A Literature Review of Foreign Ownership and Company Performance

Iuliana Oana MIHAI

ABSTRACT

The purpose of this article is to review the results of research papers conducted in the area of foreign ownership impact on company's performance and to highlight the specifics of this linkage in the environment of transition economies. Several authors have documented greater efficiency of private companies compared to state-owned. According to different studies, an alternative option for transition economies is foreign ownership. Recent studies show that the effect of ownership forms on companies and financial performance is more significant in Eastern European countries compared to developed countries. However, study results are often contradictory, therefore they require additional research.

1. Introduction

There is a rich dedicated literature throughout the world investigating the impact of the ownership structure upon performance (Mihai, 2014).

Performance represents confirmation of the company's efficient activity and it reflects the manner in which the company knew to valorise the available resources (Mironiuc, 1999). The company performance is a multidimensional concept which contains various aspects, such as the operational efficiency, the reputation or the survival of the organization. However, the most studied aspect of the company performance is the economic and financial one – to reach the company's economic goals (Radu, et al., 2013).

The ownership structure influences the company performance from several viewpoints. Firstly, the differences in the identity of shareholders, the different degrees of concentration, the distribution of resources among the shareholders influence their power and ability to control the managers. Secondly, the shareholders' different objectives influence company performance in different ways. For instance, the financial investors are mainly interested in the short-term returns of their investments, whilst shareholders, such as non-financial corporations, are mainly interested in establishing a long-term relation with the company they invested in.

The ownership structure can be studied from multiple perspectives: the typology of investors/shareholders (managers, individuals or families, the state, institutional investors, corporations, etc), the origin of their equity capital (domestic capital, foreign capital) or the ownership concentration degree.

2. Theoretical background

The studies regarding the impact of the ownership structure upon performance are closely related to the existence of agency relations between the various parties involved in the existence of a company and the asymmetry of information among these parties.

The economic relations between agents are various and display particular characteristics, such as those connecting managers to shareholders. These problems were firstly analysed in the work of Berle and Means (1932) and materialized later on, in 1976, in the “agency theory” elaborated by Jensen and Mackling (Jensen & Meckling, 1976).

From this theory's perspective, the company is seen as a true “knot of contracts”, where a set of relations between the various participating parties is established. The agency theoreticians obviously focus on the shareholders-managers relation, seen as a potential source of the most significant conflicts of interests. Along with the expansion of joint-stock companies, the 19th century had noticed the fact that the economic activity was subjected to the capital contributors’ control. In the 20th century, along with the development of the union movements and the representative instances of the personnel, this kind of control expanded to the level of employees. The century we live in will witness the continuous growth of other parties interested in or
affected by the company's decisions, including those who do not have contractual relations with it but who are affected by its activity or who influence these relations (Feleaga, 2006).

The agency theory shares the idea of clarifying the control mechanisms which, in the case of the managerial enterprise/company, will allow for the conflicts between shareholders and managers or other parties involved in the company's activity to be resolved.

The agency relation generally appears when a party (the agent) is delegated to act on behalf of another party (the principal). Within the "shareholder-manager" agency relation, the principal (the shareholder) will entrust an agent (the manager) with the administration of the company. This will act according to the interests of its "principal". The agency's problems appear as a result of the gap between the agent's interests and incentives. The main cause of this gap is the data asymmetry between the two parties.

The information asymmetry is present in any economy and it generates distortions for both companies, and managers, such as weak participation of investors, high costs, poorly developed capital markets, unfavourable results.

From this viewpoint, each company will have to organize a specific governance system, in order to favor the alignment of the managers' interests to those of the shareholders. In principle, only the companies which will become compatible with the interests of shareholders and managers as well are considered capable of long-term survival. The agency theory also mentioned the main reasons for which the managers' interests might diverge from those of the shareholders. However, the theory considers that some internal and external mechanisms will allow for the interests of the two parties to align. In the case of the external mechanisms, these are mainly the financial market, labour market, competition on the goods and services market.

The internal mechanisms refer to the right to vote, the control of the board, the manner of motivating the managers, the mutual supervision, in other words, the components of the corporate governance system. In recent years, the corporate governance has become an important topic for the developed economies, but also for the transition ones. Most theoretical aspects referring to corporate governance start from the agency theory.

Corporate governance has significant implications as far as the growth perspectives of an economy are concerned, because good governance practices reduce the investors' risks, attract investments of capital and improve company performance (Spanos, 2005). It is considered that a good CG system ensures the corporate responsibility, enhancing the reliability and quality of financial data, enhancing, therefore, the integrity and efficiency of the capital markets which, on their turn, will improve the investors' trust (Rezaee, 2009).

According to OECD, CG is the mechanism through which an entity is managed and controlled. “CG implies a set of relations among the company's managers, the board, the shareholders and other interested parties. CG offers the structure through which the company's objectives are established together with the means of reaching these objectives and of monitoring the performance”

As for the relation between corporate governance and company performance, the empirical results are uncertain. Many studies highlighted the fact that a good corporate governance system is associated with company performance. But there is a category of studies which have not identified a statistically significant relation of this type. The specialised literature shows that the positive relation between corporate governance and performance is based on the agency theory.

The concept of corporate governance appeared in Romanian at the beginning of the 2000's. The primary legal sources referring to corporate governance comprise: the law of trade companies, the law regarding the capital market, the law of insolvency, the accounting regulations issued by the Ministry of Finances, the Accounting Law. Explicit requests of corporate governance for listed companies can be found in the Corporate Governance Guide issued by the Bucharest Stock Exchange, in 2008, in force since 2009. This code is applied voluntarily by the companies listed on the regulated segment of the Stock Exchange. Therefore, we cannot talk about a well-developed system of corporate governance in Romania.

3. The role and importance of the companies with foreign ownership in the Romanian economy. General aspects regarding the establishment and development of companies with foreign ownership in Romania

The companies with foreign ownership are those companies whose share capital consists entirely or partially of subscribed contributions of foreign investors. The term of company with foreign ownership is associated most often with the term of foreign direct investment. The foreign direct investment is a long investing relation between a resident entity and a non-resident entity; as a rule, it implies that the investor exerts a significant managerial influence upon the enterprise he invested in.

According to Romanian legislation, the following are considered foreign direct investments: the paid-up share capital and the reserves resting with a non-resident investor who owns at least 10% of the subscribed share capital of a resident enterprise, the credits/loans between this investor or the groups he belongs to and the enterprise he invested in, as well as his reinvested profit. Moreover, one can also consider as direct foreign investments the capitals of the resident companies upon which the non-resident investor
exerts a significant indirect influence such as the equity capitals of the resident associates and subsidiaries of the resident enterprise in which the non-resident investor owns at least 10% of the subscribed share capital.

Therefore, the term foreign direct investment has a larger area of meaning including the foreign participation of capital as well.

Foreign direct investments comprise, thus, two basic components the equity capital consisting of the subscribed and paid-up share capital, both in cash and through in-kind contributions, held by non-residents in resident enterprises, as well as the related share in reserves; in the case of the branches, the available endowment capital is taken into account accordingly.

The net credit consisting of the loans received by the direct investment enterprise from the foreign direct investor or from the group of non-resident companies that the former belongs to, less the loans extended by the direct investment enterprise either to the foreign direct investor or to another entity within the group of companies.

The foreign direct investments are considered to be the main channel of economic development, especially for the ex-communist countries (Alfaro, 2004), and the companies with foreign participation represent the main form of foreign direct investments. The ways by means of which the foreign capital reaches Romania (by contribution to the equity flow in direct investment enterprises) are: Greenfield, mergers and acquisitions and corporate development.

Greenfield investment means establishment of enterprises by or together with foreign investors. They are also called nihilo investment. Greenfield investment occurs when the foreign investor establishes a new company, new production, distribution or other facilities in the host country. This is normally welcomed by the host country because of the job-creating potential and value added output.

Mergers and acquisitions mean partial or full takeovers of enterprises by foreign investors from residents. Mergers and acquisitions suppose an acquisition of or a merger with, an established company in the host country. This form of FDI is cheaper and also it allows the foreign investor to gain quick access to the market. Foreign companies may be motivated to engage in cross border acquisitions or mergers to strengthen their competitive position in the world market.

Corporate development presumes that foreign direct investors increase their participation in the capital of direct investment enterprises.

Whether a company would choose greenfield investments or mergers and acquisition depends on a series of factors (UNCTAD, 2000). The literature (Harzing, 2002) has identified a number of firm-specific, host country-specific and industry-specific-factors that affect the mode of entry of firms into foreign markets: technological advantage, diversification, size, advertising intensity, cultural and economic differences between host and home countries, etc.

Cross border merger or acquisitions of a domestic company is a politically sensitive matter, as most countries prefer to maintain local control of domestic firms. In such conditions, while countries may welcome foreign greenfield investments, foreign firms’ attempts to acquire domestic firms are often resisted, and sometimes even resented. The principal argument here is that M&As are less beneficial than greenfield FDI, and may even be destructive, because they do not improve the productive capacity but rather represents a transfer of ownership that may be accompanied by layoffs or termination of some beneficial activities. If mergers and acquisitions take place in some sensitive areas, such as exploitations of natural resource sector, then it may seem like a threat to the national culture or identity (Moosa, 2002).

In the countries with developing, transition or emergent economy, foreign capital is perceived as a source of economic development, modernization, and increase of income and of the population employment degree.

In general, the factors that encourage foreign investment in a country are connected to the specific features of the target country, such as the access to natural resources, the geographic location, the infrastructure, the size of the market and its development potential, the cost of the production factors, especially the cost of labour, the fiscal policies, the liberalization of prices, the institutional development, the technological absorption capacity, the quality and solidity of economic policies, etc (Bloningen, 2005).

In the particular case of Romania, the foreign investors could take into account the fact that Romania is one of the largest markets in Central and Eastern Europe, with over 22 million inhabitants, coming second, after Poland, its attractive geographic location at the crossroads of some international trade routes, which facilitates the access to the former USSR countries, to the Middle East or North Africa, its reach natural resources, its touristic potential, its navigation facilities on the Black Sea and the Danube, etc.

In general, the benefits of the foreign capital for the host country, as they are synthesized in the specialized literature, consist of the attraction of innovative technologies, formation of human capital, integration in the international commerce, the creation of a competitive business environment which leads to economic growth, and this is the most important instrument in eradicating poverty. Besides these strictly economic benefits, the foreign capital often helps to improve the social and environmental conditions in the host countries, for instance by the transfer of certain “cleaner”, non-polluting technologies and implementation of corporate social policies (OECD, 2002). However, according to the 2002 OECD report, it seems that in the less developed countries the foreign capital has a smaller effect on the economic growth. In
order to fully enjoy the benefits of foreign capital, a country must have already reached a certain level of education, technological development and infrastructure. The underdeveloped financial market can minimize the benefits of foreign capital.

The liberalization policies of the international capital flows generated vivid controversies in the business environment as well as in the academic one. Historically speaking, the existence of foreign ownership generated concerns about the loss of sovereignty and national identity, as, in extreme cases, it might imply the control of multinational companies over the local authorities. For this reason, governments have imposed restrictions regarding the presence of foreign ownership. Such restrictions consisted of limitation of foreign capital’s participation to the share capital, monitoring and special procedures, proving the capacity of obtaining benefits, restrictions regarding hiring foreign personnel or stipulations regarding the resident persons’ majority in the board.

For example, the foreign ownership is limited to less than 50% in the cases of EU and North-American airline companies, in the case of the telecommunication companies in Japan or in the case of the maritime or fluvial transportation in the United States of America. Other countries forbidden foreign ownership in the natural resources exploitation sector, with the purpose of offering the resident citizens the access to the benefits associated to them. For instance, in Iceland foreign ownership is forbidden in the fishing sector and in the energy sector while in Mexico foreign ownership is forbidden in the oil sector (OECD, 2011). In recent years the governments worldwide have reconsidered these restrictions by signing some formal agreements regarding the capital flows.

Establishing or developing a company with foreign ownership in Romania does not require particular investment approvals. The procedure presupposes meeting certain legal formalities such as obtaining a judge’s notice and enrolling in the Trade Register Office and the Fiscal Administration of Romania. According to the Romanian laws, companies with foreign ownership may be founded in all economic sectors. Ever since 1991, the Romanian legislation has focused on attracting foreign capital into the economy. This is why, in order to stimulate the interest of foreign and domestic investors to develop investment projects in Romania, the legal framework has change more than once, trying to identify the most suitable and efficient stimulants for the development of the economy.

Foreign investors must comply with the national regulations having the same rights and obligations as any domestic investor. There is no limit of the foreign capital participation in the Romanian companies; a foreign investor may found or may acquire 100% of the shares or social parts of a Romanian trade company from any sector open for private domestic companies with the exception of the national and international air transportation sector, where foreign capital is limited to maximum 49% as in other countries of the European Union, for those investors which do not come from countries of the European Economic Zone. The foreign investors’ contribution may take multiple forms, including hard currency, equipment, services, intellectual property rights, know-how and managerial expertise or reinvested earnings coming from other business in Romania. The Romanian legislation also stipulates warranties regarding nationalization, expropriation or other similar measures.

4. Literature review of foreign ownership and company performance

Numerous studies research the impact of various types of ownership structure upon company performance, both in developed countries, and in emergent ones. All this studies have the origin in Berle and Means’ work of 1932 – “The Modern Corporation and the Private Property”. The impact of ownership structure upon performance can be examined from multiple perspectives: according to the investors/shareholders’ identity (managers, individuals or families, the state, institutional investors, corporations, etc), according to the origin of the equity capital (domestic capital, foreign capital) or according to ownership concentration degree.

This paper focuses on the origin of the capital (foreign ownership capital and domestic ownership) and the impact of foreign ownership upon the Romanian companies’ performance. Although there are numerous studies analysing company performance and influencing factors, the effects of foreign ownership upon companies in Romania have been relatively unexplored. Here follow a presentation of a few international studies on this topic.

Given the different factors that impact the operation of companies with foreign ownership, it is not surprising that the applied literature found mixed evidence on the productivity consequences of foreign ownership, with some papers discovering positive effects, even in the immediate after-math of an acquisition, and others finding zero or even negative effects. We now concisely discuss some of the more important evidence in the literature concerning productivity, and, due to space constraints, we pass over other important effects such as those on wages and total employment.

Caves (1996) and Dunning (2008) suggest that companies with foreign ownership have certain advantages as compared to companies with domestic capital, which generates superior performance. Dunning considers the superior performance of companies with foreign capital is the result of foreign investors’ ability to exploit the economies of scale and the superior governance system. The opinions
supporting the superior performance of companies with foreign ownership as compared to companies with domestic ownership base of Hymer’s arguments and suppositions (1976).

In Venezuela, Aitkin and Harrison (1999) demonstrated on a sample of Venezuelan companies that the existence of foreign capital is tightly connected to productivity improvement, but the connection is significant only for small and medium enterprises.

In Mexico, Perez-Gonzales (2005) demonstrated that the subsidiaries controlled by multinational companies improved the global productivity of their production factors, especially those which are active in sectors based on technological innovations, the latter being transferred by the mother companies. In India, Douma, Rejie and Kabir (2006), demonstrated a positive and significant impact of the foreign capital owned by industrial corporations upon performance. Their analysis focused on the differential impact of two categories of foreign shareholders: foreign institutional investors and foreign non-financial corporations.

In India again, Petkova (2008) demonstrated that the Indian companies acquired by foreign investors showed important productivity growth within three years since acquisition. A similar study was performed in Indonesia by Arnold and Javorcik (2005). They demonstrated that the Indonesian companies acquired by foreign investors recorded substantial productivity improvement in the acquisition year and in the next years as well.

This kind of studies has been performed in developed countries as well. In USA for instance, Doms and Jensen (1995) demonstrated that the US companies with foreign capital were more productive than companies with American capital but are, on an average, less productive than the American multinational companies. Girma (2005, 2006, and 2007) noticed in the case of American companies substantial growth rates as soon as they had been acquired by non-American investors. These studies, thought, did not take into account the country of origin of the foreign investor, to see whether he comes from an emergent economy or from a developed one.

Antkiewicz and Whalley (2006) emphasised the Chinese companies’ attempts to acquire companies from OEC; this tendency was dictated by the need to an easier access to resources, new technology and distribution networks in the target countries.

Greenaway, Guariglia and Yu (2009) made a study on a sample of 21,582 Chinese companies between 2000 and 2005 and they came to the conclusion that the most profitable companies are those with mixed capital, of joint-venture type, as compared to the companies with completely Chinese capital or those with completely foreign capital. Practically, the study suggests that a minimum of domestic capital is necessary to ensure an optimum performance.

In Canada, Boardman, Shapiro and Vining (1997) concluded that the subsidiaries of the multinational companies have better performance than corporations with domestic capital, the cause being the smaller agency costs generated by more concentrated ownership structure.

Also in Canada, an empirical study made by Globerman et all (1994) evaluated the performance of Canadian companies with foreign and domestic capital and pointed out that the foreign subsidiaries had a significantly higher added value per worker than companies with domestic capital and the fact that they paid higher salaries, but these differences diminish when the impact of factors such as capital’s size and intensity is controlled.

Kim and Lyn (1990) studied the American companies to establish whether there were differences between the performance of companies with foreign capital and the performance of those with domestic capital. The empirical research done by the two authors pointed out that companies with domestic capital are more profitable than those with foreign capital, in terms of financial rentability and less efficient in terms of managing the assets, the assets managing rates being smaller in the case of companies with foreign capital. The authors explained that foreigners invest in USA in order to obtain economic and technological advantages. They same study identified differences between companies with foreign capital; i.e. depending on the capital’s country of origin, the companies whose shareholders are companies from Western Europe are the most profitable and most efficient ones.

In a trans-national study on panel-type data performed in three countries (Bulgaria, Romania and Poland), Konings (2001) investigates whether the financial performance of the companies with foreign capital is better than the performance of the companies with domestic capital. Konings’ results suggest that, in the case of Romanian and Bulgarians, the companies with foreign capital do not have better performance than the companies with domestic capital. In Poland’s case, the results pointed out a significant and positive impact of foreign capital. Konings’ explanations suggested that the effects of foreign capital needed a long period of time to be felt due to the delayed reforms.

Munday et all (2003) made an analysis on a data panel covering the 1994-1998 period in order to compare the productivity of companies with domestic capital with the productivity of the foreign subsidiaries in Great Britain. The results pointed out the relatively weak performance of the foreign subsidiaries in the manufacturing industry, the Japanese companies displaying the weakest performance of all.

Barbosa and Lourie (2005), in a comparative made in Greece and Portugal, found no significant differences between multinational companies and companies with domestic capital, in terms of economic
rentability. They demonstrated that the company performance in Portugal was not affected by the existence of foreign capital after having checked both the company’s and the industry’s characteristics.

Yudaeva et all (2003) analysed the productivity of companies in Russia in terms of the differences between companies with completely domestic capital and companies with partially foreign capital. The results indicated that companies with foreign capital were more productive than those with completely domestic capital. They argued that the superior efficiency of the companies with foreign capital is due to managerial experience, to investments in research and development activities and to distribution networks. However, the same study concluded that there was no significant difference, statistically speaking, between companies with foreign capital and those with domestic capital when the share of foreign capital participation is taken into account.

In the specialised literature there is also a category of studies which investigate the impact of the foreign capital’s origin upon company performance. For instance, Ford, Rorke and Elmslie (2008) demonstrated that the capital’s country of origin generated productivity differences between domestic companies and those with foreign capital. Bilyk (2009), in Ukraine, showed that the performance differences between companies with foreign capital and those with domestic capital can be explained by the capital’s country of origin. Thus, the companies whose capital comes from developed economies have better performance than companies whose capital comes from less developed countries, and the capital coming from less developed countries negatively affects the company performance.

In a study made in Turkey on data panel covering the 2005-2007 period, on non-financial listed companies, Gurbuz and Aybars (2010) demonstrated that companies with foreign capital between 10% and 50% had better performance than companies with domestic capital or companies with more than 50% foreign capital. Moreover, companies with more than 50% foreign capital had weaker performance than companies with domestic capital. According to the authors’ opinion, foreign capital improves company performance up to a point beyond which the effect of foreign capital is reversed.

In China, Li, Lu and Ng (2009) analysed the differential impact of various categories of foreign investors and concluded that only the capital held by foreign corporations or companies has a positive impact upon performance, and not the capital held by foreign institutional investors, banks or legal persons. Among the factors explaining this situation, Li, Lu and Ng mentioned exports, transfer of technology and managerial skills.

5. Concluding remarks

Companies with foreign capital represent the main form of foreign direct investments in a country. These are generally perceived as a source of development, modernization and economic growth. Numerous studies and research from the specialized literature converge at the idea of superior productivity of companies with foreign capital as compared to those with domestic capital. However, there are also papers which do not confirm this hypothesis. The benefits of foreign capital for the host country, summarized in the specialised literature, consist of the attraction of innovative technology, the formation of human capital, the integration in the international commerce, the creation of a competitive business environment, but these benefits appear when a country has already reached a certain level of education, technological and entrepreneurial development, and infrastructure.

Consequently, analysing the studies from the specialised literature, we can notice that the results are mixed. There is no consensus, despite numerous empirical studies performed both in developed countries, and in less developed countries or emergent economies. The conclusions differ significantly between the developed countries and the developing ones. There is no certainty that the results obtained either in developed countries, with market economies, with mature capital markets, or in less developed countries hold true for the new market economies from Central and Eastern Europe as well. In these countries, there are vivid debates, in favour and against foreign direct investments (Eriksson and Pytlíková, 2010). Many times, the topic of foreign capital is used for political purposes. In general, the presence of foreign capital in these countries is explained by the lower production costs, especially by the labour costs and by a certain proximity to the new expanding markets.

References
