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# Domestic Acquisition Experience and the Internationalization of Chinese Firms: The Role of Institutional Heterogeneity<sup>1</sup>

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**ABSTRACT** The liability of foreignness increases firm risk of doing business abroad. However, it appears not to deter Chinese firms as evidenced by their risky internationalization pattern. This study is concerned with explaining this phenomenon. Drawing on organizational learning and institutional theories, I argue that institutional heterogeneity in China gives firms an opportunity to develop routines to overcome the liability of foreignness through acquisition experience gained outside of their home provinces. Further, I propose that coastal and inland firms draw different routines from their acquisition experiences. I test these arguments on a panel data of listed Chinese firms, tracing their acquisition behavior from 2006 to 2015. My analyses suggest that acquisition experience outside of home province matters and that, in the case of inland firms, coastal acquisition experience facilitates subsequent internationalization. The present study contributes to the literature on the internationalization of Chinese firms. It highlights the value of context-specific measures for Chinese management research, sheds light on the functionality of institutional heterogeneity in China and provides evidence to re-evaluate the riskiness of Chinese firms' internationalization pattern.

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## INTRODUCTION

The liability of foreignness (LOF), resulting from the institutional distance between home and host countries, elevates the risk of doing business abroad and deters firms from internationalization (Eden & Miller, 2004). Chinese firms particularly suffer from LOF because of the markedly different home institutional environment, Sinophobia, and the lack of traditional firm-specific advantages (Deng, 2013). While a staged, increasing commitment to more distant markets may offer one remedy for reducing LOF, the internationalization pattern of Chinese firms evidences that they do not take this route (Johanson & Vahlne, 2009; Lyles, Li, & Yan, 2014; Ramaswamy, Yeung, & Laforet, 2012).

The attempts to solve this puzzle have fostered an exploding research avenue studying LOF-offsetting factors. Drawing on the institutional theory, most scholarly attention has been on firms' privileged access to resources and markets through home government support (Hong, Wang, & Kafouros, 2014; Liu, Gao, Lu, & Lioliou, 2016; Liu, Lu, & Chizema, 2014; Lu, Liu, & Wang, 2010; Luo & Wang, 2012; Sun, Peng, Lee, & Tan, 2015; Wu & Chen, 2014). Adopting an organizational learning perspective, fewer scholars have focused on the counter-LOF effects of learning about foreign markets through alliances with foreign firms and top management's international experience (Cui, Li, & Li, 2011; Hong & Lee, 2015; Liu, Gao, Lu, & Lioliou, 2016; Lyles, Li, & Yan, 2014; Zheng, Khavull, & Crockett, 2012). With some exceptions (Lu, Liu, Wright, & Filatotchev, 2014), studies deploying institutional theory have fallen short of showing how home institutions are internalized by firms, whereas research within the organizational learning tradition has disregarded that learning may be conditional on the institutional context.

I bridge these two groups of studies by investigating the effect of context-dependent firm learning on the internationalization of Chinese firms. I suggest that institutional heterogeneity

of Chinese provinces offers firms an opportunity to learn how to overcome three dimensions of LOF – unfamiliarity, discrimination and relational (Eden & Miler, 2004) – if they have acquisition experience outside of the headquarters’ home province. I probe into the institutional heterogeneity further and discuss the implications of the coastal-inland institutional divide for building counter-LOF routines. I suggest that coastal and inland acquisition experiences result in firms crafting different kinds of routines, because inland provinces are characterized by stronger state intervention and lower institutional development. Furthermore, routines developed by inland firms through coastal acquisition experience may be more valuable for the subsequent internationalization than routines of coastal firms developed through acquisition growth in inland provinces. I test these ideas on a sample of manufacturing firms listed in China tracing their completed domestic and cross-border acquisitions from 2006 to 2015.

The study makes several contributions to the literature on the internationalization of Chinese firms. First, I develop novel measures of domestic acquisition experience that are China-specific (Barney & Zhang, 2009). Second, I show that the institutional environment of the whole firm, and not only of its headquarters, affects cross-border growth. Third, while previous studies have conceived of institutional heterogeneity as a source of transaction costs firms avoid by internationalizing, I show that Chinese firms, particularly inland, can utilize it for the development of counter-LOF routines (Boisot & Meyer, 2008). Fourth, the findings indicate that the unprecedented risks Chinese firms seem to be willing to take in cross-border growth can be partly accounted for by the fact that their learning curve already starts at home. This provides substance to re-evaluate how ‘aggressive’ and ‘accelerated’ internationalization of Chinese firms, in fact, is (Luo & Tung, 2007; Mathews & Zander, 2007).

## **THEORETICAL BACKGROUND AND HYPOTHESES**

The organizational learning theory suggests that firm strategy is a function of its experience. Firms' experiences are broken down into routines and stored in the organizational memory ready to be used in the future decision-making (Argote & Miron-Spektor, 2011; Levitt & March, 1988; Nelson & Winter, 1982). The organizational development of routines involves collective discussions, implicit knowledge articulation, and codification, making them firm-specific investments. It follows that it is more cost-efficient for firms to build their strategy based on the routines they already possess than engage in operations requiring new routine generation (Argote & Todorova, 2007; Zollo & Winter, 2002). Considering this, for example, studies confirm that acquisition experience increases the chance of a subsequent acquisition (Haleblian, Kim, & Rajagopalan, 2006).

The acquisition process initiates the development of two types of routines. The first type draws on the knowledge of how to conduct acquisitions through identification of acquisition needs and suitable targets, execution of due diligence, negotiations, and other technical pre-acquisition tasks. The second type relates to managing a post-integration stage and achieving synergies (Nadolska & Barkema, 2007). While having these routines is advantageous, the context of their development is an important factor conditioning their value. Specifically, routines generated from domestic acquisition experience may be less valuable for cross-border acquisitions. Compared to domestic, cross-border growth entails uncertainty that originates in the institutional difference between home and host environments (Basuil & Datta, 2015). Therefore, firms with domestic acquisition experience are likely to be unprepared to overcome LOF (Collins, Holcomb, Certo, & Hitt, 2009; Nadolska & Barkema, 2007).

Contrary to the mainstream view, I argue that, in the context of China, firms have a possibility to generate counter-LOF routines through domestic acquisition growth. The difference in formal and informal institutions across China's provinces (North, 1990), which I refer to as institutional heterogeneity, necessitates firm learning about ways to overcome LOF. Eden and Miller (2004) have broken down LOF to unfamiliarity hazards related to the lack of knowledge or experience in a host country, discrimination hazards stemming from the differential treatment by the host governments, businesses, or consumers, and relational hazards defined as the challenges of managing business relationships at a distance. I contend that firm acquisitions outside of home province can be a source of experience that helps acquiring firms shape counter-LOF routines along each of the three dimensions.

First, China is a regionally decentralized state consisting of provinces that historically aimed to be self-sufficient (Ke, 2015). This is reflected in the regionally decentralized system of governance with local governments maintaining considerable legislative powers in their jurisdictions (He, Wei, & Xie, 2008). According to the World Bank, in 2008, for example, it took under four months to settle a commercial dispute in Jiangsu's courts, whereas in Qinghai it took over a year (*The World Bank Group*, 2008). In addition to the differences in formal institutions, a historical tendency towards relative provincial isolation has resulted in differences in culture, dialects, local identity, even consumer preferences and the ways of doing business among the Chinese people (Fang, 2005; Luo, 2007; Talhelm, Zhang, Oishi, Shimin, Duan, Lan, & Kitayama, 2014). For example, research shows that Shanghai and Beijing differ in their business negotiation styles: in the former it is more professional whereas in the latter it is relationship-focused (Fang, 2005). The variation in formal and informal institutions across provinces is a considerable source of unfamiliarity hazard. To be able to acquire a target in a different province, a firm should be able to investigate socio-

economic trends in the province, scrutinize legislation and assess the firm's ability to comply with or even gain advantage of it, as well as manage regional stereotypes (Ambler, Witzel, & Xi, 2017) at the negotiation table.

Second, extending business outside of home province presents a firm with discriminatory challenges. They largely emerge as a consequence of the fiscal federalism regime, whereby lower-tiered government must hand over a proportion of its taxes to the higher-tiered government. This effectively reduces revenue from which local governments can meet demanding policy targets rolled down by Beijing and fulfill other developmental goals (Liu, Song, & Tao, 2006). Thwarting acquisition proposals by acquirers from outside the province for the fear of losing control over local firms and outright discrimination of outsider firms are among the strategies local governments deploy to increase the local tax base (Eberhardt, Wang, & Yu, 2013; Young, 2000). In this light, firms wishing to acquire targets in other provinces need to craft routines helping them to navigate and countervail discriminatory claims.

Third, the majority of business activities in China are conducted through *guanxi* network. Using *guanxi* is embedded in the culture and helpful for overcoming low institutional trust and institutional voids (Li, Poppo, & Zhou, 2008). Yet, the power of social networks decreases with geographical distance (Li et al., 2008; Lu et al., 2014). Thus far, research elucidating how Chinese firms conduct their business across provinces is scant. Anecdotal evidence suggests that firms may move across provinces following the transfer of a high-ranking official with whom they have *guanxi* (Ma, Lin, & Liang, 2012). Hence, while a cross-province acquisition event may itself be embedded in *guanxi*, operations in the new province are likely to be conducted outside of the usual business network. Accordingly,

cross-province acquisitions, at a minimum, would require a firm to revisit some routines related to building trust and managing new relationships.

On balance, I propose that institutional heterogeneity in China is an important source of variance in counter-LOF routines between firms that have or lack acquisition experience outside of home province. Having such routines will decrease the perception of risk associated with LOF in international growth, and thereby increase the probability of a cross-border acquisition. I propose the main hypothesis:

*Hypothesis 1: The likelihood of conducting a cross-border acquisition increases with acquisition experience outside of the home province.*

### **Heterogeneity of Acquisition Experience**

The policy of gradual ‘opening up’ rolled out by Deng Xiaoping, focused on attracting foreign direct investments (FDI) to coastal provinces. In the mid-1990s this policy resulted in coastal provinces attracting 90 percent of all FDI into the country (Cheung & Lin, 2004). Multinational companies became the catalysts of change in the institutional fabric of coastal provinces in their own right, if not directly through corporate political activity, then indirectly through the demonstration and professionalization effects on the local business community and labor force (Kwok & Tadesse, 2006). Consequently, this policy resulted in the accentuation of administrative and economic distances between coastal provinces and the rest of the country, thus solidifying the coastal-inland divide as a spatial dimension of institutional heterogeneity in the country.

Despite the adoption of the ‘Go West’ policy in the late 1990s aiming at narrowing down this divide, the institutional heterogeneity along the coastal-inland boundary persists. Coastal provinces have a much stronger developed non-state financial sector, more and higher quality



market intermediaries such as accountants that could offer objective financial advice, and a higher proportion of privately-owned firms (Li, 2004; Wang, Fan, & Yu, 2016). The strong position of the government as a key resource gatekeeper in inland provinces implies that firms rely on it for doing business more than in coastal provinces (Fligstein & Zhang, 2010).

What can be inferred from the aforementioned facts is that firms with acquisition experience in inland and coastal provinces may generate different routines with regard to discriminatory and relational hazards of LOF. Specifically, in the context of underdeveloped institutional environments, such that firms encounter in inland provinces, resorting to social connections to get things done is an important firm routine (Puffer, McCarthy, & Boisot, 2010). Considering that the key stakeholder in inland provinces is the government, firm success depends on its ability to cultivate political connections. Such connections may not only provide access to land or credit, but also to business and political information which is often controlled by the local government and crucial for pre-acquisition due diligence (Piotroski & Wong, 2013; Tan, Yang, & Veliyath, 2009). In the more sophisticated markets of the coastal provinces, better functioning formal institutions gradually diminish the unequivocal dominance of firm routines based on social connections (Guthrie, 1998). In effect, with the increasing importance of building connections with competitors, customers, and suppliers, the reliance on political connections loses its pivotal role (Sheng, Zhou, & Li, 2011). Therefore, firms with acquisition experience in either inland or coastal provinces are likely to develop different relationship-building routines.

Discriminatory hazards also vary along the coastal-inland divide. As mentioned, provincial political leaders have vested interests in generating economic growth in their jurisdictions, first, because the local tax base is the main source of revenue to fuel future growth and, second, because higher growth rates improve their chances for promotion (Li &

Zhou, 2005). This creates conditions for a symbiotic relationship between the local government and the local business community whereby the former may allocate resources to selected businesses and shield them from competition through various administrative decrees (Bai, Du, Tao, & Tong, 2004). In return, such firms become vehicles for the local government's imperative to achieving various socio-political goals such as low unemployment rates (Zhou & Delios, 2012). In line with this reasoning, prior research has identified that the size of the state-led economy in the province and government expenditure are associated with the lower openness of provinces to the inter-provincial flow of goods, services, and other business activities (Bai et al., 2004). Over the course of 1995-2011, on average, coastal provinces had just above half of their workforce employed in the state-owned firms compared to the nearly three-quarters in inland provinces, and government expenditure as the proportion of gross domestic product was just under 10 percent in the coastal provinces compared to 13 percent in inland provinces (Ke, 2015: 593). Based on this, firms with acquisition experience in inland provinces are likely to be exposed to discriminatory hazards more than in coastal provinces and thus may need to dedicate resources to the development of routines to overcome this specific LOF dimension.

Altogether, this means that acquisition experiences generated in inland and coastal provinces differ in the kinds of routines they shape. However, it is important to recognize that when firms grow across the provinces they are not blank slates but rather entities already socialized into learning how to gain legitimacy in their home institutional environments (Meyer & Rowan, 1977). Hence, from the outset, firms headquartered, for example, in inland provinces learn to develop routines that ensure their survival in this environment such as sophisticated strategies for cultivating ties with political stakeholders while forgoing routines related to building ties to other stakeholders. Inland firms, therefore, already have routines in

their arsenal allowing them to overcome the dimensions of LOF specific to inland provinces. On the one hand, this may still be helpful for expanding to other inland provinces. On the other hand, organizational learning perspective informs us that the repetition of routines creates a dominant logic, which becomes a source of organizational rigidity (Lan & Lubatkin, 1998; Zahra & George, 2002). This implies that inland firms with acquisition experience in other inland provinces may not be able to develop routines that work outside of the familiar environment and thus they may not be able to overcome LOF in the international context. Hence, for domestic acquisition experience to have value in the international context, it is imperative for inland (coastal) firms to obtain acquisition experience in coastal (inland) provinces that emphasizes different LOF dimensions leading to the development of new routines (Argote & Miron-Spektor, 2011). Experience with developing new routines along different dimensions would prepare a firm to better adapt to foreign contexts and decrease risks associated with overcoming LOF in cross-border growth. Hence, I propose:

*Hypothesis 2a: The likelihood of conducting a cross-border acquisition by inland firms will be greater when they have coastal acquisition experience than when they have inland acquisition experience.*

*Hypothesis 2b: The likelihood of conducting a cross-border acquisition by coastal firms will be greater when they have inland acquisition experience than when they have coastal acquisition experience.*

Both coastal and inland firms can reduce organizational rigidity when acquiring outside of their home province group. In addition to this, I argue that in the case of inland firms, acquisition experience in coastal provinces helps them broaden their routine portfolio that becomes more versatile and thus applicable to overcome LOF in a variety of institutional

contexts. In contrast to this, coastal firms with inland experience may only deepen their routine portfolio.

Although coastal provinces are more developed compared to inland, the institutional framework of these two groups of provinces has common roots in the communist ideology and state capitalism. Moreover, coastal provinces were at a developmental stage comparable with inland provinces only few decades earlier. Therefore, while routines developed in inland and coastal provinces have different emphases along the LOF dimensions, coastal firms may possess embedded experiential and congenital knowledge (Hubert, 1992) regarding how to operate in lower developed contexts with significant state intervention. This means that, for coastal firms, inland acquisition experience may be less of an exercise in developing new routines, but rather reviving and refining routines stored deep in the organizational memory. Based on this, coastal firms with acquisition experience in inland provinces are likely to mainly yield value from breaking down their organizational rigidity and not widening their routine portfolio. Therefore, coastal firms' inland acquisition experience would improve their ability to overcome LOF less compared to inland firms' coastal acquisition experience. I propose the final hypothesis:

*Hypothesis 3: Inland firms with coastal acquisition experience have a higher likelihood to acquire cross-border than coastal firms with inland acquisition experience.*

## **METHOD**

### **Data**

To test hypotheses, I extracted a sample of firms listed on the Shanghai and Shenzhen Stock Exchanges between 2006 and 2015 with Chinese ultimate ownership. Both firms that did and did not conduct cross-border acquisitions in the observed period were included in the sample.

To capture the longitudinal nature of the study, I introduced a requirement that firms in the sample existed and were listed in each of the ten years, hence, firms that were either listed or established after 2006 were excluded. I focused on the sample of manufacturing firms (SIC 20-39) because firms in natural resources, real estate, and financial industries are heavily regulated and subject to larger state intervention that may cloud the observation of organizational learning (Chen, Sun, Tang, & Wu, 2011).

To obtain data on firm acquisitions I used Zephyr produced by Bureau van Dijk. I restricted my analysis to acquisitions involving the transfer of majority ownership rights, i.e. the percentage of final shares is limited to 50 percent and above (e.g. Gubbi, Aulakh, Ray, Arkar & Chittoor, 2010). This was done to ensure that acquiring firms were involved in managing their targets, and they were not pursuing a variety of other business goals which may reflect a different predisposition to risk (Ouimet, 2013). Also, minority and majority acquisitions present markedly different learning opportunities (Contractor, Lahiri, Elango, & Kundu, 2014). Acquisitions of targets located in Hong Kong, Singapore, Macau, and known tax havens in the Caribbean were excluded from the sample because these deals are likely to be driven by tax considerations (Hampton & Christensen, 2002). In total, the sample contains 10,440 firm-year observations.

## **Variables**

*Dependent variable.* *Cross-border acquisition* is a dichotomous variable that equals '1' if a firm completed a majority acquisition in the given year and '0' if no cross-border acquisitions were conducted that year. The number of majority cross-border acquisitions is 199.

*Independent variables.* The first independent variable is *acquisition experience outside of home province* measured as the number of provinces entered by a firm through an acquisition mode per year. I derived information on the location of an acquisition target either from its name or from the description that accompanied the deal. In creating this variable, I considered only new provinces that the firm enters each year. Over 60 percent of firms in the sample acquired a target outside of the home province.

For Hypotheses 2a, 2b and 3, I generated three new independent variables. First, I divided Chinese provinces into coastal and inland. I used two criteria for the classification. First, I calculated median values for the marketization index of Chinese provinces for each year (Fan, Wang, & Zhu, 2011; Wang, Fan, & Yu, 2016). Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Shandong, Guangdong, Hebei, Liaoning, Hubei and Chongqing were provinces with values above the median for each year. Second, for consistency, I referred to prior studies. For example, Qian and Smyth (2007) and Kanbur and Zhang (1999) classified Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Shandong, Guangdong, Hebei, Liaoning, Fujian and Guangxi into a coastal group of provinces. Meyer (2008) discussed the Chinese economic belt as comprised of Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Shandong, Guangdong, Hebei, and Liaoning. I coded provinces common to all three classifications as coastal: Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Shandong, Guangdong, Hebei, Liaoning. The rest of the provinces were classified as lower developed or inland. I assigned '1' for the coastal *HQ location* of an acquiring firm and '0' for the inland location. Over half of the sampled firms were located in coastal provinces. Then, I have divided *acquisition experience outside of home province* into the *coastal acquisition experience* and *inland acquisition experience*. *Coastal (inland) acquisition experience* is a number of new coastal (inland) provinces entered through an acquisition mode per year.

*Control variables.* There are a theoretical case and mixed empirical evidence suggesting that firms can learn from experiences with similar, but not identical, strategies. For example, firms wishing to conduct cross-border acquisitions may benefit from prior exporting behavior or alliances with foreign firms (Liu et al., 2016; Lyles et al., 2014). To address this, I controlled for a variety of firm experiences. First, I included information on firm *export* experience defined as foreign sales to total sales per year (Lyles et al., 2014). Second, I controlled for *joint venture* experience with a foreign firm in China, taking it as a number of joint ventures a firm established each year. Third, I also controlled for the *number of foreign subsidiaries* a firm had before the observed period (Lyles et al., 2014). The foreign subsidiary was similarly defined as a majority-owned subsidiary outside of Hong Kong, Macao and tax havens. Due to data restrictions, I could not specify whether a foreign subsidiary was a result of an acquisition or other establishment modes. Over 70 percent of firms in the sample did not have a foreign subsidiary prior to 2006 with the average number per firm amounting to 1.08 subsidiary. I also included a measure built similarly to the *number of foreign subsidiaries* denoting the *number of domestic subsidiaries* prior to the observed period to capture a firm's experience with domestic growth.

I also controlled for the *percentage of state ownership* in the acquiring firm (Lu et al., 2014). Compared to private, state-owned firms have a different propensity for risk-taking and exhibit differences in the internationalization behavior (Wei, Clegg, & Ma, 2015). I included firm *performance* proxied by a logarithm-transformed net income divided by total assets (ROA) and firm unabsorbed *slack* defined as a ratio of current assets to current liabilities. I also controlled for the firm's *R&D intensity* as a proxy of absorptive capacity (Lan & Lubatkin, 1998). I included firm *age* and *size*, defined as a difference between a focal year and the year of the establishment and log-transformed number of employees respectively.

Both of these variables have been shown to increase a chance for a firm's decision to internationalize (Lu et al., 2014).

The level of firm *diversification* has been found to be an important predictor of acquisition growth and internationalization, primarily because such firms have more learning opportunities (Lu et al., 2014). Here I used an entropy measure of product diversification proposed by Palepu (1985). In addition, I controlled for a province *market size* through log-transformed gross regional product per capita. Although there is mixed evidence regarding the sign of the expected relationship between *market size* and firm internationalization, it is important to control for in the context of emerging markets where home market may be appealing for firm growth (Luo & Wang, 2012; Stoian, 2013). I also included in each model *industry* and *year* dummies to account for the industry- and province-effects of unobserved heterogeneity. To capture the dynamic nature of the relationship between home acquisition experience and a firm's decision to internationalize, all independent variables were included with a one-year lag.

## **Model**

To account for the dichotomous nature of the dependent variable, I estimated binary logistic regression. Because the data have a panel structure, the observations nested under one firm are not independent of each other and there might be certain effects that I did not account for. Based on the estimation of the Hausman specification test, fixed or random effects models are typically chosen to address this issue. Fixed-effect models are sensitive to within-subject variability and built to only control for the effects of time-invariant variables and not estimate them. Since I am interested in estimating the effect of *HQ location*, that is time-invariant, I fit a random-effects model.



Out of 199 acquisitions, 79 were conducted by serial acquirers. To address possible autocorrelation, I included a one-year lagged dependent variable on the right-hand side of all statistical models (Holburn & Zelner, 2010).

## RESULTS

The means, standard deviations, and correlations of all variables are presented in Table 1. All domestic acquisition variables and those related to other sources of knowledge about foreign markets are weakly but significantly correlated with the dependent variable. There is a large, but expected, correlation between *acquisition experience outside of home* and *coastal acquisition experience* and *inland acquisition experience* respectively ( $r = 0.76$  in both cases). There is also a correlation between the coastal and inland subtypes of acquisition experience ( $r = 0.15$ ). The *number of foreign subsidiaries* and the *number of home subsidiaries* are also significantly correlated ( $r = 0.53$ ).

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 INSERT TABLE 1 AROUND HERE  
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To estimate multicollinearity issues further, I have computed variance inflation factor (VIF) values. All values, except *acquisition experience outside of home province*, returned below 1.50 with the mean 1.12, which is highly acceptable for the regression models (Neter, Wasserman, & Kutner, 1996). This indicates that the correlation between the *number of foreign subsidiaries* and the *number of home subsidiaries* can be tolerated. The high value of VIF on *acquisition experience outside of home province* could have been an issue if some hypotheses required using this variable together with its two derivatives – *coastal* and *inland acquisition experiences* – in the same model. Since this is not the case, it is possible to

conclude that, for the purposes of testing the hypotheses of this study, multicollinearity between independent variables is not an issue.

Table 2 contains the results of the logistic regressions testing hypotheses proposed in the study. Model 1 is a baseline model containing only control variables and the lagged dependent variable. *Export*, *joint venture experience* and the *number of foreign subsidiaries* have a strongly significant effect on the likelihood of acquiring cross-border ( $p < 0.001$ ). *Market size* also strongly affects the likelihood of going cross-border with firms operating in larger markets having a lower propensity for internationalization. Furthermore, the *percentage of state ownership* and *firm performance* negatively impact the likelihood of going cross-border ( $p < 0.050$ ).

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To test Hypothesis 1, I introduced *acquisition experience outside of home province* into Model 2. The new model demonstrates only a slight improvement over the baseline model ( $p < 0.10$ ). It shows a positive and significant impact of *acquisition experience outside of home province* on a subsequent cross-border acquisition ( $b = 0.42, p < 0.007$ ). In terms of the effect size, each acquisition entry into a new province increases the odds of a subsequent cross-border acquisition by 52 percent. This lends strong support to Hypothesis 1, I further ran a Wald test to compare beta coefficients of *acquisition experience outside of home province* with the other predictors of firm international activity. It is a stronger predictor of internationalization compared to firm *export* ( $b = 0.01$ ) at  $p < 0.014$  and marginally stronger than the *number of foreign subsidiaries* ( $b = 0.13$ ) at  $p < 0.090$ . The influence of experience

drawn from a *joint venture* is strong ( $b = 1.23$ ) and significantly larger than that of *acquisition experience outside of home province* at  $p < 0.009$ .

To test Hypotheses 2a, 2b and 3, I introduced into the models *HQ location*, *coastal acquisition experience* and *inland acquisition experience*. Model 3 demonstrates the direct effects of these variables on the likelihood of acquiring cross-border. Only *coastal acquisition experience* has a direct positive impact on the dependent variable ( $b = 0.60$ ,  $p < 0.010$ ). This can be interpreted such that one unit increase in coastal acquisition experience leads to 82 percent increase in the odds of a cross-border acquisition. Model 4 tests the interaction effects between *HQ location* and *coastal* and *inland acquisition experiences* respectively. Both are significant at a comparable significance level ( $b = -1.35$ ,  $p < 0.006$  for the *HQ location* x *Coastal acquisition experience* and  $b = 2.29$ ,  $p < 0.036$  for the *HQ location* x *Inland acquisition experience*).

In non-linear regressions, direction and magnitude of interaction effects depend on the values of all other variables and their direct reading from the results table may be misleading (Greene, 2010). To address this, I plotted predicted probabilities of the interaction effects on the dependent variable in Figure 1 and Figure 2 keeping the values of independent continuous variables at their means and dichotomous variables such as industry profile at their medians. Figure 1 depicts the moderating effect of *HQ location* on *coastal acquisition experience* and Figure 2 captures its interaction with the *inland acquisition experience*. Figure 1 illustrates that entering a new coastal province improves the chance of an inland firm to acquire cross-border, whereas the propensity of a coastal firm to acquire cross-border is insensitive towards the number of new coastal provinces they enter. The plot in Figure 2 demonstrates that those inland firms that grow in other inland provinces do not acquire cross-border. It also shows

that each entry of a coastal firm into a new inland province increases the likelihood of acquiring cross-border. These illustrations offer qualitative support for Hypotheses 2a and 2b.

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Hypothesis 3 proposes that inland firms' *coastal acquisition experience* has a stronger effect on cross-border growth than coastal firms' *inland acquisition experience*. The comparison of the two plots shows that the dotted line in Figure 1 is steeper than in Figure 2. In fact, for an inland firm, acquisition experience in 4 coastal provinces improves the probability of acquiring cross-border by over 40 percentage points, whereas coastal firms' acquisitions in 4 inland provinces increases the probability by only under 5 percentage points. This evidence also points in favor of Hypothesis 3.

To provide statistically sound conclusions regarding Hypotheses 2a-3, I relied on a procedure suggested by Wiersema and Bowen (2009) and examined the sign and statistical significance of marginal effects of *coastal* and *inland acquisition experiences* at coastal and inland *HQ location*. The marginal effect of *coastal* and *inland acquisition experiences* (X) for inland and coastal *HQ location* (Z) is determined by the following equation:

$$\text{Marginal effect of } X = \frac{\delta\pi(V\beta')}{\delta X} = \pi(V\beta')(\beta_x + \beta_{xz}Z)$$

Tables 3 and 4 show the results of this procedure. Drawing from Table 3, I found a statistically significant positive marginal effect of inland firms' *coastal acquisition experience* on the likelihood of acquiring cross-border ( $b = 0.3249$ ,  $p < 0.007$ ), showing that

an acquisition in an additional coastal province boosts an inland firm's probability of acquiring cross-border by 0.32. The findings depicted in Table 4 show that the marginal effect of inland firms' *inland acquisition experience* on cross-border growth is not significant. This provides support to Hypothesis 2a. In the case of coastal firms, Tables 3 and 4 show that having either *coastal* or *inland acquisition experiences*, although following the predicted signs, does not offer a statistically significant improvement in the likelihood of cross-border growth. Hence, Hypothesis 2b is rejected. The marginal effect of inland firms' *coastal acquisition experience* on the likelihood of acquiring cross-border is stronger than the statistically insignificant effect of the coastal firms' *inland acquisition experience*, thus lending partial support to Hypothesis 3.

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## **DISCUSSION**

The premise of the study is that internationalization is risky and one specific risk that firms suffer from is caused by LOF. I conceptualized that institutional heterogeneity in China makes it possible for firms to acquire counter-LOF routines through domestic acquisition experience that subsequently helps them internationalize. The regression results confirmed that acquisition experience outside of home province is a strong predictor of cross-border acquisition growth and it is stronger than the other types of experience such as firm exports

and foreign subsidiaries. It, however, is a weaker predictor of internationalization than joint venture experience with a foreign firm. One explanation of this is that a joint venture may directly reduce the magnitude of all three LOF hazards, for example, by providing partnership opportunities in foreign markets. Nevertheless, not all firms can have such experience, thus highlighting the importance of searching for the alternative learning routes. The strong effect of the context-specific measure of domestic acquisition experience developed in this study confirms the rationale calling for China-specific theory building (Barney & Zhang, 2009), and contributes to the understanding of the peculiarities of the internationalization of Chinese firms (Lu et al. 2014; Lyles et al. 2014).

I further unpacked acquisition experience outside of home province by investigating the coastal-inland provincial divide. I found a significant difference between the role of inland and coastal acquisition experiences for firm internationalization. First, only coastal acquisition experience adds value for cross-border growth. Second, it is inland firms that benefit from coastal acquisition experience the most. Inland acquisition experience is not advantageous for either inland or coastal firms. This may be because entering inland provinces does not offer experience heterogeneous enough for the development of novel counter-LOF routines. It alludes to the fact that transaction costs associated with entering inland provinces may not be as high as the literature assumes (Boisot & Meyer, 2008). Meanwhile, the expansion of inland firms to coastal provinces constitutes a significant challenge, creating an important learning context for these firms. This finding emphasizes that spatial organization of economic life in China requires further scrutiny.

Neither inland nor coastal acquisition experiences facilitate coastal firms' cross-border growth, indicating that coastal firms do not develop counter-LOF routines through cross-province acquisitions. This could be accounted for by a variety of reasons. For example,

coastal firms may be more risk-taking because of better market intermediaries that may insulate them from the negative effects of LOF through better accounting advice or bank credit. Moreover, coastal firms have more opportunities for interaction with co-located foreign firms that can facilitate the development of counter-LOF routines. Inland firms, however, do not have this option or to a much lesser extent, thus exhibiting more ingenuity with regard to building routines.

Furthermore, the findings of the study show that a firm's HQ location does not directly impact firm internationalization. Prior studies evidence that various levels of institutional development of firms' home provinces have different structural push factors of internationalization (Luo & Wang, 2012). In addition to this, promotional policies of local governments related to internationalization for technological upgrading are likely to be adopted uniformly across provinces (Luo, Xue & Han, 2010). Therefore, first, the absence of the difference between coastal and inland firms' propensity to internationalize is consistent with these arguments. Second, while government policies are a factor of internationalization, the results of the model provide indirect evidence that it may not be the decisive one. This is so, because the government usually implements its interests through state-owned firms, however the results show that they were less likely to internationalize compared to private. This restates that studying domestic acquisition growth is important because it advances our understanding of the sources of variance of Chinese firms' internationalization.

Together, these findings provide several contributions to the literature on the internationalization of Chinese firms. First, I offer novel insights on the effect of the institutional context on firm internationalization. Prior studies examined the effect of home market by looking either at the level of institutional development of a firm headquarters' province or the level of home government's support (e.g. Hong et al., 2014; Liu et al., 2016;

Lu et al. 2010; Sun et al., 2015). These studies, however, treated institutional context as either confined to the provincial borders or as a collection of sweeping nation-wide factors. This study emphasizes that a firm may span over a number of provinces. Therefore, studying the effect of institutions only of a province where a firm is headquartered significantly underplays the complexity of the institutional environment in which it may be embedded.

Second, prior studies tend to dismiss institutional heterogeneity of a domestic market as a push factor that makes Chinese firms ‘escape’ into foreign countries. Boisot and Meyer (2008) were among the first to argue that internationalization may involve lower transaction costs than cross-province growth. I reveal a different role of institutional heterogeneity showing that, rather than escaping, over a half of Chinese firms in the sample engage in cross-province growth and some of them directly use experience gained along the way for subsequent internationalization. Moreover, transaction costs involved in moving across provinces are precisely what enables firm learning about ways to overcome LOF. It follows that the discussion with regard to the impact of institutional heterogeneity in China on firm internationalization is important to continue. This study is among the first that purposefully analyzes how institutional heterogeneity of the domestic market may be internalized by firms. The field is ripe for more studies that blend perspectives and clarify mechanisms whereby institutional context impacts firm strategy.

Third, the evidence that Chinese firms can learn how to overcome LOF through engaging in home acquisition growth has implications for studies investigating their internationalization pattern. Gradual acquisition of international experience and the ability to overcome LOF has been at the core of our understanding of the internationalization of Western firms that first enter more similar countries through less risky entry modes before advancing into more distant countries. The way Chinese firms internationalize – into more



institutionally distant countries and through riskier entry modes – has been fascinating for scholars because it is not clear where do they learn how to internationalize and, especially, overcome LOF. This puzzle fueled some colorful epithets of the way Chinese firms expand internationally such as ‘accelerated’ (Mathews & Zander, 2007), ‘aggressive’ (Luo & Tung, 2007), ‘entrepreneurial’ (Madhok & Keyhani, 2012), ‘leapfrogging’ (Young, Huang, & McDermott, 1996) and ‘Chinese way’ (Lyles et al., 2014). This study provides evidence that firms learn how to overcome LOF by expanding domestically. Hence, it is important to consider that Chinese firms’ learning curve originates not with their first cross-border entry, but with domestic growth. This offers grounds to re-evaluate just how ‘accelerated’ and ‘aggressive’ internationalization of Chinese firms really is.

#### **LIMITATIONS AND FUTURE RESEARCH**

This study has limitations that present an opportunity for future research. I built the case that acquisition experience outside of home province can be the source of counter-LOF routines. It is likely, however, that not all three dimensions are and can be internalized equally with every cross-province acquisition. Future studies may address this by investigating differences along the three dimensions between the home province of the firm, provinces where it is already present and a new province. Learning along some dimensions could be easier for the firm because of its current knowledge stock or short distances between home and host provinces. More importantly, learning certain routines may be more or less relevant for the firm based on the perceived need. Also, I investigated this mechanism on publicly traded Chinese firms, which a priori have access to resources and benefit from more advanced corporate governance practices, but how other firms are able to deal with institutional contexts outside of the home province remains a valid question.

I discussed that the development of counter-LOF routines decreases the perception of risk associated with operating in a different environment, thus providing the impetus for internationalization. What is unknown, however, is whether counter-LOF routines generated domestically are indeed useful for Chinese firms across the border. This should be an important extension of the current study by looking at performance rates, survival and growth of foreign subsidiaries. It may be that Chinese firms do learn from domestic experience, but they are not able to capitalize on it in the international context.

Finally, the random effects model tested in the study assumes that unobserved characteristics of firms are time-invariant and randomly distributed in the population. Although I have considered and controlled for the most commonly used variables affecting the dependent variable recognized in the previous literature, I cannot completely exclude the potential negative effect of endogeneity on the results. As for future research, the studies may address this aspect by, for example, running a two-stage model with an instrumental variable (e.g. Acemoglu, Johnson, & Robinson, 2001).

## **CONCLUSION**

I investigate the effect of domestic acquisition experience of Chinese firms on subsequent cross-border acquisitions. I argue that institutional heterogeneity in China offers firms an opportunity to develop counter-LOF routines. Further, I suggest that coastal and inland firms generate different routines from coastal and inland acquisition experiences because inland provinces are less developed and have stronger state intervention in the economy. I test the hypotheses, and find support to some of them, on a sample of Chinese listed firms observing their acquisition behavior between 2006 and 2015. The findings contribute to the literature on the internationalization of Chinese firms and China-specific management theories.

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Table 1. Descriptive statistics and correlations

Variables	Mean	SD	1	2	3	4	5	6	7	8
1. Cross-border acquisition	0.01	0.12								
2. Acquisitions outside of home	0.11	0.38	0.04							
3. Coastal experience	0.06	0.25	0.04	0.76						
4. Inland experience	0.05	0.25	0.02	0.76	0.15					
5. HQ location	0.63	0.48	0.01	-0.00	0.00	-0.00				
6. Export	15.05	23.08	0.07	-0.02	-0.01	-0.03	0.17			
7. Joint venture	0.01	0.15	0.10	0.00	-0.00	0.00	0.02			
8. Number of foreign subsidiar.	1.08	2.97	0.15	0.07	0.05	0.05	0.09	-0.00		
9. Number of home subsidiar.	19.07	23.36	0.08	0.10	0.07	0.08	0.06	-0.04	0.08	
10. Percent state ownership	15.96	20.82	-0.03	0.01	0.01	0.01	-0.09	-0.08	0.04	0.53
11. Performance	4.64	0.09	-0.02	-0.02	-0.02	-0.01	0.08	0.01	-0.01	0.00
12. Slack	2.17	3.13	0.01	-0.02	-0.02	-0.02	0.03	0.07	-0.02	0.03
13. R&D intensity	1.16	2.18	0.05	0.04	0.04	0.02	0.09	0.09	-0.02	0.03
14. Age	13.58	6.07	0.03	0.04	0.04	0.02	-0.02	-0.01	-0.02	0.00
15. Size	7.50	1.24	0.05	0.06	0.03	0.06	-0.06	0.08	0.06	0.25
16. Diversification	0.56	0.47	0.02	0.01	0.02	-0.00	0.00	0.01	0.00	-0.01
17. Market size	10.41	0.66	-0.04	0.01	0.01	0.00	0.14	0.01	0.00	0.02
			9	10	11	12	13	14	15	16
10. Percent state ownership			0.08							
11. Performance			0.00	-0.10						
12. Slack			-0.09	-0.08	0.11					
13. R&D intensity			-0.07	-0.08	0.01	0.20				
14. Age			0.07	0.06	-0.11	0.00	0.14			
15. Size			0.33	0.09	-0.07	-0.16	0.04	0.06		
16. Diversification			-0.01	-0.01	-0.03	0.03	0.04	0.01	0.02	
17. Market size			0.04	0.03	0.00	-0.02	-0.01	0.02	0.03	0.00

Note:  $N = 10,044$ ; Correlations with an absolute value equal or larger than 0.02 are significant at 0.05 level.

Table 2. The results of the logistic regression analysis, the likelihood of a cross-border acquisition is the dependent variable

Variables	Model 1	Model 2	Model 3	Model 4
Export	0.01 (0.00)***	0.01 (0.00)***	0.01 (0.00)***	0.01 (0.00)***
Joint venture	1.25 (0.27)***	1.23 (0.27)***	1.24 (0.27)***	1.27 (0.28)***
Number of foreign subsidiaries	0.13 (0.02)***	0.13 (0.02)***	0.13 (0.02)***	0.13 (0.02)***
Number of home subsidiaries	-0.00 (0.00)	-0.00 (0.00)	-0.00 (0.00)	-0.00 (0.00)
Percent state ownership	-0.01 (0.01)**	-0.01 (0.01)**	-0.01 (0.01)**	-0.01 (0.01)**
Performance	-1.19 (0.58)**	-1.20 (0.58)**	-1.16 (0.58)**	-1.20 (0.58)**
Slack	0.02 (0.02)	0.02 (0.02)	0.02 (0.02)	0.02 (0.02)
R&D intensity	0.05 (0.03)	0.04 (0.03)	0.05 (0.03)	0.04 (0.03)
Age	0.01 (0.02)	0.01 (0.02)	0.01 (0.02)	0.01 (0.02)
Size	0.14 (0.08)*	0.14 (0.08)*	0.14 (0.08)*	0.14 (0.08)*
Diversification	0.29 (0.18)*	0.29 (0.17)*	0.29 (0.18)*	0.31 (0.18)*
Market size	-0.42 (0.11)***	-0.43 (0.11)***	-0.42 (0.11)***	-0.42 (0.11)***
Lagged DV	0.91 (0.36)**	0.91 (0.36)**	0.93 (0.36)**	0.91 (0.36)**
Experience outside of home province		0.42 (0.15)**		
Coastal experience			0.60 (0.23)**	1.31 (0.31)***
Inland experience			0.23 (0.27)	-1.65 (1.06)
HQ location (coastal=1)			-0.19 (0.20)	-0.14 (0.21)
Coastal experience * HQ location				-1.35 (0.49)**
Inland experience * HQ location				2.29 (1.09)**
Pseudo R-squared	0.1425	0.1462	0.1473	0.1556
Log-likelihood	-698.49	-695.48	-694.57	-687.79

Note:  $N = 10,440$ ; Parentheses contain standard errors; industry and year dummies included in all models. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.000$



Table 3. The moderating effect of HQ location on the marginal effect of coastal acquisition experience on cross-border acquisitions

HQ location	Marginal effect of coastal acquisition experience at min (1)	z-statistic	Marginal effect of coastal acquisition experience at max (4)	z-statistic
Inland	0.03065	0.35	0.32497	2.71**
Coastal	-0.00031	-0.15	-0.00026	-0.17

Note:  $N = 10,440$ ; \*\*  $p < 0.05$

Table 4. The moderating effect of HQ location on the marginal effect of inland acquisition experience on cross-border acquisitions

HQ location	Marginal effect of inland acquisition experience at min (1)	z-statistic	Marginal effect of inland acquisition experience at max (7)	z-statistic
Inland	-0.00202	-0.33	-0.00001	-0.21
Coastal	0.00641	0.33	0.12941	0.59

Note:  $N = 10,440$ ; \*\*  $p < 0.05$

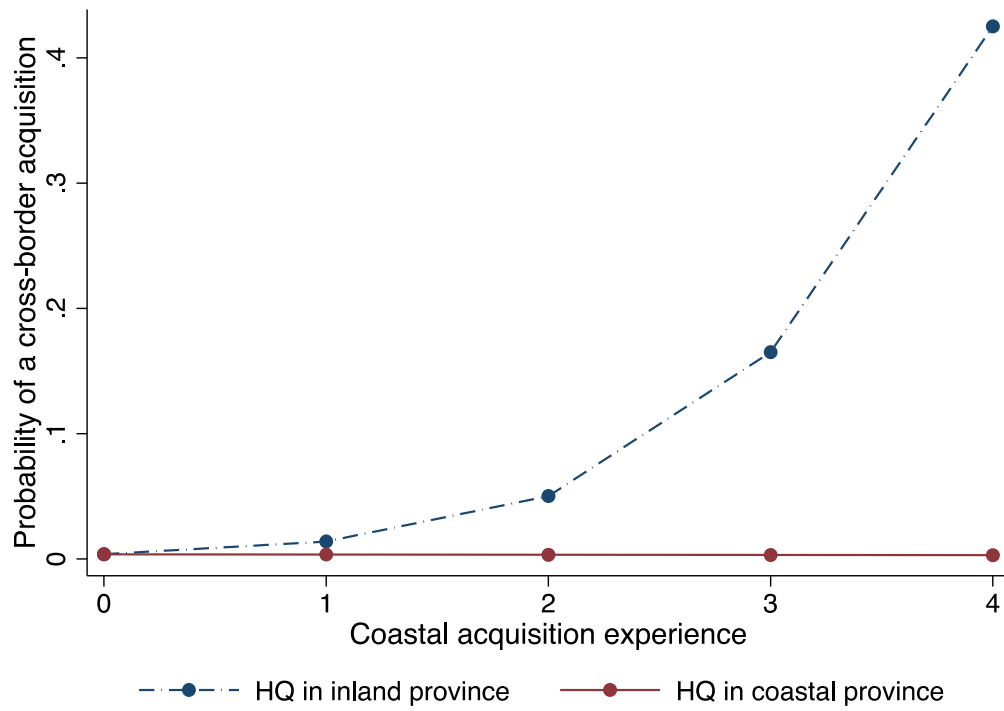


Figure 1. The interaction effect between coastal acquisition experience and firm location on the likelihood of a cross-border acquisition

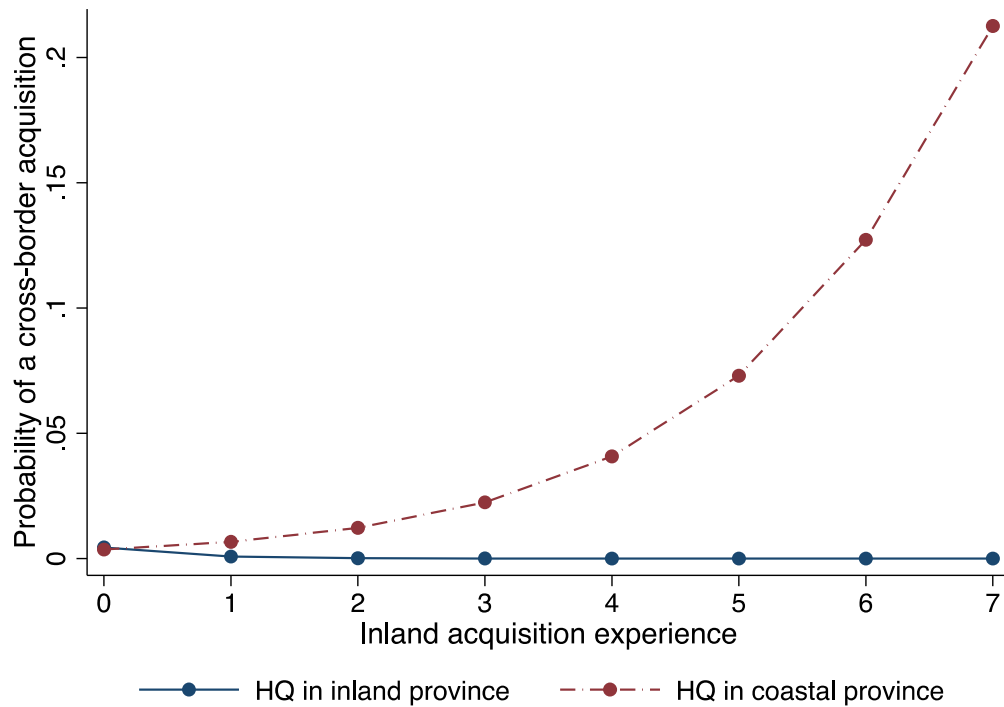


Figure 2. The interaction effect between inland acquisition experience and firm location on the likelihood of a cross-border acquisition