

# Unrelated acquisitions in China: The role of political ownership and political connections

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**Abstract** In this paper, we examine government influence on the acquisition behavior of Chinese firms. Drawing from the state capitalism literature, we test hypotheses regarding the effect of provincial government ownership and managerial ties respectively on industry relatedness of firm acquisitions. We furthermore test hypotheses concerning the moderating effect of institutional development and governor age and tenure. We test our hypotheses based on analysis of 346 majority acquisition deals completed by first-time acquirers in China between 2002 and 2014. Our results show that provincial government-owned firms and firms with ties to the same are more likely to conduct unrelated acquisitions within their home province compared to acquisitions across provincial boundaries. Similar patterns do not exist for privately owned firms or for firms with no managerial ties to provincial governments. Institutional development and governor age and tenure are found to have no moderating effects. We relate our findings to the main theoretical views of state capitalism and suggest that our results reflect government attempts to promote economic growth and social development. Our study contributes to the understanding of Chinese state capitalism and the cross-province barriers for business in China.

**Keywords** Diversification · Acquisitions · Strategy · Political connections · China

How government influences firm strategic behavior in countries with state capitalist economic systems is an important question which recently has received growing

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attention in the literature (Bai, Lu, & Tao, 2006; Cui & Jiang, 2012; Li, Cui, & Lu, 2014; Lin, 2011; Peng, Tan, & Tong, 2004; Tan, 2002). Our study is motivated by this question. We are however not only interested in the question *how* government influences firm strategic behavior but also *why* it influences. We focus our analysis on the impact of provincial government on firm acquisitions in China. The defining characteristic of the acquisitions we study is the degree of relatedness between industries in which the acquiring and target firms operate. We compare acquisitions conducted in home provinces of acquiring firms with acquisitions outside of home provinces, because it allows us to capture the effect of provincial governments on acquisition behavior. We hypothesize that provincial governments, through ownership or political ties, influence firms towards more unrelated acquisitions. That influence will, however, only be visible in the acquisitions made within the jurisdiction of the provincial governments.

Identifying government influence on acquisitions is a step towards answering the question *how* government influences firm strategic behavior. As for the *why* question, we propose that this influence could occur for two main reasons. The motives can either be personal, with top government officials trying to boost their political careers or secure illicit streams of income (rent-seeking), or the influence may be motivated by the attempts to reach social or economic development goals in the province. Our research design allows us to investigate which of these two possible motives dominate.

Our results show that firms owned by provincial governments (henceforth SOELGs) are more likely to conduct unrelated acquisitions in their home provinces than in other provinces. In contrast, privately owned firms (POEs) do not exhibit such a pattern: There is no difference in the degree of industrial relatedness between acquisitions made in home or cross-province by POEs. We find a similar pattern in regard to managerial ties to provincial government, with firms with ties exhibiting differences between home and cross-province acquisitions compared to firms without such ties. We also find that the intensity of provincial government influence on firm acquisition behavior does not vary with level of provincial institutional development. And finally, we find that the specific career stages of provincial governors do not affect the acquisition behavior of firms in their jurisdiction. We explain these findings as the result of provincial governments' influence on firms, and we further use the results to argue that the motivation for this is to achieve economic and social goals. Our results also allow us to rule out a competing theoretical explanation, namely that unrelated acquisitions are a result of poor corporate governance, and subsequent opportunistic behavior, of SOELG managers.

For two reasons our dataset comprises only first-time acquirers: First, the international business literature indicates that acquisitions are heavily path dependent (e.g., Collins, Holcomb, Certo, & Hitt, 2009). In a Chinese domestic context, that would make a firm that already has conducted cross-province acquisitions more likely to repeat such cross-province acquisitions, and more likely to repeat acquisitions in the specific foreign province the firm already has entered. Second, once the firm has established its presence outside its home province, the foreign provincial government may potentially gain leverage over the firm's subsidiaries, in which case the firm is subjected to pressure from more than one provincial government. Studying only first-time acquirers mitigates both these biases.

While the *general* influence of state ownership and political ties on firm acquisition growth and diversification has already been documented (see literature review below), this study is, to our knowledge, the first one to draw out the implications of it very often

being local governments that are the influencers. A recent literature review showed that there are only four papers on domestic Chinese acquisitions (Zhu & Zhu, 2016) and there are no papers on the effect of local state ownership. We show that there are patterns to firms' strategic behavior that correspond with government jurisdiction. This helps explain some inconsistencies in prior research results on state ownership and diversification (see review below). Beyond this, our study contributes to the literature on Chinese state capitalism. This body of literature has generally shown that government continues to exert great influence over the Chinese economy and Chinese firms (Musacchio, Lazzarini, & Aguilera, 2015; Naughton, 2011) and that this influence is present at different levels of government with these different levels exerting different kinds of influence (Li et al., 2014). We make a key contribution to this literature by showing that the influence takes place in order to realize social and economic objectives rather than realizing personal, political or financial goals of senior government officials. Also, our results indicate that the acquisition behavior of SOELGs are not the result of poor oversight over these firms and managerial agency problems. Combined, our results address one of the key debates within the literature on state capitalism where there are conflicting views of the motives and consequences of political influence (Musacchio et al., 2015). Our results lend credence to the state activist view within the state capitalism literature.

## Literature review: Acquisitions and diversification in China

Firm acquisition is a fundamental growth strategy, not least in a growth-driven market like China where firms seek to secure new knowledge, resources and access to new markets fast (Peng, Luo, & Sun, 1999). A recent review of the literature on Chinese mergers and acquisitions shows a diverse body of literature covering both antecedents and results of acquisition as well as various moderating factors (Zhu & Zhu, 2016). The review also indicates that political influence is a relatively strong driver of international acquisitions with policies for natural resource procurement and creation of innovation capabilities as main drivers. In the domestic context, the review shows close to zero research focusing on government influence on acquisitions. However, Zhu and Zhu (2016: 1135) stated that government has encouraged acquisitions in order to create competitive companies and promote economic growth. Lin, Peng, Yang, and Sun (2009) found evidence that political support can change network relations in firm alliances which in turn can lead to acquisitions. Li and Qian (2013) found that having politically connected CEOs reduce the ability of majority owners to resist takeovers. Chi, Sun, and Young (2011) found that acquiring firms with political support reap greater gains from acquisitions than acquiring firms without such support. Similarly, Zhou, Doukas, Hua, and Guo (2015) found that acquiring state-owned firms (SOEs) outperform acquiring non-SOEs.

Our study is, however, not concerned with the political impact on acquisition growth in general, but investigates the political impact on the degree of industrial relatedness as one specific characteristic of acquisition behavior. The literature shows that Chinese firms tend to be more diversified than non-Chinese firms (Fan, Huang, Oberholzer-Gee, Smith, & Zhao, 2008). Underdeveloped factor markets, markets for corporate control as well as market institutions in general may make conglomerate diversification worthwhile. Conglomerates can internalize various transactions thus reducing the high

transaction costs stemming from imperfect market institutions, and can more efficiently allocate scarce resources (Hoskisson, Johnson, Tihanyi, & White, 2005; Khanna & Palepu, 2000). In line with this, several studies of Chinese firms show performance benefits of unrelated diversification. Chen and Yu (2012) found benefits of both related and unrelated diversification with the latter having the largest effect. Li and Rwegasira (2008) reported a U-shaped relationship between diversification and performance so that focus strategies and unrelated diversification are associated with performance benefits. Deng, Tian, Li, and Abrar (2012) found a positive short-term effect for unrelated diversification for politically connected firms and a long-term performance effect of related diversification generally. Li and Wong (2003) found that a combination of related and unrelated diversification creates performance benefits. Lin and Su (2008) found positive performance effects of diversification but also that ownership moderates this so that the effects are smallest for SOELGs. This is, if not fully consistent, then at least aligned with Yi and Xi (2006) who, drawing on agency theory, found that SOELGs pay a performance penalty for diversification, while no significant effect is found for central government owned firms (SOECGs). Lu and Yao (2006) found that firms affiliated with state-owned business groups benefit from diversification. In contrast to these findings, Delios, Zhou, and Xu (2008) reported negative effects of diversification.

Several studies, including some of the performance studies just mentioned, show a positive relationship between state ownership and diversification as a strategy (Du, Lu, & Tao, 2015; Zhao, 2010; Zhou & Delios, 2012). Moreover, Delios et al. (2008) found that state ownership concentration increases diversification. Another study (Yi & Xi, 2006) found that concentration of state ownership and diversification exhibit a U-shaped relationship for SOELGs but not for SOECGs. In addition, Delios and Wu (2005) found an inverse U-shaped relationship between legal person shareholding (a type of shareholder generally closely connected to the state) and diversification. In contrast to this, Jiang (2008) found that state ownership concentration reduces propensity for diversification. In parallel to the studies of state ownership, several studies have shown a positive relationship between firms with political connections and diversification (Deng et al., 2012; Jing, 2011; Li, He, Lan, & Yiu, 2012; Zhang, Su, Sun, Zhang, & Shen, 2015). Hu and Shi (2009) found that political connections are associated only with unrelated diversification.

We conclude this literature review by noting, first, that while there is little research on the impact of government on acquisitions, there is a sizable body of literature on the impact of government on the degree of diversification, most of which shows that government ownership is related to a high degree of diversification. Second, there are differences between the effects of local and central state ownership (Lin & Su, 2008; Yi & Xi, 2006), which, however, are not explained by existing research. Third, there are conflicting results with regard to performance effects, which leads to some unresolved theoretical issues. The studies that are based on the resource-based view and social capital theory suggest that SOEs and firms with political connections can use their government relationships to gain access to restricted industries and to acquisition opportunities. These theories also suggest that political capital is a resource that firms can and do exploit across unrelated industries, and that SOEs often have excess financial resources, which may be an incentive to diversify. The general thrust of these approaches to diversification is inherently firm-centric, assuming strategic agency of firms implying that firms strategically exploit political ties and other resources. The other

common approach taken in the reviewed literature attributes agency to government, not firms. The predominant theory used in the second approach is principal-principal agency theory. The assumption is that the state is using its concentrated ownership to influence firm strategy in order to transfer assets from the firm, thus expropriating minority owners.

The significant shortcoming of a firm-centric perspective is that while it is well equipped for explaining the effect of political ties, it struggles to explain the effects of government ownership on diversification, and also the performance effects of such diversification. The government-centric perspective is well equipped for explaining the effect of government ownership, especially its concentration, but struggles to explain the effect of political ties. Agency theory, which is the prominent government-centric approach, has at least one other shortcoming: The core proposition of agency theory is that a high concentration of ownership, state or otherwise, raises the risk of majority owners engaging in diversification with the aim of expropriating minority owners (Delios & Wu, 2005; Yi & Xi, 2006; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008), or in other ways conducting asset stripping with the aim of self-enrichment (Johnson, Boone, Breach, & Friedman, 2000a; Johnson, Porta, Lopez-de-Silanes, & Shleifer, 2000b; Lin & Su, 2008). However, interference by government owners may well be motivated by factors other than opportunism. As mentioned by some scholars applying agency theory to Chinese management, transfers of assets or resources instigated by government owners may be based on political or social motives rather than be due to opportunistic self-enrichment (Chen, Li, & Shapiro, 2011; Wang & Ye, 2014). On this basis, we suggest that agency theory is correct in emphasizing government agency but poorly equipped for grasping non-opportunistic motives. In the theory section below, we, therefore, seek alternative explanations.

## Theoretical background and hypotheses

Our theoretical alternative is drawn from two closely related theoretical views of government influence found in the literature on state capitalism (for a detailed review, see Musacchio et al., 2015). One of the views, the “state activist view” (also referred to as the “social view”) sees unrelated acquisitions as a result of the Chinese government influencing firms with the aim of creating positive externalities. Thus, the ultimate goals are socio-economic, for example, welfare provision or economic growth (Lee & Jin, 2009; Lu & Yao, 2006; Seo, Lee, & Wang, 2010; Zhao, 2010; Zhou & Delios, 2012). Another view also found in the state capitalism literature is the “political view.” The premise is the same as for state activism: The government intervenes, but while the state activist view sees intervention to be motivated by development goals, the political view sees the intervention to be grounded in personal goals of senior political officials, be they financial or political (Musacchio et al., 2015).

According to the state activist view, there are several ways in which unrelated acquisitions can help achieve such social or economic perspectives. For example, unrelated acquisitions will lead to the formation of business groups that can function as “catch-up devices” for economic growth and technological development (Keister, 1998; Lee & Jin, 2009). Another motive behind unrelated acquisitions may be to provide jobs and services (or improve their quality) for employees and the population

in general. Zhou and Delios (2012: 779) argued that SOEs are expected to act as “mini societies” that provide its employees with welfare services. Such welfare provision can be generated, for example, by diversifying into service industries (Ma & Lu, 2005). The government may also use unrelated acquisitions to disseminate best practices, for example by urging SOEs (and other firms under government influence) that have proved able to comply with environmental standards or create good working conditions for its labor force to acquire other firms, also in unrelated industries, that have compliance problems (Naughton, 2011). Yet another motive may be that government seeks to stave off unemployment problems by getting financially sound firms to acquire financially struggling firms, again often in unrelated industries (Lu & Yao, 2006; Zhao, 2010; Zhou & Delios, 2012).

The political view holds political intervention to be ultimately motivated by the self-interests of government officials. Such self-interests may be either political, financial or both. Applied to the context of acquisitions, senior government officials may, for example, seek to enrich themselves or their family members by having SOEs acquire family-owned firms at inflated prices. Or, as an example of political self-interests, they may influence the same SOEs into acquiring the firms controlled or owned by potential allies in attempts to secure political support or alliances (Lin & Milhaupt, 2013; Yi & Xi, 2006).

Both views are government-centric. The political view assumes opportunistic behavior of political officials and is thus aligned with agency theory, but the inclusion of a state activist view means that any intervention may have more altruistic motivations. Combined, the core proposition of the two views is that government actively uses its influence over firms (through ownership but also through informal means) to achieve various objectives, political, economic, social, or personal.

We have provided some examples of how and why governments intervene but we do not hold this to be an exhaustive list. Three things follow from this core proposition. First, while this view is government-centric, it may be expanded to apply also to managerial political ties. Indeed, two of the studies reviewed above do exactly that (Deng et al., 2012; Du et al., 2015). Both studies argue that because such social ties are reciprocal, a firm with political connections will be expected to return political favors gained from such connections. Such reciprocity may well be a “social burden” (Deng et al., 2012: 475) for firms. Second, the core proposition can be combined with the most frequent and general explanation for why emerging market firms diversify, namely to mitigate institutional voids. Institutional voids should increase the incentives for government to seek social and economic development through state activism. The same voids may also increase the risk of government officials acting opportunistically due to lack of regulation and transparency. Also, lack of transparency and regulation would make intervention more feasible or less risky.

Third, and most important for our study, for SOELGs, the impact of government intervention should be geographically delineated. SOELGs operate under the discretion of the provincial governments, who focus solely on the economic growth and improvement of social indicators *within* their jurisdiction, not beyond it, as they are involved in a yardstick competition for growth with other provincial governments (Jing & McDermott, 2013; Liu, Song, & Tao, 2006). Therefore, SOELGs will be subjects to (provincial) government influence only within their home provinces. In contrast to SOELGs, POEs are subject to less political influence, hence, acquisition behavior of



POEs should exhibit a much weaker, if any, variance in acquisition relatedness across provincial boundaries. Based on this we formulate the following hypothesis:

**Hypothesis 1** Chinese SOELGs exhibit a higher propensity for unrelated acquisitions within their home province than outside, a tendency that is stronger than for POEs.

Hypothesis 1 is concerned with the effect of ownership based on the proposition that governments use ownership to exert influence over firms' strategic actions. Research on political connections suggests that political influence also can happen through social ties (Dillard, Rigsby, & Goodman, 2004; Zhou & Delios, 2012). Research on political connections in China (social, or *guanxi*, ties to political stakeholders) has discussed the positive and negative consequences for firms that have such connections. One negative consequence is that the norms of reciprocity embedded in such ties often put firms under the obligation to comply with the wishes of the political stakeholders (Luo, Huang, & Wang, 2012). Thus, government may use not only ownership, but also network ties to influence firms' strategies. According to the basic proposition regarding government intervention outlined above, such influence may lead to unrelated acquisitions in an effort to achieve various political, economic, social, or personal goals.

However, political connections may also be resources that enable firms to conduct unrelated acquisitions. Through political connections, firms can gain resources and opportunities, for example, permissions, licenses, contracts or information, which can make it possible or lucrative to make unrelated acquisitions (Du et al., 2015). Along these lines, there are two different reasons why firms with political connections may engage in more unrelated acquisitions, with the first (government-centric) focusing on government influence due to the reciprocal nature of firm-government relationships, and the second (firm-centric) focusing on firm exploitation of resources accessed through government connections.

As outlined in relation to Hypothesis 1, provincial governments will tend to have a politically motivated interest in unrelated acquisitions only in their own province. Equally, provincial governments can only be expected to offer firms to whom they have ties access and other opportunities to engage in unrelated diversification in their own province. Any coercion or incentive to make unrelated acquisitions through provincial government ties would, therefore, be province-related. Thus, we can formulate the following hypothesis:

**Hypothesis 2** Chinese firms with managerial connections to provincial government exhibit a higher propensity for unrelated acquisitions within their home province than outside, a tendency that is stronger than for firms without such political connections.

If a government uses diversification as a catch-up device, the degree of governmental pressure on firms to achieve economic and political objectives may be expected to depend on the degree of catching-up needed, that is, the level of provincial development. This corresponds with a third view found in the state capitalism literature that, taking an institutional approach (Peng, 2002), sees state influence and ownership as a response to institutional voids (Musacchio et al., 2015). We expect government influence to be more intensive in provinces with lower institutional development. This can be because less-developed provinces have a greater need for development, or because rent-seeking is more

likely to go unseen if institutions are underdeveloped, or because state influence generally carries fewer negative consequences if market institutions are underdeveloped. In any case, the less developed the province, the more inclined the government is to pressure firms into unrelated acquisitions. We expect the effect of the level of institutional development to be most visible in acquisitions made by firms under provincial government influence. Such influence could be exerted through ownership or through social ties. Provincial government would, on the other hand, have difficulties exerting influence over POEs. On this basis we formulate the following hypothesis:

**Hypothesis 3** The higher propensity exhibited by SOELGs, and by firms with provincial government connections, to conduct unrelated acquisitions in their home provinces compared to outside is enhanced when the level of institutional development in their home provinces is relatively low.

Our discussion of the political influence on strategic behavior has balanced a social (state activist) and political view. If political interventions are driven by self-interests and rent-seeking of government officials as prescribed by the political view, then it would, primarily, be the self-interests of a political elite that has the requisite power to both wield influence and be insulated from possible recriminations or sanctions. In terms of wielding influence over firms in a given province, that would mean the most senior officials in the provincial government, especially the governor (Li & Zhou, 2005). Furthermore, we would expect to see specific stages of governors' careers where the incentive for opportunistic behavior and rent-seeking would be greater and/or where the need to establish political alliances would be greater. Because the political view encompasses both alliance motives and rent-seeking motives, these stages may differ. Specifically, we would expect that provincial government senior officials, at the beginning of their terms, would be more inclined to influence firm-strategic behavior in order to promote or ensure their own political positions in their provinces while we would expect the same officials to be more inclined to influence firms in order to seek rents in purely financial terms at the end of their political careers. In line with the hypothesis above, we would expect any such influence to happen either through ownership or through managerial connections. Focusing on governors, who occupy the top decision-making positions in the provinces, we thus formulate the following two hypotheses:

**Hypothesis 4a** Any propensity for unrelated acquisitions in home provinces compared to cross-province exhibited by SOELGs or firms with provincial government connections is enhanced the earlier the provincial governor is in her/his tenure.

**Hypothesis 4b** Any propensity for unrelated acquisitions in home provinces compared to cross-province exhibited by SOELGs or firms with provincial government connections is enhanced if the provincial governor is approaching retirement age.

## Methods

To test our hypotheses we selected a sample of manufacturing firms listed on the Shanghai and Shenzhen Stock Exchanges with ultimate Chinese ownership. We



restricted the industries, because the natural resources, real estate and finance sectors are subject to significant state intervention (Chen, Sun, Tang & Wu, 2011a). We drew data on firm acquisitions conducted between 2002 and 2014 from the ZEPHYR database produced by Bureau van Dijk. The information on acquiring firms was drawn from the China Stock Market & Accounting Research (CSMAR) database produced jointly by GTA Information Technology Co. Ltd. and the China Accounting and Finance Research Center.

We applied several restrictions to the deal characteristics. First, we only included acquisition deals transferring (majority) ownership rights of over 51%. Second, only firms conducting their first domestic acquisition were included. We did so to exclude path-dependent acquisitions. However, if a firm conducted multiple acquisitions in the *same* calendar year, then all deals within that given year were included. The reason for this is that acquisition growth is a highly premeditated decision. We did not find grounds to choose one acquisition over another within the same calendar year given that the decision process can span several years. On that account, the final sample consists of 346 acquisition deals.

### Dependent variable

Our dependent variable *acquisition relatedness* is derived from Wang and Zajac's (2007) firm diversification measure. Specifically, a firm acquisition was coded "1" when the first digit of the target firm's four-digit SIC (Standard Industry Classification) code was (1) different from that of the acquiring firm and (2) this difference fell outside the 20–39 scope of the SIC codes that denote manufacturing industry. The code "1" thus represents unrelated diversification of an acquiring firm. Next, ".75" was assigned to cases when the first digits of the acquiring and the target firms' SIC codes were either 2 or 3; ".5" was assigned in cases where the first two digits of the two firms' SIC codes were identical; and ".25" was assigned when three digits were identical. Finally, "0" was given to a deal where four digits in the SIC codes of the acquiring and the target firms were identical, representing related diversification. Our sample comprises 121 unrelated diversification deals ("1") and 105 related diversification deals ("0"), with the remaining 120 deals being "somewhat related/unrelated" between ".75" and ".25." In the analysis, we use a recoded version of the dependent variable, where "1" is related acquisition deals, "2" is "somewhat related/unrelated" deals and "3" is unrelated acquisition deals. Alternative measurements of the dependent variable have been tested as robustness checks.

### Independent variables

*Target location* is an independent variable coded "1" when the acquiring and the target firms are located in different provinces (or an acquisition deal is cross-province) and "0" when both firms are located in the same province (or the deal is within-province). Just under one-half of the acquisition deals in the sample are cross-province. In our study, we focus on two *firm ownership* types—POE and SOELG. *Firm ownership* is

based on information on the actual owner provided by the CSMAR. The actual owner is defined as the one having the highest proportion of firm shares among all owners. In addition to the proportion of shares owned by the actual owner, CSMAR offers a comprehensive list of 65 actual owner codes covering a variety of ownership types from Ministry of Finance to labor union, which we regrouped in order to obtain two ownership types. The *ownership type* variable was coded “0” if a firm is SOELG and “1” if it is POE. The distribution of *acquisition relatedness* deals across the firms of the two ownership types is presented in Table 1.

In line with prior studies, *local political connections* of managers were identified based on the biographical information of the firms’ chairperson provided in annual reports of the sampled firms, specifically, whether she or he was or is an official in a provincial government (e.g., Arnoldi & Villadsen, 2015). The *level of market development* in the province of an acquiring firm is measured by the Marketization Index of Chinese provinces compiled by the National Economic Research Institute (Fan, Wang, & Zhu, 2011). The higher the values in the index, the higher the level of provincial development. The values are available for 1997 to 2009 so to obtain the values for the whole period, we used a damped-trend exponential smoothing (Gardner, 2006). This variable is included with a one-year lag. Finally, information on the *tenure* of the provincial governor and *governor age* was collected from publicly available sources. Similar measures have been used in other studies involving provincial governors (e.g., Li & Zhou, 2005). *Tenure* was measured as the number of years an individual occupied a governor position in a focal province, while *governor age* was proxied by a dummy variable coded “1” if an individual was 60 years or older, and “0” if she or he was younger than 60. Finally, in order to test Hypotheses 3, 4a and 4b, we constructed a variable, *locally controlled firm*, which comprises all firms that are SOELG and/or have connections to provincial government.

## Control variables

We included several variables to control for the alternative drivers of acquisition relatedness. *Firm performance* was measured as return on assets (ROA) one year before a focal acquisition may increase the chance of related diversification

**Table 1** Acquisition relatedness by firm ownership type

Acquisition relatedness	Firm ownership	
	POE	SOELG
Related	69	36
Somewhat related/unrelated	99	21
Unrelated	87	34
Total number of deals	255	91

(Chen & Yu, 2012; Park, 2002). Organizational *slack*, calculated as a one year lagged logarithm-transformed ratio of current assets to current liabilities, may increase risk acceptance leading to unrelated growth (Chatterjee & Wernerfelt, 1991; Daniel, Lohrke, & Fornaciari, 2004; Park, 2002). Firms connected to a business group coordinate their investment decisions, benefitting from access to internal markets (Keister, 1998). Hence, *business group affiliation* may increase a firm's propensity for unrelated diversification. Following Wang, Yi, Kafourous, and Yan (2015) we define *business group affiliation* as follows: a firm's ultimate owner must control, partly or wholly, at least five other firms in a year preceding a focal acquisition, and the assets of the ultimate owner must exceed RMB 100 million. Data on the shareholding structure of the firm's ultimate owner were extracted from Bureau van Dijk's ORBIS database. The proportion of business group affiliated firms in our sample is 32%. This database is rarely used in China business studies. However, our proportion of business group affiliated firms is consistent with He, Mao, Rui, and Zha's (2013) study reporting just under one-third of listed firms are affiliated with business groups. *Firm age* is likely to be positively related to unrelated acquisitions because young firms have fewer resources and less experience (Bernardo & Chowdhry, 2002). In contrast to this *firm size* may relate negatively to unrelated diversification, because large firms tend to have inflexible decision-making mechanisms inhibiting organizational change, such as changes brought in by unrelated acquisitions (Park, 2002). *Firm size* is the one year lagged logarithm-transformed number of employees. We expect a negative impact of *ownership concentration* on a firm's unrelated growth (Amihud & Lev, 1999). Unobserved industry effects are controlled for by including two-digit SIC codes of acquiring firms (Goranova, Alessandri, Brandes, & Dharwadkar, 2007). In our sample we have 13 manufacturing sub-industries which we control for by including industry *dummies* in every model. We also included Gross Regional Product (*GRP growth*) to control for the effect of the economic cycle on a firm's likelihood of conducting unrelated acquisitions, expecting that low *GRP growth* prompts firms to diversify (Chen & Yu, 2012; Park, 2002). We also considered that firms might choose unrelated over related diversification because in their province there simply might not be any good acquisition targets in their industry. To account for this possibility, we included the measure of a provincial *profit margin*. The higher the profit margin, the more efficient the firms in the province; thus they may constitute more attractive targets. The data on *GRP growth* and *profit margin* were sourced from the National Bureau of Statistics of China (2001–2013). Finally, since our sample spans 13 years, *year dummies* were included in every model.

## Model

*Acquisition relatedness* takes three values: “1” (related diversification), “2” (somewhat related/unrelated diversification) and “3” (unrelated diversification). These values imply an order, yet we are unable to estimate the intervals between them, all of which reflects an ordinal measurement of the dependent variable. To test our hypotheses we thus deploy ordered logistic regression. Our data are unbalanced and pooled across years, and to correct for this we estimate models with robust standard errors.

## Results

The descriptive statistics and correlation coefficients are presented in Table 2. In addition to the inspection of the correlation matrix, we have calculated variance inflation factors (VIFs) for each of the variables. All VIFs are below 4, suggesting no multicollinearity problems (Silver, 1997).

The results of our hypotheses are presented in Tables 3 and 4. Ordered logit models estimate  $M-1$  cut-off parameters, where  $M$  is the number of orders of the dependent variable. In our model, we have two such parameters, based on which the probability that the dependent variable takes a particular value is estimated. If the outcome of the dependent variable calculated from the beta coefficients falls below the cut-off point 1, the acquisition deal is related. If it falls between the cut-off points 1 and 2, then the deal is “somewhat related/unrelated.” Finally, if the outcome is higher than the cut-off point 2, the acquisition is unrelated.

Model 1 contains only control variables; Model 2 adds main effects of the independent variables; Models 3 and 4 test Hypotheses 1 and 2, Model 5 introduces a new independent variable *locally connected firm* and Models 6 through 8 test Hypotheses 3 to 4b respectively. Model 1 shows that firm *slack* has a negative marginally statistically significant effect on *acquisition relatedness*. This effect continues in all models. Model 2 offers a slight improvement in explanatory power over Model 1. It shows that there are no independent variables with direct effect on *acquisition relatedness*.

Model 3 presents interaction effects between *target location* and *firm ownership* with POE corresponding to “1” and SOELG to “0.” The beta coefficient on the interaction term is strong and statistically significant ( $\beta = 3.29, p < .05$ ), revealing that the choice between related and unrelated acquisition strategy of POEs differs from that of SOELGs when controlling for *target location*. We have plotted interaction terms between firm ownership types and target location in Fig. 1. It shows that SOELGs, compared to POEs, are considerably less likely to acquire unrelated targets when acquiring outside of home province, but more likely to do so when an acquisition takes place in the home province. Hence, Hypothesis 1 is supported.

Hypothesis 2 is tested in Model 4. The interaction effect between *target location* and firm *local political connections* is significant ( $\beta = -1.12, p < .05$ ). We plot the interaction effect in Fig. 2. It shows that firms with *local political connections* are more likely to acquire unrelated targets in their home provinces rather than outside. The propensity to acquire unrelated targets by firms without *local political connections* does not vary with target location. Hypothesis 2, therefore, is also supported.

Model 5 in Table 4 introduces a new independent variable *locally controlled firm* which is calculated as a sum of provincial state ownership and provincial political connections. This combined variable does not have direct effect on *acquisition relatedness*. Model 6 tests Hypothesis 3 suggesting that the higher likelihood of *locally controlled firms* to acquire unrelated targets when the acquisition is conducted in their home province compared to outside of home province is further enhanced if the firms are located in lower developed provinces. The triple interaction effect between *target location*, the level of

**Table 2** Descriptive statistics and correlations

Variables	Mean	SD	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1. Acquisition relatedness	2.04	.81															
2. Target location	.44	.50	-.10														
3. Ownership (POE=1)	.73	.44	.05	.21**													
4. Provincial development	9.61	2.44	.01	-.06	.27**												
5. Local polcon	.40	.49	.02	-.09	-.17**	-.05											
6. ROA	3.98	.21	-.04	-.04	.13*	.09	-.02										
7. Slack	3.54	4.17	-.13*	.08	.29**	.10	-.04	.11*									
8. BG affiliation	.34	.47	.02	-.07	-.19**	-.15**	.08	-.00	-.16**								
9. Firm age	11.57	5.40	.05	-.10	-.28**	.05	.08	-.09	-.13*	.13*							
10. Firm size	4.81	4.39	.06	-.11*	-.24**	-.24**	.07	-.01	-.19**	.14**	-.06						
11. Concentration	34.95	17.03	-.06	.03	-.05	.13*	.08	-.00	.09	-.03	-.12*	-.05					
12. GRP growth	1.14	.05	-.12*	-.03	-.16**	-.24*	.12*	.04	-.04	.05	-.12*	.06	-.17**				
13. Profit margin	14.40	3.55	-.05	-.00	-.06	-.04	.11*	.09	.12*	-.01	.12*	-.08	-.04	.16**			
14. Tenure	3.72	2.25	.04	-.00	-.05	.02	.02	-.04	-.01	.07	-.00	.14**	.06	-.04	.03		
15. Governor age	.45	.49	-.01	-.01	.09	.27**	.08	-.02	-.06	.02	-.05	.07	.14**	-.11*	-.04	.34**	
16. Locally controlled firm	.52	.50	-.04	-.17**	-.57**	-.16**	.78**	-.10	-.14*	.12*	.17**	.11*	.06	.17**	.12*	.00	-.01

N = 346, \* p < .05, \*\* p < .01

**Table 3** The results of the ordered logistic regression; acquisition relatedness is the dependent variable

Variables	Model 1	Model 2	Model 3 (H1)	Model 4 (H2)
Firm performance	-.06 (.42)	-.06 (.42)	-.54 (.48)	-.35 (.43)
Firm slack	-.05 (.03)*	-.06 (.03)**	-.06 (.03)**	-.06 (.02)**
Business group affiliation	-.01 (.26)	-.03 (.27)	.01 (.28)	.01 (.27)
Firm age	-.01 (.02)	-.01 (.02)	-.00 (.02)	-.01 (.02)
Firm size	.04 (.02)	.04 (.02)	.04 (.03)	.05 (.03)
Ownership concentration	-.01 (.01)	-.01 (.01)	-.00 (.01)	-.01 (.01)
Profit margin	-.03 (.03)	-.03 (.03)	-.03 (.03)	-.04 (.03)
GRP growth	-5.41 (3.40)	-5.02 (3.60)	-5.71 (3.74)	-4.47 (3.55)
Target location		-.38 (.26)	-3.18 (.77)**	.02 (.31)
Ownership (POE = 1)		.46 (.35)	-.31 (.39)	.51 (.35)
Local political connections		.07 (.25)	.10 (.25)	.52 (.32)
Provincial development		-.01 (.05)	-.02 (.05)	-.02 (.05)
Tenure		.05 (.06)	.01 (.06)	.05 (.06)
Governor age		-.36 (.26)	-.23 (.26)	-.36 (.25)
Target location × Ownership			3.29 (.83)**	
Target location × Local polcon				-1.13 (.52)**
Cut-off point 1	-6.48	-6.41	-12.33	-6.57
Cut-off point 2	-4.78	-4.70	-10.53	-4.82
Pseudo $R^2$	.10	.11	.14	.12
Log pseudolikelihood	-340.32	-337.62	-325.53	-334.76

$N = 346$ , robust standard errors in parentheses; industry and year dummies included in all models. \*  $p < .1$ , \*\*  $p < .05$

*provincial development* and local control is not statistically significant. Hence, we reject Hypothesis 3.

Finally, Models 7 and 8 in Table 4 test Hypotheses 4a and 4b, which examine whether provincial government influence on acquisition behavior varies according to career stages of the governors. Based on the absence of significance of the triple interaction effects, both hypotheses are rejected.

### Robustness checks

To address potential endogeneity bias resulting from the systematic differences between firms acquiring targets outside and within their home provinces, we apply a Heckman's two-stage procedure (Heckman, 1979). In the first stage, we ran a probit regression to estimate the likelihood that an acquiring firm would carry through a deal within its home province, coded "0," or outside it, coded "1." To estimate this, we included two instrumental variables that can be expected to be related to the within-province/cross-province variable but not to *acquisition relatedness*. The two variables are the top manager's cross-province experience outside the home province, and the number of listed firms

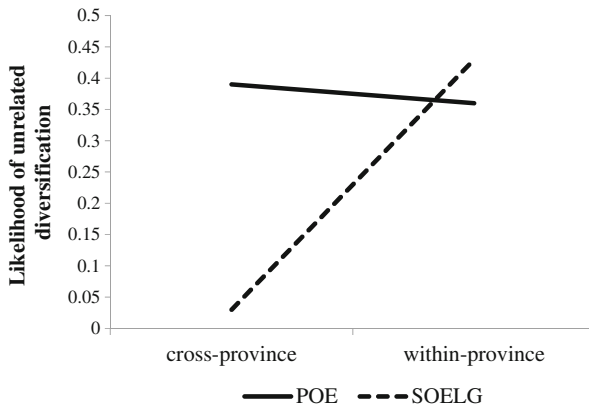


**Table 4** The results of the ordered logistic regression; acquisition relatedness is the dependent variable

Variables	Model 5	Model 6 (H3)	Model 7 (H4a)	Model 8 (H4b)
Firm performance	-.08 (.42)	-.42 (.47)	-.28 (.47)	-.28 (.45)
Firm slack	-.06 (.03)*	-.06 (.02)**	-.06 (.03)**	-.06 (.02)**
Business group affiliation	-.03 (.26)	.13 (.27)	.03 (.27)	.05 (.27)
Firm age	-.01 (.02)	-.02 (.02)	-.01 (.02)	-.01 (.02)
Firm size	.04 (.02)	.04 (.03)	.04 (.02)	.05 (.03)
Ownership concentration	-.01 (.00)	-.01 (.00)	-.01 (.00)	-.01 (.00)
GRP growth	-4.31 (3.54)	-3.34 (3.57)	-3.92 (3.71)	-3.51 (3.50)
Profit margin	-.03 (.03)	-.04 (.03)	-.04 (.03)	-.05 (.03)
Target location	-.37 (.27)	-.54 (1.61)	-.03 (.56)	.13 (.45)
Provincial development	-.01 (.05)	-.09 (.13)	-.01 (.05)	-.01 (.05)
Tenure	.05 (.06)	.04 (.06)	-.06 (.10)	.04 (.06)
Governor age	-.31 (.25)	-.27 (.25)	-.28 (.26)	-.54 (.53)
Locally controlled firm	-.24 (.25)	.09 (1.48)	-.40 (.59)	.26 (.47)
Target location × Locally controlled firm		-3.42 (2.21)	-.56 (.99)	-1.32 (.70)*
Target location × Provincial development		.08 (.15)		
Locally controlled × Provincial development		.02 (.13)		
Target location × Locally controlled firm × Provincial development		.21 (.21)		
Target location × Tenure			.10 (.11)	
Tenure × Locally controlled			.21 (.13)	
Target location × Tenure × Locally controlled			-.26 (.21)	
Target location × Governor age				.46 (.62)
Governor age × Locally controlled				.26 (.65)
Target location × Governor age × Locally controlled				-.50 (.95)
Cut-off point 1	-5.85	-8.63	-7.18	-6.66
Cut-off point 2	-4.14	-6.85	-5.41	-4.90
Pseudo $R^2$	.11	.12	.13	.12
Log pseudolikelihood	-338.19	-330.27	-331.23	-332.37

$N = 346$ , robust standard errors in parentheses; industry and year dummies included in all models. \*  $p < .1$ , \*\*  $p < .05$

in a home province engaging in cross-province acquisitions within a period of three years prior to the acquisition. We expect that top managers' experience outside the home province leads to more cross-province acquisitions because they are more risk-taking and have a larger *guanxi* network to rely on in the acquisition process (Muratova, 2015). Likewise, we expect that in the context of low information transparency and (perceived) provincial trade barriers, firms may monitor and be influenced by the behavior of their rivals to a greater degree. The information on top managers' studies and work experience come

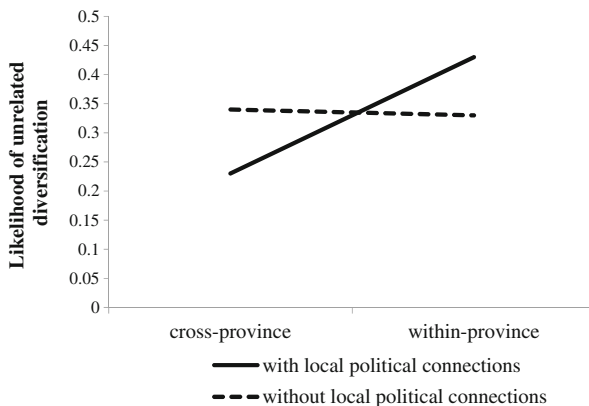


**Fig. 1** An interaction effect of firm ownership type and target location on the likelihood of unrelated diversification

from the CSMAR database, and the number of firms conducting cross-province acquisitions come from the ZEPHYR database. In the selection equation, we have included *firm performance* and *slack*, *ownership type*, *industry* and *year* dummies. To correct for the multiple observations per firm, we generated firm-clustered standard errors.

We used the values from the selection equation to calculate an inverse of Mill’s lambda, which we then include in the main ordered logistic model as an additional regressor, to control for the selection bias. In none of the Models was Mill’s lambda statistically significant, indicating the absence of endogeneity bias related to firms’ propensity to conduct cross-province acquisitions, increasing our confidence in the findings.

We made two metric changes to the dependent variable. First, instead of grouping the degree of acquisition relatedness into the three levels, we used the original 5-scale variable as a quasi-numerical and fitted least-square regression.



**Fig. 2** An interaction effect of firms with local political connections and target location on the likelihood of unrelated diversification

The results remained unchanged. Second, we made a more radical change to our dependent variable, coding it “1” if an acquisition was unrelated and within-province and coding it “0” if it was related and/or cross province. We ran logistic regression with this dichotomous dependent variable. This model demonstrated poorer fit than the main model, but, overall, the results confirmed a negative direct effect of private ownership on the likelihood of conducting unrelated within-province acquisitions and a positive effect of having provincial political connections.

## Discussion

The results of our study show that ownership and political ties significantly influences Chinese firms’ first-time acquisitions. The likelihood of SOELGs conducting unrelated acquisitions within their home province is considerably higher compared to the likelihood of unrelated cross-province acquisitions. We find a similar effect of managerial connections to provincial government, which indicates that provincial governments also exert influence over firms through ties. We find that institutional development does not decrease the likelihood of unrelated acquisitions in the firm’s home provinces relative to cross-province for locally controlled firms. There may well be other reasons why firms in lesser developed provinces would be more likely to conduct unrelated acquisitions, but government influence does not seem to intensify. Finally, we find that governor proximity to retirement and tenure do not moderate the effects of provincial government connections or ownership. This indicates that the motives for provincial government influence are not grounded in personal career ambitions or opportunism of provincial governors, something which runs counter to the core proposition of the political view. We return to this issue below.

Our findings do not suggest that provincial governments prohibit SOELGs, or firms with ties to provincial government for that matter, from conducting cross-province acquisitions. The data show that SOELGs do engage in cross-province acquisitions. Also, we do not suggest that all home province acquisitions are conducted with political purposes. In fact, we expect that SOELGs, and firms with ties to provincial government, in many cases conduct acquisitions based on firm-strategic objectives. Indeed, as provincial governments are under pressure to ensure that SOELGs are competitive, we assume that provincial government often encourages acquisitions based on firm-strategic (non-political) objectives. However, this does not negate the argument that, at other times, there are political objectives involved that lead to unrelated acquisitions. We are not making any assumptions as to which of the two scenarios is the most frequent. We also do not assume any fixed sequential order of the decision process so that acquisition target location choice by necessity should be preceded or succeeded by the decision on acquisition relatedness. Rather, we propose that in the cases when SOELGs conduct home province acquisitions, there is a likelihood that the acquisition will be politically motivated.

Our analysis has been framed by state activist and political views from the state capitalism literature rather than more firm-centric theoretical views such as the

resource-based view. However, we acknowledge that there, in addition to the government influence theorized above, likely is a more indirect government influence on acquisition behavior, which involves firm resources. As shown in the literature review above, there is abundant evidence that SOEs and firms with local political connections have easier access to bank loans and other financial resources, which may create incentives for unrelated acquisitions. At first glance, this should translate into differences in acquisition behavior regardless of the target location. This, however, was not found in our analyses. We suggest that this is because SOEs and firms with local political connections only enjoy such resource advantages when planning acquisitions in their home provinces. Previous research shows, first, that there is relatively little cross-province lending in China (Cheng & Degryse, 2010). Second, lending decisions of Chinese banks, including, but not restricted to, the big four state-owned banks, are significantly influenced by provincial governments (Cai, Xu, & Zeng, 2017). The yardstick competition between the different provinces, above all in terms of meeting GDP growth targets, means that any such political influence will have as its scope the given province. Illustrating this, lending is more extensive when provincial leaders struggle to meet their growth targets (Cai et al., 2017). On this basis, the resource advantages of SOELGs and firms with local political connections would only apply when the planned acquisitions are within the home provinces. However, this also means that there ultimately are political reasons for the financial resource endowments.

## Contributions

In the beginning of this article, we argued that government influence on firm strategy in state capitalist countries is an important topic. Our study offers a window into how such influence occurs in China. More importantly, our study contributes by answering what the objectives of such influence are. We have built hypotheses based primarily on two theoretical views within the state capitalism literature. Our results lend much greater support to the state activist (social) view than the political view. But the theoretical contribution of our study extends beyond distinguishing between these two different views of state capitalism. In their comprehensive review, Musacchio et al. (2015) identify a total of four views of state capitalism. The additional two are an institution-based view and a managerial agency view. The former proposes that the government is exerting influence as a result of, or in the attempt to fill, institutional voids. It is a perspective, which can be combined with several other views of state capitalism—exemplified by Hypothesis 3 in the present study. We do not find evidence that government influence on firm strategic behavior is more intense in provinces with lower institutional development. It may well be so that government is more active in such provinces generally, but our results show that the degree of influence on firm strategic behavior does not vary depending on this factor. The managerial agency view would explain unrelated diversification by SOEs as a result of poor governance mechanisms in SOEs and lack of expertise of government owners which results in poor oversight. This creates ample opportunity for SOE managers to engage in unrelated acquisitions and various other types of opportunistic behavior. However, in that case, we would expect SOELG managers to engage in unrelated acquisitions deals *outside* of their home province, as provincial government owners would be even less able to monitor corporate activities outside of their own provinces. Our results run

counter to that. Thus, out of the four different views, our results lend support to the state activist (social) view.

### Limitations and future research

Our study has several limitations. We hypothesize and interpret the results focusing on the home province factors that affect firms' acquisitions. We thus implicitly suggest that cross-province acquisitions are less influenced by government and that we would see more related acquisitions if firms were making decisions based only on economic considerations. These two assumptions may be overly simplistic. Dealing with the former, the evidence suggests that the host governments may discriminate against firms entering from another province (e.g., Eberhardt, Zheng, & Yu, 2013). However, provincial governments may in fact be keen to attract outside investment (e.g., Yu, Zhou, & Zhu, 2013). Therefore, there is a certain degree of government intervention that shapes cross-province acquisition dynamics. Also the latter assumption, namely that firms, if free from government intervention, would favor related acquisitions over unrelated, may be too simplistic. The assumption is based on the view that related diversification is less risky compared to unrelated, because the latter means entering industries in which firms have no first-hand experience (e.g., Park, 2002). However, according to another perspective suggests, related diversification may be more challenging than unrelated, since it demands exceptional expertise at the post-acquisition integration stage (e.g., Chakrabarti & Mitchell, 2013).

If we are correct in pointing to state activism as the motivation behind unrelated acquisitions, then the question is if such state activism will continue in China and whether it will continue to be visible in acquisition behavior. While we believe the answer to the first question is yes, we cannot be sure that provincial governments will continue to strive for socio-economic goals through the means of unrelated acquisitions. The trend seems to be, at least on a central government level, that SOEs increasingly are asked to specialize, something which may well trickle down to provincial level in the future. Generally, how government influence changes as policy changes is an important avenue of future research.

### Conclusion

Drawing on a state capitalism perspective, in this paper we have explored provincial patterns of unrelated acquisitions in China. We have demonstrated that provincial governments exert influence over Chinese firms through ownership and managerial ties. This influence results in differences in acquisition behavior of SOELGs and firms with managerial connections to provincial governments when comparing home province and cross-province acquisitions. Our study also looked into the motives behind such provincial government influence. Our results support the idea that Chinese government exerts control over firms in order to achieve objectives related to social and economic development. Thus, our results offer support to the state activist view of state capitalism.

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