Stock payment and the effects of institutional and cultural differences: A study of shareholder value creation in cross-border M&As

Hyejin Cho, He Soung Ahn*

Korea University Business School, 145, Anam-ro, Seongbuk-gu, Seoul, 136-701, South Korea

ARTICLE INFO

Article history:
Received 14 December 2015
Received in revised form 17 October 2016
Accepted 20 October 2016
Available online xxx

Keywords:
Stock payment
Cross-border M&A
Institutional distance
Cultural distance
Shareholder value
Event study

ABSTRACT

Recognizing that cross-border mergers and acquisitions (M&As) are not alike in terms of how the payment method is structured, this paper investigates the role of stock payment that results in ownership sharing with foreign targets. Based on our empirical analysis using a sample of 4720 cross-border M&A deals during 1997–2012, we find that stock payment in cross-border M&As has a detrimental effect on shareholder value because of the negative signaling effect. We further show that stock payment can be beneficial when a foreign target located in a weaker institutional environment and when the cultural distance is larger. This implies that stock payment can be beneficial in deals with particularly large information asymmetry and agency problem. Upon the completion of a cross-border M&A, the acquirer and foreign target will form a new principal–agent relationship and our findings propose that stock payment can serve as an effective incentive mechanism that aligns the goals of the acquirer and target.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

Cross-border mergers and acquisitions (M&As) allow for complete access to all valuable resources embedded in a foreign target, and can contribute to a successful foreign entry by the acquirer. However, the increased burden of execution and the overheads of acquiring a foreign firm remain (Chen, 2008). When an acquirer fully acquires a foreign target, the former may seem to bear all the benefits and costs involved. However, the current paper focuses on the fact that not all cross-border M&As are alike because they differ in the structure of payment, and the proportion of stock or cash. Although the acquirer can be fully exposed to the market and business risks in cross-border M&As when payment is made only in cash, deals with stock payment allow target shareholders to become partial owners, which gives the latter the chance to realize benefits from the potential synergy as well as share the risks (Rappaport & Sirower, 1999). Specifically, we test the effect of stock payment on shareholder value and emphasize the contingencies that involve more risks, under which stock payment can play an important role.

The effect of payment method in M&A on shareholder value has been discussed in the finance literature. Owing to the inevitable information asymmetry that shareholders face, the choice of cash or stock by the acquirer provides an opportunity to understand how its management values its stocks as well as its ability to achieve synergy via M&As (Campbell, Sirmon, & Schijven, 2015; Fu, Lin, & Officer, 2013). Given the benefits of using overvalued stocks to pay for the target, such stock payment decisions can signal managers’ belief in the overvaluation of their stocks (Boone, Lie, & Liu, 2014; Chang, 1998; King, Dalton, Daily, & Covin, 2004). Furthermore, stock payment signals the fact that the acquirer has weaker confidence with respect to the ex post value of the acquisition (Fuller, Netter & Stegemoller, 2002). An acquirer with more confidence in the outcome of an M&A is likely to pay in cash because it believes that stocks will eventually be worth more in the future.

While the negative signaling effect of stock payment in domestic M&A has been proposed in the literature, the analysis of such an effect in the cross-border M&A context lacks attention. To address this gap in the literature, we test the signaling effect of stock payment, particularly in cross-border M&As. Cross-border M&As are characterized by greater information asymmetry and a higher risk of the improper evaluation of a foreign target than domestic M&As (Gatignon & Anderson, 1988). Acquirers engaging in cross-border M&As also face the additional burden of integrating foreign target shareholders — who are accustomed to their own local values, rules, and regulations — into the current ownership structure. Due to this nature of cross-border M&As, a stock...
payment decision is expected to have a negative signaling effect on cross-border M&As, thereby leading to a deterioration in shareholder value. While Dutta, Saadi, and Zhu (2013) demonstrate the positive effect of stock payment on shareholder value by using a sample of cross-border M&As by Canadian acquirers during 1992–2002, our cross-sectional sample including deals between 1997 and 2012 and acquirers from 42 countries allows us to further analyze the generalized effect of stock payment with a broader sample.

Despite the predicted detrimental effect of stock payment on shareholder value in cross-border M&As, simply concluding that stock payment is an unfavorable method of payment leaves incomplete our understanding of why firms adopt such a choice. We focus on two major contingencies, the level of institutional development and cultural distance of the target, under which stock payment plays a beneficial role. While cross-border M&A literature has extensively analyzed the implications of national distance between an acquirer and a foreign target (e.g., Chakrabarti, Gupta-Mukherjee, & Jayaraman, 2009; Morosini, Shane, & Singh, 1998; Reus & Lamont, 2009), our study analyses the joint effect of stock payment and national distance on shareholder value.

National distance between an acquirer and a foreign target is closely related to the level of information asymmetry and uncertainty, which the acquirer will face after a cross-border M&A deal is closed. After a cross-border M&A is completed, the increase in information asymmetry and uncertainty creates greater scope for agency problems in the principal–agent relationship created between the acquirer and target. That is, the agent (i.e., newly acquired firm) is expected to make decisions that are congruent with those preferred by the principal (i.e., acquiring firm), while it may have its own goal and engage in actions that deviate from the acquiring firm’s interest (Holmstrom, 1979). Agency theory suggests that agency problems intensify when the information asymmetry between the principal and agent is larger, since it is hard to monitor the agent’s behavior (Fama & Jensen, 1983). In such circumstances, stock payment can be an incentive to align the goals of the agent with those of the principal (Jensen & Meckling, 1976). Moreover, the international business (IB) literature on international joint ventures (IJVs) also supports the idea of the benefits of partial ownership and suggests that the amount of stock a firm holds in the newly set-up JV is a decision that aims to reduce the risks or costs involved in the new business (Malhotra, Sivakumar, & Zhu, 2011; Morschett, Schramm-Klein, & Swoboda, 2010; Richards, 2000; Yamin & Golesorkhi, 2010). Sharing ownership with another party has been argued to have the benefit of increasing its willingness to cooperate and of accessing market knowledge (Chari & Chang, 2009; Chen & Hennart, 2004; Malhotra et al., 2011). Based on these ideas, our research suggests that the intensified information asymmetry and uncertainty from larger national differences between the acquirer and target can be mitigated by stock payment.

The disparity in the national institutions of the acquirer and the target contributes to the magnitude of the difficulties that acquirers face in cross-border M&As (Dikova, Sahib, & van Witteloostuijn, 2010). Given that a lack of institutional development imposes considerable uncertainty and business risks because of market failures (Khanna & Palepu, 2000), we propose that stock payment in cross-border M&As is particularly beneficial when a deal involves targets located in less institutionally developed nations, as the acquirer can enjoy the support of the target’s shareholders in ex post contract enforcement (Chen & Hennart, 2004). A similar argument can be applied to the domain of cultural distance, which is inevitable in any transaction between firms from two different nations. Differences in national characteristics such as informal values and norms (Hofstede, 1980, 1991; Kagot & Singh, 1988) increase uncertainty and risk for the acquirer. An acquirer needs to adjust the organizational routines and practices in a foreign target to accommodate a different cultural environment. Thus, we argue that the risks associated with a lack of familiarity with the national culture of the target can be addressed by the remaining target shareholders via stock payment.

In fact, there is recognition in the IB literature that acquirers have a greater tendency to use certain payment structures to mitigate risk in cross-border M&As. For instance, Reuer, Shenkar, and Raguzzino (2004) empirically test whether an acquirer attempts to mitigate risk in cross-border M&A by using a performance-contingent payout structure that ties the target to the post-performance of an M&A deal; they demonstrate that the likelihood of the acquirer using contingent payout in a cross-border M&A is higher when information asymmetry is particularly high. If a link exists between higher information asymmetry and the adoption of contingent payout as they suggest, then the benefits of stock payment should be valued by shareholders and reflected in shareholder value. Accordingly, we suggest that the risk-mitigating role of stock payment positively influences shareholder value when information asymmetry and uncertainty are intensified due to larger national differences.

The above arguments are empirically tested by using a sample of 4720 cross-border M&As during the period 1997–2012. We focus on the 10% of full acquisition through which the acquirer becomes the owner of the target firm. At the same time, the variation in the level of stock payment within the sample of full acquisitions implies that different levels of partial ownership by the target’s shareholders exist. First, we find empirical support that stock payment has a negative effect on shareholder value and measure this with an event study method using cross-border M&A announcements. This result can be interpreted such that stock payment in cross-border M&A signals negative information to the market in general. We further show that although the choice of stock payment has a negative effect in general, it retains the potential to act as a risk-diverging mechanism when a particular cross-border M&A deal involves a target firm located in a less institutionally developed and culturally distant nation. Multiple robustness tests on the long-term performance variables and institutional/cultural distance variables also support the main empirical findings of this paper.

This paper makes three major contributions to the literature. First, we extend previous finance literature on the signaling effect of payment method in M&A by showing its applicability in a cross-border context. Given that stock payment is expected to have a negative effect on shareholder value owing to the signaling of a manager’s evaluation of stock value or M&A deal value, we test its effect on cross-border M&As, which is less researched in the literature. Contrary to Dutta et al. (2013), who demonstrate a positive effect of stock payment on shareholder value by using a sample of cross-border M&As by Canadian acquirers, we show that stock payment has a negative effect on shareholder value in cross-border M&A in general, which is aligned with the negative signaling hypothesis in the finance literature. Our finding provides the insight that the choice of stock payment is an influencing factor in cross-border M&As, especially because foreign target shareholders in the ownership structure create complexity in the governance dynamics.

Second, our study extends agency theory within the scope of the IB literature by focusing on an underexplored context to test the value of an incentive mechanism that reduces agency problems. Agency theory has previously been applied to the IB literature to explain the relationship between the headquarters and foreign subsidiary as a principal–agent relationship and studies have paid attention to remedies for reducing agency problems (e.g., direct monitoring of target management) by focusing on the periods after such a relationship is formed (Eisenhardt, 1985;