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International investors' reactions to cross-border acquisitions by emerging market multinationals

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ABSTRACT

How do international investors react to announcements of cross-border mergers and acquisitions (CM&As) by emerging market multinational enterprises (EMNEs)? Using a unique and manually-constructed firm-level dataset, this paper examines the stock price reactions to CM&A announcements made over the period 1991–2010 by Chinese MNEs listed on the Hong Kong Stock Exchange and the wealth impacts of their corporate governance. Our empirical findings confirm a positive stock price reaction on average, and suggest that international investors react positively to the presence of large shareholders, but negatively to the presence of institutional shareholders. There is a negative impact if the largest shareholder is either the State or the corporate founder. We suggest that this is because the international investors perceive potential principal–principal conflicts in such ownership/control constellations and discount equity prices accordingly. We also find that Board size and independence have positive effects on the price reaction, but that large supervisory boards engender negative reactions.

1. Introduction

The last decade has witnessed a remarkable surge of outward foreign direct investment (OFDI) from developing economies. Whilst FDI outflows from developed countries declined during and after the global financial crisis of 2007–2008, the developing economies' share of the world's FDI flows continued to rise, surging from 13.5% in 2007 to 24.8% by 2011 (UNCTAD, 2011). One of the primary internationalisation modes for developing country firms has been cross-border mergers and acquisitions (CM&As) (Bhagat, Malhotra, & Zhu, 2011). The share of the world's CM&As made by firms from developing countries nearly doubled from 15% in 2005 to 29% in 2010 (UNCTAD, 2011). In particular, CM&As are the dominant internationalization mode for Chinese firms (Sun, Peng, Ren, & Yan, 2012).

There is a considerable literature investigating the impact of foreign acquisitions by listed companies upon shareholder wealth, and the determinants of the size of that impact. Most of these empirical studies use data for multinational enterprises (MNEs) from the United States or other developed economies, and there are few that focus on multinationals from developing and/or emerging economies (EMNEs). But there are good reasons to suspect that the impact determinants will differ for EMNEs, both because of their different ownership and/or control characteristics and because of the weaker corporate governance and investor protection regimes in their home countries. CM&As are critical strategic decisions that are made by executives (agents) under the supervision of Boards of Directors on behalf of the shareholders (principles). In emerging market economies, formal institutions and external governance mechanisms to protect property rights are often weak or absent, so shareholder concentration is common in order to reduce agent discretion and principal–agent (PA) conflicts (Claessens, Djankov, Fan, & Lang, 2002). However, such shareholding concentrations may also give rise to principal–principal (PP) conflicts whereby controlling shareholders are minded to expropriate the interests of minority shareholders (Claessens, Djankov, & Lang, 2000; Dharwadkar, George, & Brandes, 2000).

EMNEs can take action to offset the weakness of their governance systems at home by internationalising, such as via cross-listing in developed countries to "bond" to better legal and regulatory regimes (Coffee, 1999; Doidge, Karolyi, & Stulz, 2004; Reese & Weisbach, 2002; Stulz, 1999). Indeed, it has been suggested that EMNEs incorporated or cross-listed in developed countries should have a lower risk of information asymmetry and a higher firm value than their domestic counterparts (Lang, Lins, & Miller, 2003; Sami & Zhou, 2008). In this paper, we investigate the shareholder wealth effects in a sample of 335 acquisitions made by Chinese MNEs over the period 1991–2010. A novelty is that we limit our sample to Chinese MNEs that are listed on the Hong Kong Stock Exchange (HKSE). The HKSE adopts international rules for financial reporting, and these are much stricter than in

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China. The HKSE-listed companies are thus committed to higher disclosure standards than in the domestic Chinese market. Furthermore, domestic Chinese investors are restricted from trading H-shares or investing in Chinese firms incorporate in Hong Kong, hence we will be assessing the reaction of international investors to the CM&A announcements. Such international investors may be assumed to have many potential investment opportunities, and moreover to have the means and expertise to make relatively balanced judgments of the merits of individual CM&A deals. We hypothesise that several dimensions of ownership structure and corporate control, and various internal control mechanisms, should have an impact upon the stock market reactions by international investors to announcements of CM&As.

The paper is structured as follows. We first develop our hypotheses in the light of recent theoretical and empirical work on CM&As. In the following section, we provide a detailed description of the dataset and outline the event study methodology to be used to assess the stock market reactions to the CM&A announcements. We then report our research results first on shareholder value creation and secondly on the relationships between shareholder returns and corporate governance. The last section concludes the paper.

2. Literature review and hypothesis development

2.1. The stock market reaction to announcements of cross-border acquisitions

Both internalisation theory and the resource-based view suggest that firms undertaking FDI must possess some ownership (firm-specific) advantages that not only permit them to be competitive in their home markets, but also allows them to offset the additional costs associated with operating in an overseas market (Zaheer, 1995). The markets for such intermediate products (semi-processed materials, together with various types of knowledge and expertise embodied in human capital and other intangible assets) are typically imperfect, so that FDI is preferred to arm's length contractual arrangements (e.g. licensing) (Buckley & Strange, 2010). Furthermore, FDI may also allow firms to diversify risks and stabilise earnings, because market returns in different geographical areas often show low correlation. It follows that firms will undertake FDI if future synergistic benefits are envisaged and, to the extent that this judgment is shared by investors and markets are efficient (in that prices reflect all available information), the share price of the investing firm should rise on the announcement of the FDI project to reflect this expectation – there will be 'value creation'. This rise in the share price should be evident whether the FDI takes the form of a greenfield venture or the (full or partial) acquisition of a target firm in the overseas host economy. When the FDI takes the form of an acquisition, it is reasonable to assume that the investing firm will transfer some knowledge and expertise to or from the target firm – unless the investment is made purely and simply for the purposes of a financial return – and that some of the potential gain from the FDI project will be reflected in a premium paid for the shares of the acquiring firm (Meyer, Estrin, Bhaumik, & Peng, 2009). If the acquirers are listed, then its share price should thus rise on the announcement of the FDI project as information about the acquisition is made public. This stock market reaction can be assessed either as the abnormal return (AR) on the day of the announcement, or as a cumulative abnormal return (CAR) over an 'event window' around the day of the announcement[1].

[1] See Section 3 for further explanation.

Now the stock markets may have a more sceptical view of the potential synergies from the foreign acquisition[2], and may not have confidence in the firm's strategy, the timing of the FDI project, or the management's ability to implement the project successfully (Woolridge & Snow, 1990; Shimizu, Hitt, Vaidyanath, & Pisano, 2004). It is well-known that many acquisitions, both domestic and cross-border, do not realise the expected synergies either because the integration process proves more difficult or more protracted than expected, or because there were surplus assets and capabilities (including labour) than were costly to release (Shimizu et al., 2004). Moreover, investors may question whether the managers of the acquirer firm make rational and objective decisions based upon the risks and potential gains from the FDI project, whether they overpay for target firms because of hubris, or mould firm strategy to their own objectives (Seth, Song, & Pettit, 2000). Such scepticism will be reflected in a reduced (possibly even negative) share price reaction for the acquiring firm, the target firm, or both.

There is a considerable empirical literature focusing on the short-run stock reactions of acquirer firms to announcements of cross-border acquisitions[3]: see, for example, (Doukas & Travlos, 1988; Conn & Connell, 1990; Morck & Yeung, 1992; Kang, 1993; Markides & Ittner, 1994; Datta & Puia, 1995; Cakici, Hessel, & Tandon, 1996; Conn, Cosh, Guest, & Hughes, 2005; Moeller & Schlingemann, 2005; Doukas & Kan, 2006; Aybar & Ficici, 2009; Feito-Ruiz & Menéndez-Requejo, 2009; Chari, Ouimet, & Tesar, 2010; Von-Eije & Wiegerinck, 2010). Most of these studies have used data on US or other developed economy firms, and few strong conclusions may be drawn: some studies report an average share price reaction that is positive and statistically significant; some a reaction that is negative and statistically significant; and others find evidence that is inconclusive. There are a limited number of studies of CM&As by EMNEs, and again the results are mixed. For example Aybar and Ficici (2009) reported an average negative stock market responses to CM&A announcements by a sample of EMNEs from 11 countries, whereas Bhagat et al. (2011) found a significant positive market reaction to announcements in a sample of EMNEs from eight emerging markets. Chen and Young (2010) showed that Chinese acquiring MNEs have negative average CARs, whereas Boateng, Qian, & Tianle (2008) and Kling and Weitzel (2011) showed positive CARs for their samples of Chinese firms[4].

[2] There is a range of research that has discussed the general benefits of CM&As. Shimizu et al. (2004) proposed three perspectives in understanding CM&As based on the previous literature: CM&As as an international entry mode, learning opportunities of a foreign culture, and a value creation strategy. Additionally, Sun et al. (2012) provides the additional view that CM&As allows MNEs to continue enjoying national industrial factor endowments, as well as a reconfiguration of their value chain and facilitation to overcome institutional constraints. Value creation has been the key perspective in the literature. This paper examines the value creation implications of EMNEs' corporate governance.

[3] This literature appears in both IB and finance journals, and different terminology is often used for the same concepts.

[4] In more detail, Aybar and Ficici (2009) analysed 433 CM&A announcements made by 58 EMNEs during the 1991–2004 period, and showed that equity market responses are negative on average to CM&A announcements by EMNEs in 11 countries. Chen and Young (2010) studied 39 deals by 32 Chinese MNEs from 2000 to 2008 and showed Chinese acquiring MNEs have negative average CARs and those with greater government ownership generate lower value returns in CM&As. In contrast, Bhagat et al. (2011) show a significant positive market reaction based on an analysis of 698 CM&A announcements by EMNEs from eight emerging markets from 1991 to 2008. Gubbi et al. (2010) showed that CM&As create significant positive shareholder value for Indian acquiring MNEs using an event study of 425 acquisitions during 2000–2007. Kohli and Mann (2012) study a sample of 202 CM&As and 66 domestic M&As, concluding that the former generate superior wealth gains than the latter in India. Boateng et al. (2008) examined a small sample of 27 Chinese CM&As in a short period between 2000 and 2004 and saw positive value creation for acquiring firms' shareholders. Kling and Weitzel (2011) analysed 221 CM&A announcement events of Chinese firms listed in the Hong Kong, Shanghai or Shenzhen stock exchanges between 2001 and 2008 and concluded that CM&As created positive shareholder value but to a lesser extent than domestic M&As.