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Understanding the 'Enigma' of Chinese Firm Performance: Confucius and Beyond

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INTRODUCTION

McCarthy, Dolfsma, and Weitzel (2016) raise the important and interesting question of why what the authors refer to as Confucian acquirers, and in particular Chinese acquirers, tended to create value over the last decade relative to Western companies. The analysis by McCarthy et al. (2016), while restricted to an empirical examination of mergers and acquisitions[1] , calls into question the general relevance and validity of standard, Western-based economic and strategic thinking, and calls for further research into the nature of Chinese and Confucian thought and the degree to which they contribute to our understanding of merger outcomes in China, and perhaps elsewhere. At the most general level, McCarthy et al. (2016) challenge us to consider the question of whether different conceptual foundations are necessary to understand the behaviour and performance of Chinese and other Asian firms. At the heart of this question is the issue of whether there are unique country effects, or group-of-country effects, that determine to a substantial degree firm performance, and if so, what is the nature of these effects?

McCarthy et al. (2016) propose two broad streams of future research to address these questions. The first would focus on comparative corporate governance, notably the degree to which one must accept that there is a 'best practice' based on an agency-theoretic analysis of widely held firms. Indeed, this approach would be consistent with our own prior research (Chen, Li, & Shapiro, 2011), which suggests that 'one size fits all' governance practices do not explain the performance of Chinese firms. The second broad stream (which has three components), would focus on various dimensions of cultural differences across countries along the lines suggested by Hofstede (2001, 2007), Hitt, Lee, and Yucel (2002), Luo, Huang, and Wang (2011), and many others whom the authors cite.

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We follow McCarthy et al. (2016) in using mergers and acquisitions as a frame of reference for the discussion. We also organize our thinking using much the same structure as the paper, although we draw somewhat different conclusions regarding the implications of these topics. Thus, we consider the topics of classification of governance and cultural systems, merger waves and merger motivations, and merger outcomes. In each case we emphasize the need for a finer-grained definition and measurement of firm-specific motives, capabilities, and outcomes as well as country- or region-specific external factors. In this sense, our approach is consistent with studies that focus on firm- and country-effects (Makino, Isobe, & Chan, 2004) or internal- and external- governance effects (Aguilera, Desender, Bednar, & Lee, 2015).

Most importantly, we cast doubt on the idea that any simple classification system based on legal or cultural origin is useful. We argue that there is likely to be considerable heterogeneity both within and across countries in terms of institutional development, governance, and culture, and that such heterogeneity makes it difficult to classify countries and companies by simple governance or cultural characteristics, or to identify the nature of the interactions among them. In addition, we suggest that there will also be considerable heterogeneity across firms in terms of their motives and governance characteristics. Thus, we call for future research to consider both a broader set of formal and informal external institutions as well as a broader range of firm-specific outcomes and characteristics.

GOVERNANCE AND CULTURE

To conduct their empirical analysis, McCarthy et al. (2016: 227) define three governance models: 'we therefore group countries according to their corporate governance traditions, rather than their geographical locations, and identify three distinct and relatively homogenous corporate governance systems: the *Anglo-Saxon*, the *Continental* European, and the *Confucian* systems'.

There are two problems with this approach that future research must address. The first is that current research in comparative corporate governance suggests that it is not really possible to equate firm nationality with any particular governance model (Aguilera, Desender, & Kabbach-Castro, 2012). That is, governance characteristics are heterogeneous within and across countries, and the best way to evaluate them is by comparing bundles of governance characteristics across firms and countries (Aguilera et al., 2012; García-Castro, Aguilera, & Ariño, 2013). In particular, the bundles approach to governance emphasizes the various ways that governance characteristics can be substitutes and/or complements, the outcome being that firm governance can be equally effective, but different across firms and countries. However, these bundles are firm specific and can be different both within and across countries. Thus, as a general point, classifying all firms within a country as belonging to the same governance regime is problematic. Governance mechanisms at the firm level, such as ownership structure and the nature of the board of directors should

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be incorporated for a comprehensive investigation of the impact of governance on merger outcomes.

This last point is important when considering the ownership and governance structures of firms in emerging and developing countries. As is well known, firms in these countries are often organized as diversified business groups, many of them family-owned (Khanna & Yafeh, 2007), whose performance features are somewhat uncertain (Carney, Gedajlovic, Heugens, van Essen, & van Oosterhout, 2011). Although the matter is not yet settled, it is possible that these diversified groups have a governance configuration that permits them to use their internal markets to better identify, fund and integrate acquired companies. If such is indeed the case then it would be a matter of trying to determine whether there are specifically Asian or Confucian characteristics that make these business or family groups more effective than those from other countries, since business groups and family firms are not unique to Asia.

The second issue has to do with the distinction between legal origins and cultural systems, or at least their interaction. It is widely recognized that external institutions of various kinds help define the governance system within which firms operate, and that most of these institutions are national or sub-national in nature (Aguilera et al., 2015; Crossland & Hambrick, 2007, 2011; Gedajlovic & Shapiro, 1998). The legal origins literature (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998) emphasizes the importance of legal rights and draws the distinction between common law and civil law systems. However, they also distinguish *among* civil law systems notably those that are French, German and Scandinavian, a distinction not made by McCarthy et al. (2016; see also Ahern, Daminelli, & Fracassi 2015). The simple dichotomy also does not well explain China's legal system, despite the fact that in the modern era it was in part based on Germanic civil law (Ma, 2011; Yueh, 2011). Thus, for example, *JuriGlobe,* a research group at the University of Ottawa, classifies the legal systems of China, Japan, South Korea and Taiwan as 'mixed', where the mix is between civil law and customary law.

Customary laws are difficult to define, but the World Intellectual Property Organization suggests that they typically refer to established patterns or customs within a community that are accepted as being binding in some way (WIPO, 2013: 2). In this context we note that *JuriGlobe* also classifies a large number of African countries as being mixtures of civil and customary law, it being obvious that the customs referred to are not likely the same as those for Asian countries. Given the definition of customary law as being local and community based, the relevant question is whether the notion of customary law is in fact consistent with the grouping together of Asian countries as a distinct Confucian category, or whether they can all be thought of as being based on unique country-specific customs and institutions.

In fact, recent studies on the definition and measurement of culture point to the complexities of any classification system, and the likely heterogeneity of systems (Leung & Morris, 2015). It is therefore not surprising that past research has pointed

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to considerable cultural variations between and within Confucian countries. For example, one meta-analysis concludes that the Chinese are more collectivistic than the Japanese or Koreans (Oyserman, Coon, & Kemmelmeier, 2002). Furthermore, a quick and cursory examination of data from the World Values Survey (WVS) suggests that more people in South Korea identify themselves as Christians than Buddhists, which only points to the difficulty of defining South Korea as a Confucian country. In answer to the question of whether you believe that most people can be trusted, people in China responded much more favorably than those in Japan and South Korea. We also note in this context that a recent study on cross-border mergers (Ahern et al., 2015), which uses WVS data, finds some cultural distance between China, Korea and Japan. While there can be little doubt that Confucian traditions permeate all of these countries, it is not clear whether considering them as a group is helpful. A similar point has been made by Carney, Gedajlovic, and Yang (2009) in suggesting that there are in fact 'varieties of Asian capitalism'. The implication is that cultural differences, like institutional differences, may be quite prevalent, even among apparently similar countries.

Besides cultural differences among these Asian companies, their level of institutional development can also affect whether it is meaningful to group them together. China and Japan, while sharing similar legal and cultural origins, are at different stages of institutional development, with China characterized by institutional voids such as weak legal enforcement. In fact, in addition to market-based systems (Anglo-Saxon and Continental Europe), Millar, Eldomiaty, Choi, and Hilton (2005) also propose the emerging market system as a separate governance system, which is based on relationships, and includes the emerging markets of East Europe, Asia, and Latin America.

In general then, there is some doubt as to whether any simple legal origin or cultural framework classification system is useful, and that a broader institutional framework which considers a more diverse set of institutions may be preferred (Acemoglu, Johnson, & Robinson, 2005; Aguilera et al., 2015; North, 1990). Institutional theory is useful in this context because it is used to examine the rules of the game that are seen as legitimate, and can therefore lead to homogeneity in institutional and individual behavior (North, 1990; Scott, 1995), but can also consider a broad range of external institutions, both formal and informal. The role and importance of informal institutions in emerging markets has been studied by Estrin and Prevezer (2011) who show that these institutions are particularly important when thinking about countries such as China, because its formal institutions, legal and others, are weak (Yueh, 2013). Since informal institutions may well include elements that are closely related to customary law, and in particular could include elements of Confucian values, their importance and relationship to formal institutions seems like a promising avenue for future research.

Thus we conclude that future research that relies on comparative cross-country data should consider a broader range of institutions, both formal and informal, in order to define the external factors that both condition and limit firm behavior.

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Furthermore, we also suggest that future research on firm performance should not assume that all firms within a country share common governance, and should consider a bundle of governance characteristics including subnational and firm-level governance characteristics.

MERGER WAVES AND MERGER MOTIVES

McCarthy et al. (2016) suggest that there is a sixth merger wave that is global in nature, may have different characteristics in different regions, and that this phenomenon has been largely ignored. This certainly seems like an overstatement given the amount of attention paid to the number of cross-border mergers, and in particular the importance of China in contributing to the phenomenon (Deloitte, 2015; Sehgal, Reinboth, & Hirsh, 2015). More fundamentally, the very notion of a global wave implies not only that mergers originate in different countries but also that the underlying motivations are common across firms and countries. This may not be true, particularly when countries are at different developmental stages. These economic differences may systematically affect firms' merger motives that in turn can lead to variations in merger outcomes. Thus, rather than examining merger activities across countries within the same wave, future research can benefit from drawing comparisons across merger waves, so as to better control for heterogeneity in levels of economic development.

Specifically, McCarthy et al. (2016) conclude that in the 'sixth' wave, mergers in the Anglo-Saxon world destroyed value relative to those from Confucian countries. While it is hardly controversial today to argue that mergers tend on average to destroy value, at least in developed economies and particularly in the US (Haleblian, Devers, McNamara, Carpenter, & Davison, 2009), there is evidence that such was not always the case. Thus, Banerjee and Eckard (1998) found evidence of positive returns for horizontal mergers in the first merger wave of the early 1900s. It was in subsequent merger waves that the evidence of negative returns became stronger (Haleblian et al., 2009).

The discussion of waves is therefore related to the issue of merger motivation. It is well established in the literature that mergers may occur for a variety of reasons, some of which increase value (such as efficiency or market power), and some of which (such as managerial self-interest) do not (Haleblian et al., 2009). The horizontal mergers in the US at the turn of the 20th Century may well have created value because they both combined inefficient small companies and created market power. Arguably, this is not uncommon in countries, particularly large countries such as China, at the early stages of industrialization. Thus it is possible that the putative sixth wave in China is actually most like the first wave in the US, at least from the perspective of domestic mergers.

The same issue arises in the international business literature, where it has long been argued that cross-border mergers occur for different reasons, including resource seeking, market seeking, efficiency seeking and strategic asset (knowledge)

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seeking (Dunning & Lundan, 2008). However, these motives may well differ by country and in particular by stage of development. Thus, developed country firms may base their cross-border acquisition strategies on their ability to exploit ownership advantages, while developing and emerging market firms may base their strategies on knowledge acquisition. This has prompted Dunning, Kim, and Park (2008) to compare developed country multinationals in the 1960s with emerging market multinationals in the 2000s, with the important difference being that the latter are motivated relatively more by asset and knowledge augmentation.

Difference in motivation and purpose can matter to merger outcomes. Recent evidence suggests that mergers and acquisitions that leverage or enhance capabilities produced better post-merger outcomes over the period 2001–2012 (Neely, Jullens, & Krings, 2015). Importantly, the same study also found that 'Asian companies obtained the best results by far of any region in our sample when it comes to enhancement deals' as they 'march towards the capabilities frontier' (6). The deals were of course typically cross-border, but underscore the need to carefully understand merger motivations across companies. Equally important, the sample included Asian companies from non-Confucian countries such as India, thus raising the possibility that the benefits to some kinds of mergers are available to companies from a broad set of emerging markets. This is the clear suggestion in Kumar (2009) who argues that the acquisition of knowledge-based assets by emerging market firms, together with their implementation strategies, has made merger and acquisition activity more profitable, without the suggestion that the success is unique to companies from specific countries.

Thus, we conclude that in order to compare mergers across countries one must consider both the stage of development of the country, and the specific goals of the company. In a wave context, one must carefully consider how the wave characteristics may differ across countries at a moment in time. If, for example, Chinese domestic mergers are currently more similar to those that occurred in the US in the early 1900s, then that becomes an appropriate comparison. In an international context, one must control for the apparently different characteristics of acquisitions that were designed to augment capabilities. Indeed, the possibly different motives for domestic (e.g., seeking efficiency and market power) and international acquisitions (e.g., seeking knowledge and brand) by emerging market firms suggest that a comparison between them may shed light on the determinants of acquisition outcomes. In short, more attention must be paid in future research to carefully defining the wave and development characteristics of the home country, as well as the motivations for the merger under consideration.

MERGER OUTCOMES

It is typical in the finance literature to evaluate merger outcomes using measures of stock market response around the time of the merger, specifically using CARs as the preferred outcome measure. In the current study, CARs are measured over a

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(-20, +1) window. One can obviously quibble over the event window, and whether it is too long or too short. Evidently, one should test whether the results are sensitive to the length of the event window.

However, more important to this discussion is the degree to which stock market responses are a useful measure in the context of emerging and developing countries. It is well understood that using stock market responses (CARs) around the announcement date of an acquisition is based on the presumed ability of the market to efficiently evaluate the expected performance of the firm in future. An advantage of this method is that it reduces the number of confounding variables that can plague studies that use longer term performance measures, both financial and accounting. A potential disadvantage is that it relies on the ability of markets to efficiently and quickly evaluate all relevant information currently available. In the context of emerging and developing markets, this assumption must be questioned. The very notion of institutional voids in financial and other markets (Khanna & Palepu, 1997) suggests that market participants may not have access to all relevant information, even if the acquisitions are effected on an international stock exchange. The absence of qualified analysts and other supporting financial institutions may limit the availability and accuracy of the kind of information required for markets to make accurate long term projections. As a consequence, the need to consider a variety of outcome measures is greater when institutional voids are present.

Alternative outcome measures should allow a longer time period to assess the processes through which the acquirers create value from acquisitions (Halebian et al., 2009). Examples of such measures include post-acquisition integration, managerial turnover, and improvement in technical knowhow and brand equity. These measures are particularly appropriate for emerging market acquirers because an important motivation for their cross-border acquisition is to absorb knowledge, attract talent in targeted firms, and acquire brands.

CONCLUSION

We began with an apparent empirical puzzle suggesting that acquirers from Confucian systems, especially those from China, tend to create more value in their merger activities than acquirers from other systems. This led to the more general question of whether Confucian countries, and China in particular, have unique national cultural characteristics that translate into more effective managerial decision making, in this case with respect to acquisitions. Our commentary points to the need for a more systematic approach that clearly distinguishes firm (internal) and country (external) effects, and carefully specifies the heterogeneity that defines each. For example, since we cannot assume that all firms within a country share common governance characteristics, it is important to specify governance and ownership differences when evaluating firm performance. Similarly, when specifying country effects, one must account for a broad range of cultural and institutional differences across and within countries. In the case of institutions, it is important to account for

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both formal and informal institutions, sometimes at the subnational level. Finally, it will be important to specify the interaction between firm and country effects that advance our understanding of their relationship and potential co-evolution. Because these distinctions involve multiple variables at various level of analysis, and because their interactions are both numerous and difficult to predict *ex ante*, we suggest that the next round of empirical research should employ techniques such as fuzzy set analysis (García-Castro et al., 2013; Ragin, 2008) that can potentially accommodate such complexity.

NOTE

[1] In this study, we use the terms 'merger and acquisition', 'merger,' and 'acquisition' interchangeably.

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