalization. This, thus, brings one of the fundamental relationships back into the research spotlight.

The study demonstrates that the relationship between firm domestic experience and the choice of going cross-border is S-curved, with the first negative slope being driven by the growth within home provinces, whereas the second negative slope is driven by the overextension outside of home provinces, which leads to a competency trap and a lower probability of cross-border growth. Furthermore, crossprovince acquisition experience results in a higher likelihood of a firm to angage in internationalization. These findings indicate the risks of internationalization with home province acquisition experience only because it is unlikely to provide a firm with opportunities to learn how to manage institutional differences. At the same time, extensive cross-province growth leads a firm to a competency trap, therefore risking to losing momentum to internationalize. Hence, by proposing an S-curved hypothesis, and theoretically and empirically delineating the difference between the two types of domestic acquisition experience, I was able to provide a more nuanced application of organizational learning perspective to one of the key relationships in international business.

Moreover, by shedding the light on a complex path to internationalization of firms located in coastal and inland China through cross-province acquisitions, the study shows that location not only of a firm’s headquarters, but that of its subsidiaries, both matter in firm learning process. This qualifies empirical studies based on the springboard (Luo & Tung, 2007) and institutional escape
(Witt & Lewin, 2007) perspectives, proposing that the detrimental institutional conditions of a firm’s location push it cross-border (e.g., Liu et al., 2014; Luo & Wang, 2012; Wu & Chen, 2014). The findings of the current study indicate that it is shortsighted to limit the analysis of the institutional environment as a factor of internationalization to a firm’s headquarters only. Rather, it might be more promising to account for the complexity of a firm’s institutional environment integrating the location of its subsidiaries, too.

The identified paths to internationalization of coastal and inland firms offer interesting insights, and, in addition to organizational learning, might illuminate applicability of other theoretical approaches to internationalization. First, it is important to notice that coastal firms are much more likely to internationalize when they are heavily present in inland provinces. This finding could be accounted for by suggesting that coastal firms yield more knowledge of how to manage institutional heterogeneity from operating in a variety of institutionally disparate provinces. However, organizational learning perspective could have more merit if the highest likelihood of choosing cross-border acquisitions over domestic occurred on small-to-medium levels of coastal firms’ presence in inland provinces: it might seem odd that they would overcommit to learning in inland provinces. There is, however, a possible alternative explanation to this. Prior research shows that since mid-2000s firms from coastal provinces started to relocate their business operations to inland China for cheaper land and labor (Lemoine et al., 2015). This puzzling finding, then, could demonstrate that coastal firms first aim to secure access to cheaper factor markets, which simultaneously frees up resources they need to engage in strategic asset-seeking through cross-border acquisitions (Rui & Yip, 2008).

Second, the findings show that it is imperative for inland firms’ internationalization to first build an extensive presentation in coastal provinces. In addition to learning, by having higher presence in coastal provinces prior to going cross-border, inland firms might obtain the access to financial
resources and market intermediaries operating in coastal China, thereby hedging the risks of further internationalization. It is also possible that inland firms do not consider internationalizing before expanding domestically at all. Indeed, it is a common perspective of Chinese businessmen that “so long as we work harder to become number one in China, there is no problem for us to go international” (Liu, Xiao, & Huang, 2008: 498). So, establishing subsidiaries in coastal provinces is a viable growth path for inland firms. Besides, acquiring in coastal provinces is a good opportunity for them to engage in strategic asset-seeking similar to the one coastal firms pursue through internationalization. Therefore, coastal provinces seem to be a corridor leading inland firms to internationalization. This is a novel view on internationalization of Chinese firms, requiring further investigation directly testing the motives of domestic acquisitions of coastal and, especially, inland firms.

Another interesting point transpired through the statistical analysis, is that the highest likelihood of internationalization occurs when firms do not have any domestic acquisition experience at all. Thus, they defy organizational learning logic. The additional analysis confirms that this is not likely to be driven by born-globals. So, this finding is more consistent with acquisitions as entrepreneurship perspective. Madhok and Keyhani (2012) suggest that firms in China are entrepreneurial by nature, thus actively seek opportunities. They explain internationalization of Chinese firms as opportunity-seeking rather than realizing firms’ capabilities. Case studies of internationalization of Chinese private firms particularly highlight the entrepreneurial intent that drives their foreign direct investment – more so than firm founders’ internationalization experience, knowledge of foreign markets or network connections (Liu et al., 2008). Growing in adverse institutional environment, Chinese firms are flexible risk-takers (Cuervo-Cazurra, 2012), so they snatch the opportunity to acquire cross-border whenever it presents itself. Besides, considering a lower level of managerial skills of Chinese firms than those of advanced markets (Fornes, Cardoza,
& Xu, 2012), it is likely that they ground their decision to internationalize on fewer information points which is conducive for opportunity capturing.

Institutional escape and institutional arbitrage perspectives suggest that firms are more likely to internationalize when domestic institutions inhibit firm growth (Boisot & Meyer, 2008; Witt & Lewin, 2007). Consider, however, that the steepest negative slope of the S-curve is for within-province acquisitions. Two points are important here. The first point is that the initial growth within home province is likely to be considerably less risky and costly than cross-border acquisitions. This is also true in light of the fiscal federalism regime that makes local governments welcome investments in their jurisdictions (Yu, Zhou, & Zhu, 2013). Hence, the prospect of the initial growth within home province is unlikely to cause firms to “escape” cross-border. By growing within home province a firm learns the mechanism of firm acquisition; also a firm might create a foundation for future internationalization through establishing an internal market (Keister, 1998).

The second point is that the high likelihood of firms’ internationalization without any domestic acquisition experience could be explained by the local government’s “going out” policy. However, as the additional test revealed, there is no relationship between “going out” policy support for private firms and their subsequent internationalization. Hence, firms’ cross-border acquisitions without domestic acquisition experience are not instigated by the support of the local government. Summing up both points, it seems unlikely that cross-border acquisitions of firms without domestic acquisition experience can be construed as an “escape” from adverse institutional environment. So, acquisitions as entrepreneurship offers a more plausible explanation of this finding. Hence, this study shows that it is not only highly technological born-globals that engage in internationalization without extensive domestic experience, but other firms in China are able to do so due to their entrepreneurial orientation that captures opportunities, often regardless of where they arise. Overall, this finding offers a limitation to organizational learning theory in a way that “entrepreneurial
alertness” of Chinese firms seems to diminish the path-dependent nature of learning promoting, instead, “learning agility” (Madhok & Keyhani, 2008: 28).

Limitations

The study is the first one to explore the complexity of domestic acquisition experience and its effect on firm’s decision to internationalize. It, however, bears several limitations. I analyze how firms generate experience from domestic acquisitions to acquire cross-border. Hence, I make an explicit assumption that firm’s behavior is predicated on a qualitatively similar prior experience. This, however, neglects studies based on a staged internationalization perspective showing that firms tend to increase their international commitment incrementally from exporting to establishing wholly-owned subsidiaries (Buckley & Casson, 1981; Chang, 1995; Johansson & Vahlne, 1977). I do not account for the fact that the sampled firms could also have internationalized as an extension of their other cross-border experience, such as exporting, rather than as an extension of their domestic acquisitions. There are several possibilities of how access to these data could have impacted the results of this study. First, such international business experiences might not have any impact on the relationship between domestic acquisition experience and the choice to internationalize over growing domestically. The reason is that such experiences are not equivalent to the new strategy as they do not contribute to organizational learning of how to select, acquire and independently manage targets in other institutional contexts. For example, Nadolska and Barkema (2007) control for firm experience with establishing foreign greenfields, and their findings reveal that this experience has no impact on the frequency of cross-border acquisitions unlike domestic acquisition experience. Another possibility is that other international business experiences might moderate the relationship between domestic acquisitions and firm internationalization in a way that the positive slope would reach the vertex at a fewer number of subsidiaries and it would be higher, marking a
higher likelihood of choosing cross-border acquisitions over domestic when having prior international business experience. This could be a promising area of further research.

Next, studies show that most recent firm experiences have higher impact on firm decisions than the distant ones (Benkard, 2000; Thompson, 2007). However, in this study I am not able to control for the temporal effect of firm acquisitions, for example, by including only most recent ones or applying weights to account for the importance of experience that is temporally distant or recent. The absence of control for this is due to the fact that many domestic acquisitions happened before 2002, hence there is no firm annual reports readily available to extract this information from.

**Conclusion**

In this study I investigate the relationship between domestic acquisition experience of private firms in China and their subsequent cross-border acquisitions. I propose an S-curved hypothesis linking domestic and cross-border acquisitions, and further analyze the heterogeneity of domestic acquisitions by distinguishing between within-province and cross-province acquisitions. Finally, I demonstrate that firms located in inland and coastal provinces follow a different path to internationalization. The findings contribute to international business research on firm internationalization of emerging market firms, particularly studying the relationship between domestic and cross-border acquisitions, home institutional effects of internationalizing firms and acquisitions as entrepreneurship.

**References**


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