

# Agency Theory Approach For The Performance Of Returnee Entrepreneurs

Ping Yan, Hanyang University, Korea  
Yunhyeong Choi, Hanyang University, Korea  
Seong-jin Choi, Hanyang University, Korea  
Sukyoon Jung, Hanyang University, Korea

## ABSTRACT

*A returnee entrepreneur playing an important role in China market is a notable phenomenon. While their advanced knowledge and overseas networking in developed countries have advantages over local counterparts, their lack of local knowledge and connection may mitigate their advantages. This study explores the research questions how and why external management control of returnee entrepreneur is inferior to local counterpart. Based on the data collected in year 2002 from Chinese technology venture companies in Zhongguancun Science Park (ZSP), we find that the performance of returnee entrepreneur's firms is lower when they have more local subsidiaries and when they are owned by foreigners. It implies that returnee entrepreneurs may be less effective in management control over local subsidiaries which may indicate a low level of headquarters control. It also implies that foreign ownership gives rise to increase in agency conflicts between returnee entrepreneurs and foreign investors and thus has a negative impact on firms' innovation performance.*

**Keywords:** Firm Performance; Agency Theory; Returnee Entrepreneur

## 1. INTRODUCTION

A returnee entrepreneur differs from an ordinary one in that he or she studied and accumulated first hand experiences overseas. Success stories of returnee entrepreneurs from China in particular are currently in the limelight from the industrial circle as well as the academic community (Choi & Lu, 2013). While launching into a new phase of the age that has registered an economic growth close to 7%, China is attempting at an economic innovation program by helping start-up businesses under the slogan of "People's Startup, Innovation for All." The Chinese government is now actively inviting back excellent manpower from abroad. As a result, returnee startup hubs by Chinese students returned from overseas numbered over 280 at the end of 2013, and the number of businesses established on the returnee startup hubs totaled 13,000 at the end of 2012, indicating that 2,000 new businesses moved into the hubs in the year 2012 alone. Not all returnee entrepreneurs did record success stories. Recent studies find that those returnee businesses had gone so far as to fall below local venture businesses in terms of the level of financial performance, contrary to what had been commonly expected. Li, Zhang, Li, Zhou and Zhang (2012) find that businesses formerly owned by the government or those with a long career background could perform well by offsetting their weaknesses. While returnee entrepreneurs excel in technological power and can utilize overseas networks, strengths unique to them, they fall below in the level of understanding the local Chinese market, thus making it difficult to exhibit a desirable venture performance to speak of, Li, Zhang, Li, Zhou and Zhang (2012) argue weaknesses on the part of returnee entrepreneurs could be offset by their ties with government agencies. As in Lin et al. (2014), existing studies generally focus on external factors such as the returnee entrepreneur's political connections or managerial sustainability and there is little research on the internal control mechanism that can affect innovative performance. However, in the case of a venture business depending significantly on the entrepreneur's technology, an internal control on an opportunistic behavior could be more important than in other types of enterprises. Returnee entrepreneurs are likely to be inept in the way controlling intra-corporate conflicts and interests. On the other hand, according to the Principal-Principal-Agency theory (Renders & Gaeremynck, 2012), a returnee entrepreneur is the principal who founded the business and acts by nature as an agency who has been entrusted with the capital from the outside investors. The interests of the majority shareholders could differ from that of the returnee entrepreneur (Arthurs & Busenitz, 2003). The agency costs in such a complex situation have not properly been addressed in the

existing studies relating returnee entrepreneurs. This research provides an empirical contribution to the literature by documenting that failures in returnee venture are caused by costs of agency. The empirical findings in this study imply that it is essential to create venture environments coupled with controlling capability rather than simply induce returnee entrepreneurs. With the Korean policy makers' interest in start-up by returnee entrepreneurs, the study expects to arouse interest of policy makers as well.

## **2. THEORETICAL BACKGROUND AND INSTITUTIONAL FACTORS OF THE STUDY**

### **2.1 The High Tech Industry and the Capability of a Venture CEO**

A venture business generally explores new markets by providing new products or services that the CEO has developed or launched and, accordingly, it largely depends on the CEO. This makes the CEO's ability a factor crucial to the business' performance (Li et al., 2012). A company holds its own specific technology with a competitive edge. Moreover, progress in the sector of information telecommunications such as the Internet makes it so easy to locate partners who own a technology desired, and information is exchanged so fast that mutual cooperation has become commonplace. Performance of venture businesses within the high tech industry is often influenced significantly by CEO's capacity. Therefore, prior literature on the effect of the ability of a CEO on the performance of the company examines the CEO's psychological traits and capacity traits. Psychological traits are divided into the desire to achieve and the tendency to accept risks. Smith and Miner (1983) find significant relationships between the venture CEO's desire to achieve and the growth rate of a business. Chandler & Jansen (1992) group the segment of CEO's capability into entrepreneurial capability, managerial capability, and technological and technical capability. Recent studies also tried to explore link between CEO's characteristics (e.g., background, leadership, management capabilities) and firm performance using the lens of upper echelons theory (Caridi-Zahavi et al. 2016). They argue that entrepreneurial capability gives rise to high productivity, entrepreneurial capability high growth rate, and managerial capability serves as a factor essential to the company's income structure. In addition, a venture business with high profitability is the one where CEOs high technological capability and professionalism in their business field (Park & Luo, 2001).

### **2.2 The Current Status of Returnee CEO's and Existing Studies**

The rate of returnee students in 2004 stood at 21.6%, while the rate sharply rose to 85.4% level in 2013 (Ministry of Education, 2014). The establishment of Federation of Returnee Student Business Founders in 2008 under the sponsorship of the government since 1994 further stimulated the industry to spawn new businesses. The Chinese government established a returnee student business founding hub in 1994, rapidly growing in number to reach over 280 as of 2013. As a result of generous support from the government, the number of patents the business founding hubs acquired was more than 300. Chinese corporations listed on the financial market home and abroad numbered 50, leading the businesses housed in the hubs to transform themselves into those equipped with solid corporate capability. The great majority of returnee business founders housed in those founding hubs are concentrating on IT, bio-medicine and high tech manufacturing and the like to such a point that a new-coined word "Chuangke (创客)", which means a "business founding specialist", has recently come into use. With Chinese returnee students starting businesses causing qualitative shifts in the Chinese economy, performance of the businesses founded by returnee students is also drawing attention. Previous studies have been measuring performance with traits of returnees from overseas studies and external environments as variables of interest. The former made it clear that overseas sojourn of returnee business founders has dulled their sense of localization, thereby often pulling down their level of business performance (Lin et al. 2014). On the other hand, the case of the latter showed that political network and the ownership structure and their status as a state corporation help to increase corporate performance (Lin et al., 2014). Wright, Clarysse, Lockett and Knockaert (2008) use both traits of the business founder and external environments as variables of interests. They argue that corporate performance could differ depending on the stratum of knowledge the founder acquired from overseas and depending on where the startup business hub is located. Lin et al. (2014) find that innovativeness of the business increases in case the business of the returnee business founder is state-run, the returnee business founder is politically linked to the government, and the stability of the owner is guaranteed by a long-term contract.

### 3. RESEARCH HYPOTHESIS

#### 3.1 Controlling Capability of Returnee Business Founders

One of the primary roles of a headquarters is to manage its subsidiaries effectively. A multi-national business needs to have its overseas subsidiaries established in many foreign countries under control in an effective manner. This makes the decision making issue of how much of managerial right is to be delegated to a subsidiary a primary study project in this area (Paterson & Brock, 2002). Studies on how to control subsidiaries effectively on the part of headquarters have been conducted in the area of strategic management and international management (Gong, 2003). Recent studies provide valuable insights on the control of subsidiaries (Björkman, Barner-Rasmussen & Li, 2004; Gong, 2003). These studies view the relationship between the headquarters and outside subsidiaries as the relationship between the principal and the agent. The agency theory asserts that while the two parties maintain a cooperative relationship in carrying out an assignment, they could maintain purposes and attitudes different from each other (Jensen & Meckling, 1976). Therefore, should the interests of the top manager and stockholders not coincide, the top manager's hidden action is incited, and thus agency costs are incurred due to moral hazards. If an outside subsidiary takes an opportunistic action, the headquarters suffer losses in various forms. With this in view, the agency theory maintains a structure suitable for clarifying the relationship between the headquarters and its subsidiaries. Therefore, the theory of agency makes it possible to well explain the need to manage its subsidiary and understand international management environments arising therefrom (Bergen, Dutta & Walker, 1992). Asymmetric information on the headquarters and its subsidiary of a multinational business induces moral hazards on the part of the overseas subsidiary. Therefore, since it is important for the headquarters possessing incomplete information to delve into the information its subsidiary has, the headquarters could harvest corporate performance without paying agency costs by maintaining bilateral relationship with its overseas subsidiary. Eisenhardt (1989) held the view that the differing level of preferring risks between the headquarters and its subsidiary in an asymmetric environment could aggravate the situation. In case bilateral communications between the headquarters and its subsidiary go wrong, information goes asymmetrical even further, and the subsidiary starts to work independently from the headquarters. While the headquarters uses various systems in order to monitor its unruly subsidiary, when the headquarters sits down together with its subsidiary and tries its best to map out a long-term corporate strategy, the headquarters could rectify the asymmetric structure and help the subsidiary to exercise its capability to the full. Therefore, it is the headquarters' issue to build an optimum controlling structure and relationship by means of an appropriate compensational scheme. This will enable the subsidiary to help out the headquarters that is blind to jobsite experiences and help it to transfer its capability to its subsidiary lacking in technology or knowledge, thereby attaining to the same objectives as a multinational business. The returnee business founder has no choice but to fall considerably behind a business owner of local origin in terms of the capability of controlling his or her subsidiary. A returnee business founder who has stayed overseas for a long time is more or less blind to the domestic market of China, a land significantly different from overseas environments. With a returnee business founder, the cost of controlling the organization is certain to run higher in that he or she has been separated for a long time from the environment unique to the Chinese domestic market. Since subsidiaries located elsewhere are likely to act in an opportunistic manner, a returnee business founder may find it difficult to control such actions efficiently. In case a returnee business founder has established a subsidiary elsewhere in China though he or she has on hand practical technology and capability, he or she is supposed to pay out agency costs since the relationship between the headquarters and its subsidiary follows that between the owner and his or her agent. In the case of a venture business where technological capability is important, internal organizational control is more important than other types of businesses. Since opportunistic actions are most likely to occur in a place where the founder is out of reach, the business performance could drop more or less. In case the returnee business founder has not experienced failures many a time or has not been trained in controlling the organization, he or she has no other alternative but to be lacking in the capability of redressing internal conflicts. The costs of controlling the organization and settling conflicts could affect the returnee business founder's performance of venture innovation. On the other hand, an understanding of the ecology of ventures, mediating differences in opinions with investors is also essential on the part of a returnee business founder. Due to the situation inexplicable in terms of the existing theory of agency, the topic has become one of the study subjects most frequently tackled in the field (Eisenhardt, 1989). Eisenhardt (1989) asserts that the existing agency theory does not reflect actual management environment as it is but seeks to explain phenomena based on mere assumptions. Renders and Gaeremynck (2012) has come up with a Principal-Principal-Agency theory, which can account for returnee business founders in a contradictory situation where he or she acts as both the principal and the agent alike. They assert that the returnee business founder is in a position to represent interests of the investors

as well as to take care of the internal organization. This will make it possible to look into the factors leading to failure as a returnee business founder due to costs of agency accruing from the failure to control the organization.

**Hypothesis 1:** Effects of the returnee business founder on innovation performance are negatively moderated by number of local subsidiaries.

### 3.2 Ownership Structure and the Returnee Business Founder

A returnee business founder often encounters troubles since he or she cannot get adjusted to the environments of domestic institutions. They are either frequently alienated from the domestic environment featuring a close-knit political and social network or likely to miss out on important points of contact (Butcher, 2002). While the Chinese government has poured in a huge amount of subsidies to promote venture businesses, all the benefits do not necessarily go to the businesses showing outstanding indicators. Wu and Cheng (2011) found that businesses enjoying a close relationship on the political network with the government statistically received more subsidies than those without such connections with the government. The returnee business founders ultimately find themselves starting out businesses in a condition extremely unfavorable to them. Researchers stated that the performance of a returnee business founders who run businesses under the following conditions has been improved while trying to fend off such disadvantages. Lin et al. (2014) have come up with three conditions: First come venture businesses where the government holds large shares. Among venture businesses in China, many of them are government-invested. Many of Chinese venture businesses are invested by the government agencies such as public universities and local governments. Though such venture businesses are under the management of returnee business founders with little domestic experience, the mere status of ownership by the government likely makes it possible to fend off associated difficulties. A business owned by the government more chances of being exposed to information on various political networks as well. Next comes with the status where the top manager has on hand direct connection links with the government. This is because in case a returnee business founder or its TMT members are former bureaucrats of the government or a member of a local assembly, they have a ready access to the nucleus of political connections. Then, in the case of a venture with significant portion of shares are owned by foreign origins, will it be helpful in fending off the weaknesses of the returnee business founders. Most of the related studies to date have been conducted on performance of the returnee business founders with respect to whether they were owned by the government (Lin et al. 2014; Li et al. 2012). Foreign equity shares are expected to have both a positive and negative synergy impacts on returnee business founders. A positive effect of technological excellence of the returnee business founder is likely to be affirmatively amplified. A conservative internal view could arise over whether such new technology could be applied to the Chinese market. Under such a circumstance, in the case of a venture business having much of equity shares possessed by foreigners, chances are that the venture business will act a robust advocate for the application of unidentified high technology. Second, in the case of a returnee business founder, his or her capability is likely to be assessed relatively lower than otherwise. With the recent influx of overseas-trained talents finding their way back to China, it is extremely difficult to tell good from bad. Under such circumstances, either a venture or the one that has acquired an ownership from the outset are very likely to send off affirmative signals to Chinese bureaucrats as well as investors in China. However, the opposite scenario is also plausible. First, the venture owned by foreigners is likely to find itself difficult to oversee and control opportunistic acts on the part of agents. Many of the studies on management such as Roth & O'Donnell (1996) have found that an enormous amount of agency costs were incurred. The agent who has deceived the government is likely to lose footings industry wide. Even in a venture fully owned by a returnee business founder or a private business, it is hardly likely that agency costs are incurred since the agent and principal coincide or due to close mutual interests. In the case of a venture where foreign stockholders own a large portion of the shares, the venture would fare badly in performance. Second, returnee business founders have a level of knowledge much higher than local Chinese business owners. They are likely to exercise power promptly against opportunistic behaviors that deceive foreign shareholders. Lin, Officer and Zou (2011) find a significant correlation between CEO's experience and agency costs. Therefore, the venture of returnee business founders owning foreign equity shares would act as a negative synergy. Based on the foregoing contradictory logic, this study comes up with two competing hypotheses as follows:

**Hypothesis 2-1:** Effects of the returnee business founder on the innovation performance are positively moderated by foreign ownership.

**Hypothesis 2-2:** Effects of the returnee business founder on the innovation performance are negatively moderated by foreign ownership.

#### 4. DATA AND EMPIRICAL MODELS

This study investigates the impact of returnee entrepreneurs on innovation performance in China. We use data from technology venture companies in Zhongguancun Science Park (ZSP) at Beijing, China collected in 2002. Since 1995, the Chinese government has been conducting surveys on venture companies in ZSP. However, since 2003, the survey system has been revised, and the variables of the most important key variables, returnee entrepreneurs and innovation performance, are missing in the questionnaire. The sample observations consist of 225 high-tech venture companies including China's electronics information industry, medicine, mechanical & electronic integration, biotechnology, new materials, new energy, and other fields. The survey includes not only basic information such as the size of the company and the establishment year, but also the personal information derived from the innovation performance of the enterprise and the experience of the manager overseas. The dependent variable is the *innovation performance* of returnee-led venture enterprise. To measure these variables, we used commercialized R&D projects for the last three years. Previous research has also used R&D projects as innovation outcomes (Lin et al. 2014). The main independent variable, the *returnee entrepreneur* variable, measures the experience in studying abroad, and coded as the dummy variable (1 for the personal who earned degrees from abroad, and 0 if not). *The number of local subsidiaries* indicates the external branches by the question, *how many subsidiaries do you have in other regions?* Corporate ownership structures are also important control variables related to innovation performance (Berger, Clarke, Klapper & Udell, 2005). To measure the ownership structure, 1 is coded when the *foreign* or *government ownership* dominates, and 0 for otherwise. And cut-off criterion for ownership is 50% share (Lin et al., 2014). We have selected various control variables that can affect the dependent variables so that we can identify the net effect of our independent variables. *Firm age* and *firm size* may influence access to resources and information that affect innovation performance (e.g., Lederman, 2010). The empirical literature linking firm innovation and market structure has assessed that innovation rises with the size of the firm (Lederman, 2010). And recent studies also found that firm age is closely related with innovation quality (Balasubramanian & Lee, 2008). *Firm size* is measured by number of total employees, and *firm age* is measured as the number of years since start-up.

#### 5. RESULTS AND DISCUSSION

Table 1 provides the descriptive statistics of key variables and correlation. About 19% of total sample report that their top managers are returnee entrepreneurs and mean value of firm age and size (i.e., number of employee) are 5.25 and 891.92 respectively. The negative binomial regression is applied to analyze our count dependent variable (Cameron & Trivedi, 1998).

**Table 1.** Correlation Matrix

|   |                              | Mean   | S.D.    | 1      | 2      | 3      | 4      | 5      | 6      | 7 |
|---|------------------------------|--------|---------|--------|--------|--------|--------|--------|--------|---|
| 1 | Innovation performance       | 7.07   | 16.26   | 1      |        |        |        |        |        |   |
| 2 | Returnee entrepreneur        | 0.19   | 0.39    | 0.007  | 1      |        |        |        |        |   |
| 3 | Firm age                     | 5.25   | 3.89    | 0.06   | -0.053 | 1      |        |        |        |   |
| 4 | Firm size                    | 891.92 | 2818.57 | 0.063  | 0.022  | 0.108  | 1      |        |        |   |
| 5 | Government ownership         | 0.30   | 0.46    | 0.039  | -0.13  | 0.295  | 0.19   | 1      |        |   |
| 6 | Foreign ownership            | 0.14   | 0.35    | 0.008  | 0.246  | 0.112  | 0.126  | -0.269 | 1      |   |
| 7 | Number of local subsidiaries | 1.69   | 0.46    | -0.076 | 0.012  | -0.019 | -0.217 | 0.066  | -0.071 | 1 |

In Table 2 results from negative binomial analysis support Hypothesis 1 ( $p < 0.01$ ). Competing Hypothesis 2 argues that the innovation performance is amplified or reduced when the venture of the returnee entrepreneur is foreign-owned. In Table 2, the coefficient value is negative as expected, but the statistical significance is marginal ( $p < 0.10$ ).

**Table 2. Empirical Results from Negative Binomial Regression**

|                                                      | Model 1              | Model 2              | Model 3              | Model 4              |
|------------------------------------------------------|----------------------|----------------------|----------------------|----------------------|
| Firm age                                             | 0.005<br>(0.861)     | 0.005<br>(0.855)     | 0.003<br>(0.908)     | 0.002<br>(0.946)     |
| Firm size                                            | 0.000<br>(0.168)     | 0.000<br>(0.304)     | 0.000<br>(0.742)     | 0.000<br>(0.127)     |
| Government ownership                                 | -4.855***<br>(0.000) | -4.634***<br>(0.000) | -2.006**<br>(0.010)  | -4.435***<br>(0.000) |
| Foreign ownership                                    | -5.241***<br>(0.000) | -5.017***<br>(0.000) | -2.384***<br>(0.003) | -4.701***<br>(0.000) |
| Number of local subsidiaries                         | -0.743***<br>(0.002) | -0.675***<br>(0.005) | -0.960***<br>(0.000) | -0.589**<br>(0.017)  |
| Returnee entrepreneur                                |                      | 0.394<br>(0.162)     | 0.879***<br>(0.009)  | 0.541*<br>(0.081)    |
| Returnee entrepreneur * Number of local subsidiaries |                      |                      | -0.658***<br>(0.000) |                      |
| Returnee entrepreneur * Foreign ownership            |                      |                      |                      | -0.142*<br>(0.095)   |
| chi2                                                 | 332.439              | 333.327              | 356.499              | 336.075              |
| N                                                    | 221                  | 217                  | 217                  | 217                  |

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01; P-values in parentheses

In sum, Hypothesis 1 was strongly supported, but Hypothesis 2-2 was marginally supported. The practical implications of this study are as follows. First, this study has practical implications in that it addresses more practical contingent effects surpassing immediate and direct effects on direct performance of the returnee business founder. A recent study (Lin et al. 2014; Li et al. 2012) found that returnee business founder had made does not yield statistically significant outcomes. The mere factor of a returnee itself has been alienated from the social network settings unique to China for a long time and is unfavorable in transforming technology into a reality in the complicated politico-social context inherent in China. External environments that can neutralize weaknesses of returnee while highlighting strengths of the returnee business founder could be more important. While many overseas talents are called back home to China yearly through One Thousand Manpower Program, very few of the returnee venture businesses only turned out successful. Therefore, to a policy maker it would be more important to learn what conditions to provide for those returnee business founders as well as induce them back to home. Second, this study is meaningful from a practical perspective in that the study reviewed the controlling capability of the returnee business founder by identifying the fact that the returnee business founder is rather poor in managing external subsidiaries, compared with local managers. This study expanded the scope of the study on the controlling of subsidiaries to embrace the context of returnee business founders. For efficient management of external subsidiaries, it is imperative to have the capability to understand customs and practices acceptable in the overseas local market. The findings of this study have confirmed that a returnee business founder should look out for expansion of external subsidiaries, and that in managing subsidiaries the local management staff needs to be consulted. Third, while a preceding study (Lin et al. 2014) made clear in detail returnee business founder's strengths of the venture owned by the government, no study is made available on the effects of the venture owned by foreign returnee business founders. While ventures of foreign origin could be helpful to the returnee business founder's challenging research activities, it could act as an obstacle from the standpoint that it could lower the level of an understanding of the local market. That is, a venture of a foreign origin rather hinders the innovation by a returnee business founder. This implies that the Chinese government would have to pay more attention if it is to succeed in inducing ventures of foreign origins possessing potentials.

This study has following limitations. Overseas experience of a business founder would not be limited to the Western world. The capability and strategic choices of a business founder who has experienced the markets of the United States and those of Japan or other Asian countries would differ. This study has a shortcoming in that it did not take into account such differences among countries. A certain business founder could have had only a few years' overseas experience while others could have had decades of experiences under their belt. Such solidity of experience could significantly affect performance of innovation as well. The nature of external subsidiaries would surpass simplicity measured in dummy variables. For example, an external subsidiary could simply be an agent, and another could take

charge of R&D functions. The secondary data used herein does not contain sufficient information on the foregoing variety of situations. It is expected that subsequent studies could follow up by means of multi-faceted analyses.

## AUTHOR BIOGRAPHIES

**Ping Yan** is an student of School of Business, Hanyang University.

**Yunhyeong Choi** is an mater degree student of School of Business, Hanyang University.

**Seong-jin Choi** is an assistant professor at School of Business, Hanyang University. His main research interests include the corporate political strategy, business-governance relationships, and returnee entrepreneurs in China.

**Sukyoong Jung** is an Assistant Professor of Accounting in Hanyang University, Seoul, South Korea. Corresponding Author, [sukyoong@hanyang.ac.kr](mailto:sukyoong@hanyang.ac.kr)

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