Geographic distance, cultural distance, political hazards, and Japanese firms' outbound mergers and acquisitions

Dissertation Summary

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1. Objectives

A large body of literature on firms' international expansion is based on the stages model of internationalization (Johanson and Vahlne, 1977; Luostarinen, 1980), that is, a step-by-step process of international business development. The model is underpinned by the notion that insufficient knowledge of foreign markets is an obstacle to developing international operations. Therefore, extensive prior literature on international expansion strategies focused on various types of distance and provided substantial empirical evidence that geographic distance, cultural distance, and political hazards discourage international expansion (Boeh and Beamish, 2012; Chakrabarti and Mitchell, 2008; Delios and Henisz, 2000, 2003a, 2003b; Ghemawat, 2001; Grosse and Trevino, 1996; Grote and Rücker, 2007; Grote and Umber, 2006; Henisz and Delios, 2001; Li et al., 2020; Ojala and Tyrväinen, 2007; Ragozzino, 2009; Ragozzino and Reuer, 2011; Schildt and Laamanen, 2006; Zaheer, 1995).

Although geographic distance, cultural distance, and political hazards negatively influence outbound mergers and acquisitions (M&As) because both empirical and theoretical concerns exist, little is known about whether the deterrent effects of these hazards may vary with the home country, firm size, firm age, and ownership solution. More importantly, several studies on cultural clusters classify Japan as independent (Haire et al. 1966; Hofstede, 1976, 1980; Ronen and Kraut, 1977; Ronen and Shenkar, 1985; Sirota and Greenwood, 1971), meaning that wherever Japanese firms go abroad, they must adapt to very different environments (Lu and Beamish, 2001).

The objective of this study is to better understand the determinants of investment behavior of Japanese firms, one of the largest investors in the world. The extant literature has primarily investigated the location choices of foreign direct investment from the U.S. or China, some of the largest domestic markets in the world; however, strategic Japanese firms' M&A location decisions indicate that they must pursue growth in global markets and adapt to local environments due to the slow-growth domestic market. The critical mechanisms behind such decisions might be far more complicated than the prior literature concerning the U.S. or China. I examine this topic and test hypotheses by using a conditional fixed effects logit regression model in Chapter 2.

Further, little is known about whether tax-related firm-level characteristics could moderate the deterrent effect of geographic distance although both M&A location decisions and tax-related decisions involve considerable managerial judgments. I select this topic because compared with U.S. or European multinational firms, Japanese multinational firms have a relatively low-tax planning culture. Japanese multinational firms do not engage in significant tax planning, resulting in higher tax burdens (Altshuler et al., 2015; Atwood et al., 2012; Toder, 2014). Chapter 3 examines whether the effects of geographic distance on M&A location decisions may be contingent on three tax-related firm attributes, namely, tax avoidance, use of tax consolidation regime, and deferred tax asset (DTA) balance. By demonstrating strong empirical evidence that even firm-level tax characteristics of Japanese firms play a crucial role in shaping the way they evaluate geographic distance in their strategic location decision, this study provides more nuanced and conditional insights into strategic fit concerning outbound M&A of Japanese firms than is commonly understood.

Finally, there are significant gaps in our understanding of the relationship between foreign divestment decisions and geographic distances, as well as potential firm- or deal-level moderating effects because more emphasis has been placed on the influence of geographic distance on foreign acquisitions than foreign divestments. I aim to address these gaps by examining how the likelihood of foreign divestment varies over geographic distance in Chapter 4. Chapter 4 highlights the importance of drawing a clear distinction among various foreign divestment motives before inferring the impact of geographic distances rashly, especially whether it is failure-driven or global business strategy-driven. I further find that its impact hinges on parent firm- and deal-level attributes.

2. The deterrent effect of geographic distance, cultural distance, and political hazards and firm- and deal-level moderating effects

Chapter 2 comprehensively examines (1) whether geographic distance, cultural distance, and political hazards equally matter; (2) the moderating or amplifying effect of firm size, firm age, and ownership solution on geographic distance, cultural distance, and political hazards concerning Japanese firm's outbound M&A over the last decade while controlling for various country-specific variables based on a large body of literature. This study provides strong evidence that, as predicted, Japanese firms do not treat geographic distance, cultural distance, and political hazards equally when making strategic M&A location decisions. The results from data on Japanese firms' outbound M&A from 2010 to 2019 reveal that,

(1) Geographic distance is considered a direct determinant of strategic M&A location decisions. Larger firms with larger slack resources in their home country are less concerned about geographic distances and aspire to pursue growth in global

markets. The deterrent effect of geographic distance is weaker for complete control mode because of integration benefits.

(2) Due to the unique Japanese culture, cultural distance is not a critical determinant and has limited explanatory power; however, as a proxy for local adaptation cost suggested in prior literature, the deterrent effect of cultural distance is amplified by geographic distance and political hazards for Japanese firms. Furthermore, older firms long exposed to typical practices and norms are less adaptable to cultural distances, whereas firm size could reduce the amplifying effect of firm age on cultural distance.

(3) The negative effect of political hazards is not absolute and more pronounced for large Japanese firms that are usually more rigid and bureaucratic; however, I also found strong evidence that firm size eases the deterrent effect of political hazards, showing that slack resources and bureaucratization operate simultaneously.

This study makes several contributions to the literature. Instead of only investigating geographic and cultural distance, I consider political hazards that have been omitted in previous models to introduce a more expanded and comprehensive version and alleviate potential endogeneity problems. More importantly, this study is related to Li et al. (2020), examining the deterrent effects of geographic and cultural distances in Chinese firms' international expansion. They found that larger, older, and state-owned firms are less concerned about geographic distances and more concerned about cultural distance. This study extends Li et al. (2020) and differs in several ways.

First and foremost, Li et al. (2020) have improved our understanding by demonstrating that foreign countries fit well when considering geographic distances but might be misfits when considering cultural distances. Li et al. (2020) overlooked the interaction among various forms of hazards; however, this study argues that, because of the unique Japanese culture, cultural distance should not be isolated as a completely independent hazard capable of shifting Japanese firms' strategies for M&A locations. This study also examines the possibility that the effect of one hazard may be moderated or amplified by other hazards, providing strong evidence that although Japanese firms make location decisions irrespective of cultural distance, geographic distance and political hazards amplify the deferent effect of cultural distance.

Second, Li et al. (2020) are silent on the ownership structure of overseas subsidiaries. This study explored whether an ownership solution could weaken the deterrent effect of various types of distance.

Finally, Li et al. (2020) made considerable contributions by suggesting that firms more capable of dealing with the challenges of geographic distance may be less capable of coping with the challenges of cultural distances, and vice versa, due to the different mechanisms to deter outbound investment. This study extended their ideas by examining the mixed effects of firm size, firm age, and ownership solutions on international expansion. The key findings are as follows. These findings help reconcile the conflicting, often paradoxical results in prior literature and present several implications for the existing theory.

(1) The negative effect of political hazards is more pronounced for large Japanese firms in general; but absolute firm size could partially ease its deterrent effect as well.
(2) Firm size reduces the amplifying effect of firm age on cultural distance.
(3) The moderating effect of complete control on political hazards is dependent on firm size and firm age, indicating that the complete control mode significantly weakens the negative effects of political hazards for larger and older firms than smaller and younger firms.

3. Geographic distance and tax fundamentals

Since both M&A location decisions and tax-related decisions involve considerable managerial judgments, I investigate whether tax-related firm-level characteristics (i.e., tax avoidance, use of tax consolidation regime, and DTA balance) could moderate the deterrent effect of geographic distance in Chapter 3.

The key concept of effective tax planning is “all parties, all taxes, all costs.” All costs must be considered in the planning process because tax is only one business cost (Scholes and Wolfson, 1992), implying that effective tax planning must think beyond tax minimization. I propose that tax-aggressive firms are more motivated to absorb non-tax costs, including distance-related costs; thus, the geographic distance would be a less concern for them. Consolidated tax regime allows Japanese group companies to offset their profits and losses and pay corporate income tax as a single tax unit. I propose firms that use the tax consolidation regime are less concerned about geographic distance because they are more likely to take advantage of tax benefits as a result of M&A failure to shelter some portion of their taxable incomes at the consolidation level.

Furthermore, abundant prior literature focuses on DTA by investigating its two key components: pre-tax discretionary accruals resulting in temporary deductible differences and DTA valuation allowance. Among the former, the majority represent the impairment of goodwill and other intangible assets, restructuring charges, and the write-off of acquired in-process R&D (Hanlon and Shevlin, 2005), which could be considered a proxy for efforts of the past to pursue new business opportunities and therefore an indicator of a low level of internal uncertainty. Concerning the DTA valuation allowance portion, according to International Financial Reporting Standards, DTA should be recognized to the extent that taxable profit may be available, against which the temporary deductible differences can be used. Put differently, the realization of deferred assets hinges upon the future availability of taxable income. Since the optimal timing of entering a new market depends on the strengths and weaknesses of the firm's existing resource base, including capabilities, competencies, and proficiency (Lieberman and Montgomery, 1998), I propose that the deterrent effect of geographic distance would be less pronounced for firms with substantial DTAs. These predictions are supported by data from a sample of Japanese firms' outbound M&A from 2010 to 2020, following the transition from a worldwide tax system to a territorial tax system in 2009.

This study makes several contributions to the literature on the effects of geographic distance and firm-level characteristics on international expansion. First, although the deterrent effects of geographic distance on M&A have received considerable attention from management scholars, this is the first study based on a large body of existing literature to examine the relationship between the deterrent effect of geographic distance on international expansion and corporate tax aggressiveness while controlling for various country- and firm-specific variables. Rather than to understand the deterrent effect of geographic distance itself, prior tax research has attempted to address whether geographic factors shape corporate tax avoidance, focusing on geographical income shifting but pulling in different directions. To be clear, rather than investigating the relationship between geographic distance and corporate tax avoidance, I am more interested in exploring whether the widely accepted finding that geographic distance deters firms' international expansion is open to different interpretations, depending on tax-related firm-level characteristics because their interaction effect is not well established by the existing literature. This study sheds new light on a large body of literature on the issues surrounding external environmental conditions, such as geographic distance and tax policies, and presents many implications for the existing theory. This study encourages researchers to provide more creative insights into location decisions by combining finance, economics, and tax matters.

Second, due to Japan's slow-growth domestic market, lower corporate culture of aggressive tax planning, and higher corporate culture of tax compliance, this study aims to understand better key mechanisms behind Japanese firms' strategic M&A location decisions, which may be more complicated than existing literature suggests. This study systematically investigates the relevance of tax-related firm-level characteristics to the deterrent effect of geographic distance in the context of outbound M&A by Japanese firms.

Third, this study should be of interest to investors in the market because understanding how tax position impacts M&A strategic decisions would help investors better interpret the tax information disclosed in the financial statements under the circumstances that actual tax returns are not publicly observable to them.

Finally, this study should also be of interest to tax policymakers in Japan because it has several implications for them in evaluating the economic consequences of tax reforms. The results of the supplementary analysis indicate the substantial changes in Japanese controlled foreign company rules consistent with the final version of the OECD's Base Erosion and Profit Shifting project under the 2017 Tax Reform, which aims to strictly avoid multinational enterprises to shift profit or move their investment to low-tax countries, have a significant impact on real investment location decisions. That is, after the substantial amendments, the deterrent effect of geographic distance is moderated by a high level of DTA balance, but no longer moderated by use of a tax consolidation regime due to the increased cost of capital. Additionally, the effect of preferential tax regimes in foreign countries on location decisions is much less pronounced after the amendment. I hope this study could contribute to the review of previous tax reforms and the ongoing policy discussions between Japanese multinational firms and tax policymakers.

4. Geographic distance and foreign divestment

The negative influence of geographic distance as a proxy for additional costs is closely associated with failures that trigger foreign divestments. Additionally, as foreign divestment decision is a frequent and complex corporate occurrence, it can be undertaken not only because of external factors but also internal factors, such as firm-level characteristics (Benito, 2005; Delios and Beamish, 2001; Haynes et al., 2003; Kim et al., 2010, 2012; Kolev, 2016; Nguyen et al., 2013) and deal-level characteristics (Gaur and Lu, 2007; Papyrina, 2007; Park and Yoon, 2022; Wang and Larimo, 2020).

In addition to foreign acquisitions, I aim to provide an unambiguous explanation for the positive influence of the geographic distance on divestment decisions of Japanese multinational firms in Chapter 4. I distinguish the motive of divestments first and then explore whether the effects of geographic distance on foreign divestment decisions are contingent on three firm attributes (i.e., firm size, firm age, and firm's debt burden) and one deal attribute (ownership structure, i.e., shared ownership or complete acquisition).

This analysis of 868 acquisitions made by 496 Japanese firms in 45 countries or regions from 2005 to 2015 indicates that rather than considering gross exit rate as an indicator, the rationale to explain the positive effect of geographic distance on foreign divestment decisions would be unambiguous if we draw a clear line among different foreign divestment motives, whether failure-driven or global business strategy-driven. Geographic distance is not considered a key determinant of strategic divestment decisions for exit cases resulting from the need for restructuring. I further find that the impact of geographic distance hinges on firm- and deal-level attributes, both directly and conditionally. The results reveal that geographic distances were less salient for large firms, young firms, and foreign operations under complete control; however, the opposite was the case for firms with a high debt burden.

The contribution of Chapter 4 is that I reconcile conflicting empirical results based on a longitudinal study using original hand-collected data and demonstrate that the underlying mechanism behind strategic foreign divestment decisions would be obvious when it is linked to the motives of foreign divestments by firms or deals with varying attributes. Further, regarding foreign divestment decisions, the principles of resource-based theory can still explain the rationale behind the relationship between geographic distance and exit rate well after distinguishing the motives.

5. Discussion

I aim to address knowledge gaps in our understanding of how the likelihood of acquisition match and divestment vary with various distances and provide empirical evidence to explain the discrepant findings in previous studies. These findings are significant because they provide empirical data and improve our understanding of the relationships between the strategic location decisions/foreign divestment decisions made by Japanese firms and their unique attributes.

The study has some important limitations. First, potential endogeneity remains a concern, although I included several control variables based on prior literature and conducted several supplementary analyses. For example, I did not control for target-specific variables, such as the target company's firm size or age, individual growth opportunities. These unobservable factors might affect a Japanese firm's location decision; thus, they should be considered in future studies.

Second, this study overlooks the specific purpose of Japanese firms' outbound M&A. In Chapter 2, I considered 47 countries or regions with available data as potential destinations in the choice set. I strongly recommend that future research uses more soft information, such as press releases, management commentary, market commentary, and surveys, to examine this complicated issue, focusing more on the firm's or deal's idiosyncratic nature. In Chapter 3, the results show that tax decisions and real corporate decisions are highly interrelated. Taxes affect numerous real corporate decisions including strategic location decisions, which in turn eventually affect real operations and then have implications for determining the group tax policy itself and its effectiveness; however, I overlook the question that, "which one has the top priority during the process of decision making?". Similarly, in Chapter 4, as both the underlying mechanisms of foreign divestment decisions and ascertainment of causes for withdrawals are complex, the absence of a matched sample of domestic firms in each host country may lead to misinterpretation.

Finally, this study omits the post−acquisition after-tax performance of targets in distant countries. Future studies could further examine how various distances impact post-acquisition performance and explore whether the hypothesized relationships differ between M&A pre- and post-transaction.

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