Institutional distance and cross-border mergers and acquisitions completion: A conceptual framework

Nuno Rosa Reis
School of Technology and Management
globADVANTAGE – Center of Research in International Business & Strategy
Polytechnic Institute of Leiria, Portugal
Morro do Lena - Alto Vieiro
2411-901 Leiria, PORTUGAL
E-mail: nuno.m.reis@ipleiria.pt

Manuel Portugal Ferreira
FEA – Universidade de São Paulo &
UNINOVE – Universidade Nove de Julho
Programa de Pós-Graduação em Administração
Av. Francisco Matarazzo, 612, Prédio C – 2º
São Paulo - SP
CEP: 05001-100, BRAZIL
E-mail: manuel.portugal.ferreira@gmail.com

João Carvalho Santos
School of Technology and Management
globADVANTAGE – Center of Research in International Business & Strategy
Polytechnic Institute of Leiria, Portugal
Morro do Lena - Alto Vieiro
2411-901 Leiria, PORTUGAL
E-mail: joao.santos@ipleiria.pt

ABSTRACT

Cross-border mergers and acquisitions (M&As) are a widely researched phenomena among International Business scholars as these operations represent an important form for completing FDI. Cross-border M&As are delved into from several perspectives ranging from financial aspects to strategic options, from post-deal integration to the choice of M&A as opposed to greenfield operations. The pre-completion stage of the deal remains, however, underexplored. We seek to address this research gap using an institutional approach to M&A research. Therefore, we put forward a conceptual framework to explain how does institutional distance influence the likelihood of a deal to be completed and on the other hand how does institutional distance influence the time it takes a deal to be completed. We posit that institutional distance augments the likelihood of an M&A deal to fail and institutional distance also augments the time it takes an M&A deal to be completed.

Keywords: Mergers and acquisitions; pre-completion phase; institutional environment; institutional distance; conceptual framework.

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INTRODUCTION

Cross-border mergers and Acquisitions (M&As) are used by firms to expand their operations abroad. The increase of global markets for inputs and for final products lead firms to seek new markets to exploit their current capabilities or explore new sources for their resources (March, 1991). Thus expanding international activities offers firms a way to gather new strategic resources while reducing transaction costs (Hennart, 2011). Internationalization operations are not without risks, as firms have to face not only other multinational enterprises (MNEs), the local competitors and also an environment that is unfamiliar and different from the home environment in what is known as liability of foreignness (Hymer, 1976).

Over the past years, the frequency and volume of M&As have increased substantially to a volume of 2.1 trillion USD in 2007 (Reus & Lamont, 2009) and to 2.6 trillion USD in 2012 (Thomson Reuters, 2012). Despite being one of the leading forms of completing foreign direct investment (FDI), M&As are not completely understood and they are a phenomenon that grants a great deal of attention from scholars. M&A research has received a wealth of contributions from several fields of knowledge. Some scholars have used an economic perspective to grasp the effect of M&As as a vehicle of FDI (Demirbag, Tatoglu & Glaister, 2008); financial economists have delved into the economic performance of both acquirer (Ang & Cheng, 2006) and target firms (Bhagat, Dong, Hirshleifer & Noah, 2005) ; psychology and organizational behavior scholars examined issues such as post-M&A integration (Kiessling & Harvey, 2006) and organizational learning (Vermeulen & Barkema, 2001); strategic management scholars investigated the motivations for M&A (Halebian et al., 2009), and reasons for failure (Shaver, 2006). However, M&A research is quite fragmented with distinct approaches, contradictory results and lacking a unifying theory (Javidan et al., 2004).

Although there is a substantial wealth of research on M&As on the motivations for the operation and the post-acquisition phase of the deal (Shimizu et al., 2004). However, a large number of operations are abandoned after being announced (Zhang, Zhou & Ebbers, 2011), which calls for scholars' attention. An announced deal which is not concluded has several costs for the firm, ranging from reputational problems (Muehlfeld, Rao Sahib & Witteloostuijn, 2007) to high termination fees (Bates & Lemmon, 2003). Recently there has been some research on the pre-completion phase of the M&A in an attempt to address the issues that firms face before the completion of an M&A. Scholars have sought to understand the likelihood of an M&A to be completed

(Dikova, Rao Sahib & Witteloosjtuijn, 2010; Muehlfeld, Weitzel & Witteloostuijn, 2011; Zhang et al., 2011) and have also delved on the time it takes for an M&A deal to be completed (Dikova et al., 2010). However the pre-completion phase of an M&A is still not fully understood and it grants further research (Dikova, Rao Sahib, Witteloosjtuijn, 2010). Therefore, the research we put forward aims at filling the gap identified in the extant literature and thus contribute to a better comprehension of the M&A phenomena as a whole. The research question may be stated as follows: Does the institutional environment influence the completion of an M&A deal, both concerning the success of the operation and the time it takes to be completed? By answering this research question, we contribute to fill the research gap on the pre-completion phase of M&As which has received little attention from scholars so far.

This paper has three main sections following this introduction. In the next section we present an overview of the literature on M&As and institutional issues. Second we present our conceptual model and the rational for our propositions. Finally we conclude with a broad discussion and highlight avenues for future research.

LITERATURE REVIEW

For purposes of clarity, it is relevant to define the concept of cross-border M&A used. Scholars usually use the terms merger and acquisition interchangeably or in combination even though the two are conceptually different. A merger occurs when two firms combine all their assets and all their obligations and one of them ceases to exist legally or both of the firms dissolute and a new firm is created (Gaughan, 1999). An acquisition, in contrast, merely involves transferring the ownership of one firm (the acquired, or target) to another (the acquirer). The ownership transfer may be either total or partial (Gaughan, 1999). Even though different, the two concepts may be difficult to distinguish since they often overlap and occasionally some acquisition deals are termed merger for fiscal reasons (Merkert & Morrell, 2012) or to improve the motivation of the acquired firm's personnel (Zollo & Singh, 2004). As for the geographical nature of the M&A deals, if both the firms involved in the deal are from the same nation M&As are deemed domestic; if the deal involves firms from two different nations, M&As are considered cross-border (Shimizu et al., 2004). Herein I follow Shimizu and colleague's (2004) definition of cross-border M&A as "those [M&As] involving an acquirer firm and a target firm whose headquarters are located in different home countries" (Shimizu et al., 2004: 309).

Firms undertake M&A operations for various reasons. One set of reasons may be deemed as "value-creating reasons" and one may identify three main rationales in that group. Firms perform M&A operations to reduce risk, especially by diversifying to unrelated businesses (Seth, 1990), by combining income flows from unrelated business. Empirical research has showed this effect is not undisputed and some scholars argue that M&As do not reduce risk (Amihud, De Long & Saunders, 2002) whereas others posit M&As increase risk for shareholders (Geppert & Kamerschen, 2008). Firms also perform M&As to enhance their market power by reducing the number of players, augmenting their relative size and constraining both buyers' and suppliers' bargaining power (Calipha, Tarba & Brock, 2010). Another value-creating reason to perform M&A operations is to improve operational efficiency, by creating synergies and gaining economies of scale and scope (Seth, 1990). Finally, firms may perform M&As to access resources they do not yet hold (Ferreira, 2007) which contributes to building a competitive advantage.

Firms may also perform M&As for non-value-creating reasons. One of the most common explanations is termed "managerialism hypothesis" which assumes managers choose to perform M&As to maximize their own utility regardless of the firms' and shareholders' interests (Hambrick & Cannella, 2004). The hubris hypothesis is another rationale for explaining why firms perform M&As (Roll, 1986). The hubris hypothesis assumes managers of the acquirer firm make a mistake in assessing the value of the acquired firm but they choose to proceed with the deal, assuming the value is correct (Hambrick & Cannella, 2004).

Cross-border M&As are an entry mode many firms choose to enter a foreign market (Brouthers & Brouthers, 2000). Entry modes range from non-equity-based (e.g. export, licensing) to equity-based entry modes (e.g joint venture, acquisition, greenfield). Greenfield investments allow for a high level of control of resources, knowledge and also revenue, but simultaneously are likely to have high costs (Brouthers & Brouthers, 2000). Greenfield costs may emerge from building onsite facilities and developing formal and informal networks with suppliers, government and distributors (Harzing, 2002). Firms may choose to avoid greenfield costs by performing M&A operations and thus quickly gain access to knowledge, markets, technology and so forth (Harzing, 2002) while maintaining a high level of control – although marginally lower that greenfield ventures.

Firms which opt to perform M&As to enter a foreign market are influenced by factors at various levels, specifically firm level, industry level and country level. As for firm-level factors, scholars have identified determinants such as multinational and local experience (Harzing, 2002), product diversification (Brouthers & Brouthers, 2000) and relative investment size (Kogut & Singh, 1988). The results of empirical research are ambiguous since some firm-level determinants have both negative and positive effects on the choice of M&As. For instance, multinational experience is found to favor greenfield ventures (Brouthers & Brouthers, 2000) over M&As, whereas other studies find many determinants irrelevant (Kogut & Singh, 1988). Industry-level determinants such as advertising intensity, sales force intensity and technological intensity are considered to influence firms' decision to undertake M&A operations (Brouthers & Brouthers, 2000). Country-level determinants of M&As include cultural issues, specifically cultural differences and cultural traits, and market growth. Scholars have concluded that low home-host cultural distance increases the likelihood of performing M&A operations (Kogut & Singh, 1988), much in the same manner as low uncertainty avoidance in the home country (Kogut & Singh, 1988).

Firms doing business abroad face a myriad of difficulties which lead to cost (Berry, Guillen & Zhou, 2010). In fact, distance is paramount when analyzing the costs of doing business abroad. Greater geographical distance translates into increasing costs of managing a global value chain (Ghemawat, 2001). However geographical distance is not the only explanation for costs of doing business abroad. International business scholars delve into differences in culture, administrative and regulative development and economy (Berry et al., 2010; Ghemawat, 2001) which hinder firms operations abroad by increasing the costs. Institutional conditions are also different from country to country and are also delved into (Kostova, 1999). Such relative differences between countries may be posited as proxies for distance. Thus, the distance between two countries is more than just the geographical distance and all the distances should be taken into account to understand the costs firms face in a foreign market (Berry et al., 2010).

In sum, firms may undertake M&A operations to create value, by augmenting the market power or by creating synergies. Firms often undertake M&A operations to explore resources or to exploit the capabilities they already hold (Phene, Tallman, & Almeida, 2012) thus creating value. To understand why firms perform cross border M&As is especially important to look at firm-, industry- and country-level determinants which influence firms' choice of entry mode in a foreign market (Brouthers & Brouthers, 2000). Finally, it is particularly important to assess the relative differences between home and target countries to ascertain the distance and the costs associated with the distance.

<u>Institutional environment</u>

The institutional environment is often described as the set of rules and norms that allow for actors to perform in a given society (North, 1990). Therefore, institutions influence not only the individuals but also the firms through managerial decisions, consumers' choices (Humphreys, 2010) and the resources' availability (Hitt, Ahlstorm, Dacin, Levitas, & Svobodina, 2004). Institutions play a vital role for firms, especially MNEs, since without the "rules of the game" firms would have to deal with numerous contracts and deals would arguably be circumscribed to parties within the same country (Souva, Smith, & Rowan, 2008). Therefore institutions reduce the costs of business transactions, both outside and within firm boundaries (Williamson, 1985; North, 1990).

The institutional environment may be viewed as having three pillars: regulative institutions, normative institutions and cognitive institutions (Scott, 1995). The formal rules and regulations issued by a given state are part of the regulative institutions (North, 1990). The normative institutions, on the other hand, are all the social obligations, the social roles and the expected behaviours in a given country (Scott, 1995). The third pillar are the cognitive institutions which are closely related to a society's culture and comprehend the beliefs and value system of a people (DiMaggio & Powell, 1983). Firms which operate abroad, especially MNEs, have to face significant differences between home- and host-countries' institutions. The differences or similarities in the institutions are often posited as distances (Kostova, 1999) and may be different for each of the institutional pillars (Kostova, Roth & Dacin, 2008).

M&A operations are not only influenced by industry- and firm-level determinants but also by country-level determinants such as the institutional constraints firms face (Rodriguez, Uhlenbruck & Eden, 2005). Firms have to compete with other firms but the context in which they compete is the institutional environment. In fact, institutions are relevant especially because their effect is often difficult to perceive, as Scott observes: "it is difficult if not impossible to discern the effects of institutions on social structures and behaviors if all our cases are embedded in the same or very similar ones" (Scott, 1995: 146). However the institutional environment is often neglected by scholars (Dikova & Witteloostuijn, 2007) as they focus especially on developed countries.

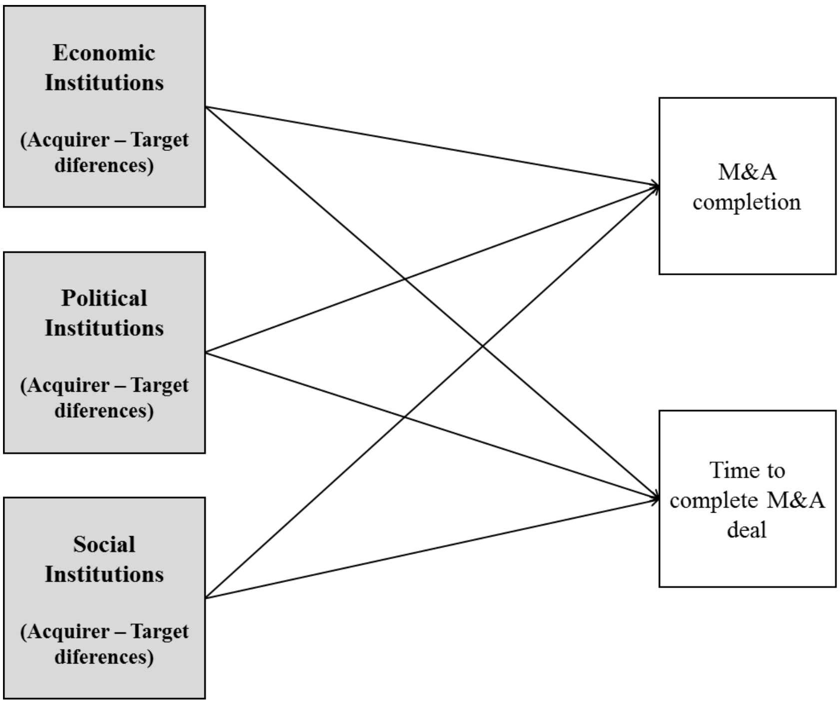
Institutional based perspectives have been use especially when delving into emerging economies (Berry et al., 2010). Emerging economies have gone through profound institutional transformation and the emerging markets' institutions arguably remain distinct from developed markets' institutions (Wan, 2005) thus creating interesting research settings. For instance, institutional differences have been found to influence firms' partner alliance selection in Russia and China (Hitt et al., 2004) since the stability of China's institutional environment favors long term partnerships focused on the partners' intangible assets and specific capabilities, whereas in Russia firms select their partners using a short term perspective and preferentially seeking access to financial resources (Hitt et al., 2004).

Scholars delving into mergers and acquisitions do not extensively use an institutional approach (Dikova & Witteloostuijn, 2007) although there are some examples in the extant literature. Using the distinction between formal and informal institutions, Dikova and collegues have found that the institutional differences have an effect in the likelihood of completion of an announced deal (Dikova et al., 2010). The institutional environment has also been found to influence M&As in other ways, such as regulatory changes which may hinder or lead to new waves of M&A deals (Muehlfeld et al., 2011). The institutional approach to M&As still warrants additional research as the M&A phenomenon is not yet fully understood (Kostova et al., 2008).

CONCEPTUAL FRAMEWORK

We seek to delve into the role of institutional environment, specifically the role of institutional distance, in the completion of M&A deals. We put forward a framework (Figure 1) that depicts the proposed influence of three dimensions of the institutional environment: the economic institutions, the political institutions and the social institutions. We aim at understanding two specific effects: (1) whether the M&A deal is completed once announced; (2) the duration of the period from announcement of the deal to conclusion of the deal. We posit the effect of institutional distance at three different levels – economic, political and social. Below we elaborate on the hypotheses and support our arguments.

Figure 1. Conceptual framework



Source: Authors

When firms decide to invest abroad the face uncertainties which lead to costs (Berry et al., 2010). Some scholars posit firms face fewer uncertainties by accumulating experience and knowledge over time thus being able to reducing costs (Johanson & Vahlne, 1977). Institutional approach suggests firms operating abroad may only survive if they gain legitimacy by incorporating formal and informal local institutions in their structures and behaviors (Meyer & Rowan, 1977). Therefore firms which incorporate local institutions adapt to the local context and may build a competitive advantage. However adapting to local institutions may be costly and firms which operate in more distant institutional countries have to cope with more problems (Dikova et al., 2010).

In this study we follow the classification used by Chan, Isobe and Makino (2008) and we propose the impact of institutional distance at three different levels: economic institutions, political institutions and social institutions. These three dimensions are adequate to delve into cross-border M&As since the economic, political and social institutions directly influence the effectiveness of international operations (Chan et al., 2008; North, 1990). Firms must address the differences in the institutional environment to survive and create value for their shareholders, as Chan and colleagues advance: "In sum, economic, political, and social institutions form the institutional environment within which firms carry out their business activities and from which they gain a return on their investments" (Chan et al., 2008: 1182).

<u>Economic distance</u>

Economic institutions determine the constraints and the incentives for economic activity (North, 1990) and include market intermediaries which reduce transaction costs in markets for products, capitals and financial services (Chan et al., 2008; Khanna & Rivkin, 2001). Economic institutions also account for the infrastructure of economic activities, such as physical infrastructures, human infrastructures and technological infrastructures which generate efficiency thus reducing transaction costs (Khanna & Rivkin, 2001).

Economic distance seeks to describe the differences in economic institutions. Firms have to cope with the differences in the economic environment between home and target country as institutions reduce transaction costs and the costs of obtaining information relevant to economic activity (Khanna & Rivkin, 2001). Similar economic institutions in home and target countries would decrease uncertainty and allow for deals to be completed, much in the same way that similar economic institutions in home and host countries have a positive influence in the performance of a firm (Bevan, Estrin & Meyer, 2004). Therefore we posit:

Proposition 1: A greater difference between acquirer and target nations' economic institutions reduces the likelihood of completing an announced M&A deal.

Firms seeking to undertake an M&A operation in a country economically distant, i.e., when home and target countries are more dissimilar, must face a higher degree of costs which hinder the profitability of the operation. Also to adapt to the local economic environment firms must develop capabilities and knowledge which may be a long and costly process. Thus, we advance:

Proposition 2: A greater difference between acquirer and target nations' economic institutions lengthens the period from announcement to completion/withdrawal of the M&A deal.

Political distance

Political institutions are relevant as they determine issues such as tax rates, regulations, restrictions to foreign trade and investment and government protection on private property and intellectual property (Chan et al., 2008). Therefore, political institutions include governments at all levels (national, state and local) and also the constraints to politicians' and political parties' actions. Policies issued and followed by political institutions may hinder or promote the international operations of firms, especially the host country policies (Henisz & Zelner, 2005). Governments may seek to attract foreign investment thus favoring international operations or governments may opt to protect local firms thus hindering cross-border operations (Chan et al., 2008). Political institutions must also be taken into account because they enforce the rule of law (Rodriguez et al., 2005) which affects international operations, for instance protecting intellectual property rights and enforcing the fulfilment of contracts (Rodriguez et al., 2005) which may deter firms from operating competitively in a given country (North, 1990). Control of corruption is also a key concern when assessing political institutions as corruption leads firms to squander resources in an unproductive manner (Chan et al., 2008).

The differences in political institutions, i.e., political distance also leads to uncertainty and costs (Berry et al., 2010). Differences in the policies and regulations between home and target country means firms must adapt to different political institutions and gain legitimacy to operate in a new country (Meyer & Rowan, 1977). When performing M&A deals it is easier for acquirers to adapt to target country's political institutions if they are similar to the political institutions of the home country (Kostova & Zaheer, 1999). For instance, differences in the legal system of home and target countries – civil law versus common law – may cause acquirer firms to withdraw the M&A deal (Dikova et al., 2010). Also the pressure to conform to unknown political institutions in the host country may be an obstacle to the completion of the deal. Thus we propose:

Proposition 3: A greater difference between acquirer and target nations' political distance reduces the likelihood of completing an announced M&A deal.

Substantial differences in the political institutions, i.e., a greater political distance may also lead to a lengthy process of adaptation to target country's political institutions. M&A deals are usually complex transactions and when coping with politically distant target countries the complexity of the deal is increased (Dikova et al., 2010). On the other hand acquirer firms from politically distant countries arguably have to cope with asymmetric information and therefore may hinder the quick completion of a deal. We propose:

Proposition 4: A greater difference between acquirer and target nations' political distance lengthens the period from announcement to completion/withdrawal of the M&A deal.

<u>Social distance</u>

Social institutions are constructed by the population of a given country in the extensive interaction over time by developing practices which are repeated and perpetuated (Scott, 1995). National culture, language, religion and value system are some of the social institutions that every society constructs throughout its History. Social institutions constrain the behavior of individuals and firms and determine the acceptable behavior in a given society to which members should comply (Chan et al., 2008). Social institutions influence attitudes towards democracy, work and trust, and also influence management dynamics and work ethics (Chan et al., 2008). Therefore social institutions influence the costs of doing business in a given country and are especially relevant for firms operating abroad, as feeble social institutions lead to social conflict and thus hindering international operations' revenue (Ghemawat, 2001).

Delving into the differences in social institutions – which we termed social distance – is paramount to assess if an M&A deal is completed. When negotiating a cross-border M&A parties have to cope with different languages which may cause to inaccurate or ambiguous language in the acquisition agreement and lead to disagreements and hinder the deal completion (Dikova et al., 2010). On the other hand, social distance may also be relevant to building a trustful relation with managers of the target firm as they are an important source for collecting reliable information on the target firm. When it is not possible to develop a trustworthy relation with target firm's managers M&A deals arguably fail (Very & Schweiger, 2001). Firms undertaking cross-border M&A often have to cope with socially distant target arguably leading to problems which may prove too difficult to manage and thus forcing the acquirer to withdraw the deal (Jemison & Sitkin, 1986). Thus, in the proposition form:

Proposition 5: A greater difference between acquirer and target nations' social institutions reduces the likelihood of completing an announced M&A deal.

Social distance may also influence the time it takes to complete a deal. Differences in the language may render negotiations more difficult and thus increasing the time needed to complete the deal (Dikova et al., 2010). Differences in the attitude towards business may lengthen the duration of the pre-completion phase of the M&A deal because more aggressive negotiators arguably will have to adapt to less aggressive counterparts and vice-versa. Also M&A deals between firms from socially distant countries arguably have to be renegotiated more often than deals between firms from socially near countries. Therefore we propose:

Proposition 6: A greater difference between acquirer and target nations' social institutions lengthens the period from announcement to completion/withdrawal of the M&A deal.

DISCUSSION AND CONCLUDING REMARKS

In this paper we sought to put forward a framework for understanding the institutional factors which influence M&A completion. The completion phase of an M&A deal is still an issue under-researched and it calls for scholars' attention (Zhang et al., 2011). We used an institutional approach as it is paramount to understand the context in which M&A operations are performed to grasp the determinants of a completed deal and what leads to a lengthy and costly pre-completion phase of the M&A. We contribute to the extant literature on M&A by discussing the effect of institutional environment on the phenomenon and we go on further to use the institutional approach to delve into an under-researched gap in the literature. From a managerial perspective, we contribute to the wealth of knowledge on M&A deals and we especially focus on the factors which cause deals not to be completed and to have long processes before the completion or withdrawal. Thus we contribute to a better understanding of the M&A phenomenon and provide managers a framework to augment the effectiveness and efficiency when performing an M&A.

Institutions are arguably useful for firms performing M&A deals as they reduce the costs of doing business abroad (Bevan et al., 2004). Institutions arguably offer information on target and acquirer, their likely behavior and thus reduces information asymmetries. By reducing information asymmetries institutions lower the risks and costs of doing business abroad (Brouthers & Brouthers, 2000). Acquirer firms analyze the institutional environment of the target firm's nation to ascertain the relative differences in the institutions and the impact they may have in the M&A deal.

Our study focuses on the differences between home and target countries moving beyond the traditional approach which focus on the level of development of institutions (e.g. Chan et al., 2008). Observing the differences in the various aspects of the institutional environment arguably provides a better understanding of firms' actions, specifically in the context of an M&A deal. Firms from countries with a high development of the institutional environment arguably has more successful international operations (Chan et al., 2008). However we argue that firms from countries with a high development of the institutional environment will face difficulties when performing an M&A deal in a target country with low institutional development. The rationale supporting our argument is that the differences in institutions lead to uncertainty, need to adapt and costs when performing an M&A deal (Dikova et al., 2010). Therefore an acquirer from a country with low institutional development when targeting a firm from a country with a low development of the institutional environment is arguably less likely to withdraw the deal than an acquirer from a country with high institutional development pursuing the same target.

Firms which undertake cross-border M&A deals in institutionally distant countries are more likely to abandon the deal. Our conceptual model dissects institutional distance at three different levels – economic, political and social – and we propose a negative relation between institutional distance and likelihood of a deal to be completed. In an empirical study, Dikova and colleagues (2010) have concluded that firms undertaking M&A deals in institutionally more distant countries are more likely to withdraw the deal. The authors delved into the moderating role of experience and found experience to be relevant only in less institutionally distant countries, since in more institutionally distant countries the experience is not useful in coping with the problems which may emerge.

Institutional distance also influences the time it takes an M&A deal to come to an end – either to be successfully completed or abandoned. Acquiring firms which have to deal with differences in economic, political and social institutions to which firms arguably have to adapt in a long and costly process thus lengthening the pre-completion phase. A long period between the announcement of the deal and its end (either successful or unsuccessful) increases the opportunity costs for acquirer firms as their managers' attention is focused on the M&A deal (Muehlfeld, Rao Sahib & Witteloostuijn, 2012). Therefore to avoid incurring in such costs acquirer firms arguably avoid announcing a deal which may lead to high costs (Muehlfeld, et al., 2012). However, a considerable number of announced deals does not come through, suggesting acquirer firms are not effective in assessing costs and benefits before announcing the deal (Zhang et al., 2011).

Future research may include operationalizing the conceptual framework to adapt it into an empirically testable model. Testing an empirical model arguably leads to a deeper understanding and a deeper analysis while confirming or refuting the validity of the model. Our conceptual model delves into the period from announcement of the deal to its – successful or unsuccessful – conclusion. On a future research perspective it would be interesting to analyze the private stage of M&A deals, i.e., the process of the M&A deal before it is announced Future research may also focus on countries with at a particular stage of economic development, for instance developed economies or emerging markets. Finally our framework may be expanded to include other theoretical perspectives – e.g. Resource-Based View or Transaction Costs Theory – to allow for a more accurate understanding of the pre-completion phase of an M&A deal.

A favorable institutional environment is arguably important for foreign firms to enter a given country. Firms seeking to enter a market via cross-border M&As assess the quality of the institutions and especially the similarity of institutions. Firms seek to reduce the costs of doing business abroad by undertaking operations in countries which are less institutionally distant which also arguably reduces the likelihood of M&A deal abandonment.

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