

# Geopolitical risk and M&A : The Role of National Governance Institutions

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## Abstract

Using 19 emerging economies from 1990 to 2018, we find a positive effect of geopolitical risk on mergers and acquisition (M&A) deal frequency driven mainly by an increase in domestic M&A. We, however, find a negative effect of geopolitical risk on the M&A deal size, highlighting the deadweight cost created by the geopolitical risk. The quality of national governance moderates the deterring effect of geopolitical risk.

**JEL classification:** G34, F51, F52

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## 1. Introduction

The ensuing tensions following the Ukraine-Russia crisis have highlighted the importance of geopolitical uncertainties on global economic activities and security. The impact of similar events such as the COVID-19 pandemic, Brexit, terrorism or the Syrian refugee crisis, especially on Europe and other developed economies are apparent (Ahmed et al., 2022; Aldhawayn et al., 2020; Corbet et al., 2018). The extant literature provides mixed evidence focusing on specific economies or sectors. While Shen et al. (2021) show a positive impact of GPR in Chinese energy sector mergers and acquisitions (M&As), Hao et al. (2022) show a negative consequence of GPR in US merger activities, and other studies focus on macroeconomic consequences of regional turmoils (Abu-Ghunmi et al., 2020; Bouoiyour et al., 2019). Motivated by this, in this study, we look into the material impact of geopolitical risk (hereafter GPR) on M&As in emerging economies. Using data from 19 emerging economies, we examine whether GPR explains variations in M&As and how differing quality of national institutions may moderate these effects.

GPR can destroy human and physical capital, as they are associated with extreme events, such as terrorist acts or fighting between a government entity and rebel groups (Caldara & Iacoviello, 2018). GPR being cumulative episodes of conflict are characterised by bursts of activities that are difficult to predict compared to other types of political risk (Oetzel & Oh, 2014). In situations of GPR, managers are unable to predict the economic fluctuations associated with the event, which suggests that managing the business during GPR events has much greater levels of uncertainty (Kelly, Pástor, & Veronesi, 2016). In essence, GPR is a type of discontinuous political risk, which confers less information on the possibility of recurrence and future predictions.

GPR is a key determinant of a firm's investment decisions (Caldara and Iacoviello, 2018). In this line of enquiry, Busse and Hefekers (2007) argue that government stability, internal and external conflicts, different natures of corruption, ethnic or racial tensions, determinants of order, political accountability, and bureaucracy all significantly affect FDI flows. We contribute to the literature by exploring business environmental risk derivations, specifically levels of risk directly resulting from geopolitical concerns. For example, a host government is more likely to impose new regulations or change regulations during episodes of major GPR. This will most likely raise the cost of conducting business for multinational enterprises (MNEs) entering that market (Li, 2006). Types of regulatory changes would be focused on restrictive trading: exchange controls, embargoes, change of terms of contract (breach of contract terms), and limitations around profit repatriation (Li & Vashchilko, 2010). GPR also leads to negative shocks against earnings due to damages to property & infrastructure, the death or injury of employees, major disruptions in the supply chain, and/or increased expenses associated with trade (Li & Vashchilko, 2010; Oh & Oetzel, 2017) making the country inflicted by GPR less attractive. We extend this line of literature to investigate the impact of GPR on the firm's attitude towards inorganic expansion strategies via M&As, specifically in emerging markets.

GPR can impact the firm's price volatility and its market valuation, as it is an important component of systematic risk. This, therefore, may drive the acquirer's M&A strategy as the cost of acquisition and also the expected post-merger synergy can be volatile (Bekaert et al., 2014; Butler and Joaquin, 1998; Hao et al., 2022). Two schools of thought explain the contrary evidence of GPR and M&A in literature.

First, under an uncertain environment, the acquiring firms have a choice under the real options theory to either undertake an acquisition to unlock timely returns or defer the deals to an appropriate time if they feel that the deals under the current environment cannot generate

value (Duku-Kaakyire and Nanang, 2004; Folta and O'Brien, 2004; Johnson, 2007; McDonald and Siegel, 1986). Acquirers' cost of external financing increases in uncertain, risky environments, thus encouraging them to delay expansion strategies (Greenwald and Stiglitz, 1990). As the GPR causes uncertainty and a risky environment, deferment of acquisition deals increases the value of delayed investments, especially as these are costly to reverse (Bernanke, 1983; Bloom, 2009; Dixit et al., 1994; Rodrik, 1991). To this end, evidence suggests that firms often defer their investments in uncertain environments (Bloom et al., 2007; Giambona et al., 2018). These arguments support the deterrence hypothesis that under a higher GPR regime, the M&A activities slow down.

Second, the prospect synergy effect theory suggests that under fierce industry competition, firms engage in higher (lower) risk under uncertain (deterministic) environments (Kahneman and Tversky, 2019). The growth option offers the acquiring firms to engage in M&A deals to enhance its competitiveness and generate abnormal returns (Shleifer and Vishny, 2003; Song et al., 2015). Engaging in M&A under these circumstances helps firms to grow faster and generate higher risk-return payoffs (Shen et al., 2021b). Additionally, the expansion of M&A activities in light of uncertainty may be driven by the managerial empire-building motive (Duchin and Schmidt, 2013). Both differing mechanisms of the prospect synergy view and managerial empire-building arguments suggest higher M&As in uncertain environments. Thus the alternative hypothesis is that a higher GPR regime increases M&A activities.

Finally, we also hypothesise that the quality of national institutions moderates the impact of GPR on M&A. Koirala et al. (2022) provide empirical evidence that robust national governance mechanisms in the forms of quality of enabling institutions moderate the effect of the market for corporate control on value-enhancing corporate risk-taking. A country's national institutions directly influence the degree of law enforcement, stakeholder protection, and confidence in financial markets (Djankov et al., 2008; La Porta, 1999; Schnepfer and Guillén,

2004). The quality of National institutions is important as they enable to government to promulgate and enforce appropriate policies and regulations.

In this study, we look at a multi-country emerging market setup and document unsettling results of a positive effect of GPR on M&A deal frequency. Further dissection of the M&A activities reveals that domestic M&A deals largely drive the positive effect of GPR on total deal frequency, which offsets the deterrence effects of GPR in cross-border (CB) deals. However, these offsetting results are not seen in deal size as we find a negative effect of GPR on the M&A deal size, highlighting the deadweight cost created by GPR. In the enquiry of moderating effect of national institutions, the deterring effect of GPR is lessened by the quality of national governance. Our findings highlight the merit of national institutional quality in providing a partial hedge to the frictions caused by geopolitical risk.

We contribute to the burgeoning literature that studies geopolitical uncertainty and corporate risk-taking M&A strategies (Aldhawyan et al., 2020; Hao et al., 2022). To this end, we provide evidence that while the M&A activities in terms of deal numbers increase significantly, the deal's overall value shrinks. We further provide new insights on the impact of GPR on domestic Vs CB M&A deals. Next, on the literature on the role of national governance and institutions on corporate decisions (Fauver et al., 2017; Koirala et al., 2022; La Porta, 1999), we provide novel evidence on how the quality of national institutions in emerging economies can moderate the effects of GPR on M&A activities. Our findings suggest robust enabling institutions soften the negative effects of geopolitical tensions and help in instilling greater confidence among firms to undertake M&A strategies.

Finally, extant literature provides strong evidence that emerging markets suffer significant falls in private consumption, and investments and experience greater capital outflows in times of exogenous uncertainty compared to developed economies (Carrière-

Swallow and Céspedes, 2013). In particular, Caldara and Iacoviello (2018) provide evidence that geopolitical risk exacerbates the decline in real economic activities and stock returns, and increases the capital outflows from emerging economies. Further, Cheng and Chiu (2018) provide empirical estimates of GPR's impacts on the business cycle contraction in emerging countries. Our paper contributes to this strand of literature on uncertainty and emerging markets by analysing how GPR impacts emerging market M&A activities.

## 2. Data and Model

We employ a high-frequency media-based measure of GPR index for 19 emerging economies (target countries) as computed by Caldara & Iacoviello (2018) for the sample period 1990-2018. We use the country-industry and year-month fixed effects model (eq.1) to investigate the impact of GPR on the total M&A deal frequency and deal volume.

$$Y_{i,t} = \alpha + \beta_1 \cdot GPR_{c,t} + \phi_k \mathbf{C}_{c,t} + \lambda_k \mathbf{X}_{i,t-1} + \mathbf{FE} + e_{i,t} \quad (\text{eq.1})$$

where  $Y_{i,t}$  is the M&A outcome variable which is deal frequency or deal volume.  $GPR_{c,t}$  is a continuous variable that captures country  $c$ 's geopolitical risk in a given month  $t$ . The dependent variables are deal frequency and deal volume aggregated at target country-industry level each month based on 2-digit SIC.  $\mathbf{C}_{c,t}$  represents the vector of country-level control variables that include *Country Size*, *Economic growth*, *FDI inflow*, *FDI-outflow*, *Trade*, *Unemployment* and *Inflation*;  $\mathbf{X}_{i,t-1}$  is a vector of Industry controls that include industry median of *Firm Size*, *Leverage*, *Cash-holding*, *Average sales growth* and *ROA*. The standard errors are double clustered at country-industry and year-month level. The variables are obtained from SDC platinum, Compustat or World bank databases (see Appendix Table 1 for source and definitions). We present the sample distribution of the 242,778 M&A target countries' deals in Appendix Table 2 and the descriptive statistics of the variables in Appendix Table 3.

### 3. Results

As reported in table 1, our empirical examination reveals an unsettling result of a positive association between the effect of GPR on M&A deals. In terms of economic magnitude one percent increase in GPR index is associated with an increase in M&A deal frequency in a range of 3.67% to 3.76% per month. This is contrary to the theoretical prediction of the deadweight cost posed by GPR to deter M&A frequency. However, consistent with the theoretical prediction of deterrence, the GPR negatively affects the deal volume (dollar size of the deal). In terms of economic magnitude, 1% increase in GPR index is associated with a decrease in deal size in a range of 14.37% to 20.96%.

**Table 1.** reports the results of the impact of GPR on the total M&A deal frequency and volume: we report p-values in parenthesis. \*, \*\*, and \*\*\* indicate significance levels at 10%, 5%, and 1% respectively. Sample period 1990-2018.

	Deals Frequency		Deals Volume	
	1	2	3	4
GPR	0.0366*** (0.00)	0.0376*** (0.00)	-0.2096*** (0.00)	-0.1437** (0.01)
<i>Country size</i>		0.6721*** (0.00)		1.1469*** (0.00)
<i>GDP growth</i>		-0.0095*** (0.00)		0.0072 (0.19)
<i>FDI-inflow</i>		-0.0035*** (0.00)		1.0116*** (0.00)
<i>FDI-outflow</i>		-0.0079*** (0.00)		0.4046 (0.39)
<i>Trade</i>		0.0039*** (0.00)		0.4615*** (0.00)
<i>Unemployment</i>		0.0234*** (0.00)		0.0656*** (0.00)
<i>Inflation</i>		0.0031 (0.16)		-0.0643*** (0.00)
<i>Firm-size</i>		0.0020 (0.34)		0.2242*** (0.00)
<i>Leverage</i>		-0.0004** (0.02)		0.0010** (0.02)
<i>Cash-holding</i>		0.0023*** (0.00)		0.3555** (0.01)
<i>Average sales growth</i>		0.0005*** (0.00)		-0.0000 (0.45)
<i>ROA</i>		0.0011** (0.02)		0.2683*** (0.01)
Adj. R <sup>2</sup>	0.4610	0.5044	0.1322	0.1637
No. of Observations	60128	60128	40362	40362
Year-month FE	Yes	Yes	Yes	Yes
Country-industry FE	Yes	Yes	Yes	Yes

To further dissect this seemingly contradicting view of the positive effect of GPR on M&A deal frequency, we divide the deals into domestic and CB, and examine the effect of GPR on these sub-set of M&A activities. The results are presented in table 2. For brevity we only report the beta coefficient of GPR on M&A deals.

As reported in Panel A, we find that 1% increase in GPR index is associated with an increase in domestic deal frequency in the magnitude of 4.95% to 5.35% and a reduction of CB deal frequency by 2.50% to 2.76% per month. The result reveals that the deterrence of overall M&A deals due to GPR (Table 1) is offset by an increase in domestic deals. This highlights the attempt by bidders to compensate for the reduction in CB-deal frequency by increasing deal initiation in the domestic market. In the face of higher GPR, the domestic market provides a better familiarity advantage than the cross-border M&A where they deal in an alien environment. However, as reported in Panel B, no such offsetting phenomenon is observed in deal volume. This is in line with the argument that M&A pose a higher degree of investment irreversibility, thereby creating deadweight transaction cost to deter M&A deal size.

**Table 2** reports the results of the impact of GPR on the Domestic and Cross border (CB) M&A deal frequency and volume. We report p-values in parentheses. \*, \*\*, and \*\*\* indicate significance levels at 10%, 5%, and 1% respectively. Sample period 1990-2018.

<b>Panel A</b>	Domestic Deal-frequency		CB Deal-frequency		CB Deal-ratio
	1	2	3	4	5
GPR	0.0535*** (0.00)	0.0495*** (0.00)	-0.0250*** (0.00)	-0.0276*** (0.00)	-0.0158*** (0.00)
Country level Controls	No	Yes	No	Yes	Yes
Industry median controls	No	Yes	No	Yes	Yes
Adj. R <sup>2</sup>	0.1607	0.1835	0.1020	0.1085	0.05652
No. of Observations	59892	59892	59984	59984	59748
Year-month FE	Yes	Yes	Yes	Yes	Yes
Country-industry FE	Yes	Yes	Yes	Yes	Yes

  

<b>Panel B</b>	Domestic Deal-Volume		CB Deals-Volume		CB Volume-ratio
	1	2	3	4	5
GPR	-0.0968* (0.09)	-0.1170** (0.05)	-0.5283*** (0.00)	-0.5001*** (0.00)	-0.0315*** (0.00)
Country level Controls	No	Yes	No	Yes	Yes
Industry median controls	No	Yes	No	Yes	Yes
Adj. R <sup>2</sup>	0.1436	0.1566	0.1381	0.1444	0.04041
No. of Observations	40337	40337	31121	31121	48674
Year-month FE	Yes	Yes	Yes	Yes	Yes
Country-industry FE	Yes	Yes	Yes	Yes	Yes



#### 4. GPR on M&A: The moderation effect of national governance

Following Koirala et al. (2022), we test the impact of the quality of national governance institutions on the effect of GPR on M&A using the following regression specification:

$$Y_{i,t} = \alpha + \beta_1 GPR_{c,t} + \beta_2 [GPR_{c,t} \times NG_{c,t}] + \phi_k C_{c,t} + \lambda_k X_{i,t-1} + FE + e_{i,t} \quad (2)$$

where  $NG_{c,t}$  is the national governance measures capturing regulatory quality [RQ], rule of law [RL], control of corruption [CC] and combined governance [PC] of Country  $c$  in time  $t$ . All other variables are same as in eq. (1). As reported in table 3, our examination of moderation by national governance reveals the deterrence effect of M&A deals is assuaged by the quality of institutions based on the RQ (model 1), RL (model 2), CC (model 3) and first principal component (PC) of RQ, RL and CC (model 4). In summary, our results indicate that better quality of institution lowers the deterrence effect of GPR on M&A.

**Table 3** reports the moderation of National Governance on the effect of GPR on M&A deal frequency. We report p-values in parentheses. \*, \*\*, and \*\*\* indicate significance levels at 10%, 5%, and 1% respectively. Sample period 1990-2018.

	1	2	3	4
<i>GPR × RQ</i>	0.0319** (0.02)			
<i>GPR × RL</i>		0.0386*** (0.00)		
<i>GPR × CC</i>			0.0289** (0.03)	
<i>GPR × PC</i>				0.0140*** (0.01)
GPR	-0.0319*** (0.00)	-0.0283*** (0.00)	-0.0210** (0.03)	-0.0251*** (0.01)
Control Variables	Yes	Yes	Yes	Yes
Adj. R <sup>2</sup>	0.1074	0.1073	0.1077	0.1074
No. of Observations	53208	53208	53208	53208
Year-month FE	Yes	Yes	Yes	Yes
Country-industry FE	Yes	Yes	Yes	Yes

#### 5. Conclusion

M&A is an important growth driver. In the face of geopolitical risk, there is uncertainty with regard to the M&A strategies adopted by firms. In this paper, we provide evidence that while GPR

induces higher M&A deal frequency driven by domestic deals, it reduces the total value of deals among emerging economies. Further, we document the quality of institutions softens the negative effects of GPR on M&A.

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# 1. Appendix Table A1. List of variables

This table shows the construction of the variables. Explanations are provided in the description of the variables in the text.

Variables	Calculation	Source
<b>Dependent Variables</b>		
Deal frequency	Natural log of one plus domestic deal frequency	SDC
Deal Volume	The total dollar value of CBA deals divided by total dollar value of (domestic and CBA) deals in a given target's country-industry and month.	SDC
Domestic Deal Frequency	Natural log of one plus total deal count aggregated at country-industry-month	
Domestic Deal Volume	The total dollar value of CBA deals divided by total dollar value of (domestic and CBA) deals in a given target's country-industry and month.	SDC
Cross border Deal Frequency		SDC
Cross border Deal Volume		SDC
<b>Independent Variables</b>		
GPR	The natural logarithm of the arithmetic average of country-level Geo-political risk for immediate three lag months.	Own Calculation
<b>Moderating variables [National Governance]</b>		
Regulatory Quality (RQ)	Continuous variable that captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.	World Governance Indicators database from World Bank
Rule of Law (RL)	Continuous variable that captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence	World Governance Indicators database from World Bank
Control of Corruption (CC)	Continuous variable that captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.	World Governance Indicators database from World Bank
Principal Component (PC)	First principal component of Regulatory Quality (RQ), Rule of Law (RL) and Control of Corruption (CC) Scores.	Own calculation
<b>Country Controls</b>		
Market size (GDP per capita)	The natural log transformation of per capita GDP in USD	World Bank WDI database
Economic growth	The growth rate of GDP	World Bank WDI database
Capital market development	The total stock market capitalization divided by GDP.	World Bank WDI database
Credit market development	The total domestic credit divided by GDP.	World Bank WDI database
Unemployment	Captures the essence of Labour dynamics. Unemployment rate as a percentage of the active population (14-65)	World Bank WDI database
<b>Industry Factors</b>		
Industry	65 unique industries based on SIC-2 digits non-financial firms	Compustat Global
<b>Industry Control</b>		
Firm-size (Industry median)	$\ln(\text{Book-value of Total Assets})$	Compustat Global
Leverage (Industry median)	$\frac{\text{Total Debt}}{\text{Total Asset}}$	Compustat Global
Cash – holding (Industry median)	$\frac{\text{Cash and Short term investment}}{\text{Total Asset}}$	Compustat Global
Average sales growth (Industry median)	Three-year average of year-on-year sales growth $[\frac{\text{Total sales}_t - \text{Total sales}_{t-1}}{\text{Total sales}_t}]$	Compustat Global
ROA	EBITDA/Total Assets	Compustat Global

## 2. Appendix Table 2 (Sample distribution)

TGT/ACQ	ARG	BRA	CHN	COL	HKG	IND	IDN	ISR	MYS	MEX	PHL	RUS	SAU	ZAF	KOR	THL	TUR	UKR	VEN	OTH	Total
ARG	1818	138	17	13	6	9	0	4	1	58	1	4	1	7	6	2	0	0	9	2158	4252
BRA	68	7886	68	25	27	40	2	30	5	68	2	14	1	18	19	5	1	0	5	4561	12845
CHN	3	4	53443	0	5323	38	17	11	161	5	22	12	6	13	233	49	1	1	0	8304	67646
COL	24	35	10	821	6	7	0	2	0	48	1	0	0	6	1	0	1	0	17	1173	2152
HKG	0	3	1335	0	11961	30	22	7	368	0	36	4	2	15	85	35	1	0	0	4044	17948
IND	0	13	57	1	200	15203	11	14	96	12	23	24	7	39	47	25	4	1	2	7669	23448
IDN	0	0	49	0	158	58	2636	0	330	6	22	3	8	7	107	68	2	1	0	2471	5926
ISR	3	1	44	0	15	26	2	1944	1	1	0	11	0	4	6	1	3	0	0	1650	3712
MYS	0	2	66	2	235	41	47	1	15465	1	20	2	11	8	25	28	1	1	0	2885	18841
MEX	20	32	11	16	14	8	0	6	2	2149	6	0	1	2	9	2	0	0	3	2989	5270
PHL	0	0	17	0	118	14	6	1	95	4	2395	0	1	3	22	45	0	0	0	1225	3946
RUS	0	1	65	0	35	30	2	14	2	0	0	23485	7	18	32	7	21	55	2	7870	31646
SAU	0	0	4	0	3	11	3	0	4	0	1	0	475	3	6	1	5	0	0	391	907
ZAF	1	6	31	0	29	55	1	6	24	0	1	9	5	6000	16	0	1	0	0	2240	8425
KOR	0	1	105	0	216	15	1	11	23	2	1	5	13	18	16631	4	1	0	0	2847	19894
THL	0	2	45	0	141	36	11	7	165	2	13	2	3	6	27	4310	0	0	0	1825	6595
TUR	0	4	10	0	9	17	1	7	12	2	0	25	26	7	11	3	2378	0	0	1839	4351
UKR	0	0	12	0	5	0	0	6	0	2	0	251	0	0	0	0	8	1742	1	2075	4102
VEN	6	14	2	11	1	4	1	0	0	12	0	9	0	0	0	0	1	1	362	448	872
Total	1943	8142	55391	889	18502	15642	2763	2071	16754	2372	2544	23860	567	6174	17283	4585	2429	1802	401	58664	242778

### 3. Appendix Table 3

	count	mean	St. Dev.	Median	25 <sup>th</sup> pctile.	75 <sup>th</sup> pctile
Ln(Deal Frequency-Total)	57908	0.6210	0.7795	0.0000	0.0000	1.0986
Ln(Deal Volume-Total)	39198	2.9066	2.4490	3.0218	1.4000	4.5915
Ln(Deal Frequency-Domestic)	57725	0.5315	0.7506	0.0000	0.0000	0.6931
Ln(Deal Volume- Domestic)	39208	2.7542	2.4675	2.8399	1.2177	4.4466
Ln(Deal Frequency-Cross Border)	57798	0.2987	0.5061	0.0000	0.0000	0.6931
Ln(Deal Volume- Cross Border)	30254	2.7200	2.3883	2.8761	1.2678	4.3742
Country size	57908	27.2194	1.2651	27.2085	26.2388	28.0848
FDI-inflow	57908	0.0422	0.0755	0.0256	0.0135	0.0373
FDI-outflow	57908	0.0305	0.0691	0.0108	0.0044	0.0213
Domestic credit	57908	0.8966	0.4964	1.0200	0.4363	1.3105
Trade	57908	0.9043	0.8514	0.5658	0.4569	0.9795
Inflation	57908	0.0738	0.5539	0.0444	0.0228	0.0780
Market-cap	57379	1.2684	2.1167	0.6617	0.3960	1.1943
GDP growth	57908	0.0488	0.0376	0.0520	0.0300	0.0743
Size (Industry median)	57908	8.0662	2.6866	7.4394	6.3450	9.1783
Leverage (Industry median)	57908	0.7456	35.5884	0.2437	0.1361	0.3429
Cash holding (Industry median)	57908	0.1120	0.0917	0.0907	0.0457	0.1510
ROA (Industry median)	57874	0.0896	0.1136	0.0853	0.0573	0.1184
HHI (market share)	57908	0.3883	0.3011	0.2984	0.1439	0.5476
Sales growth (Industry median)	56847	0.1306	0.2391	0.1041	0.0271	0.1953
Av. Sales growth (Industry median)	57908	0.1513	0.2565	0.1123	0.0468	0.1978