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The long-term performance of acquiring firms: A re-examination of an anomaly

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ABSTRACT

In this paper, we investigate the long-term stock return performance of Canadian acquiring firms in the post-event period by using 1300 M&A events in the 1993–2002 period. We use both event-time and calendar-time approaches and conduct robustness tests for benchmarks, methodological choices, statistical techniques and other related factors such as payment methods. We also assess the role of governance variables. Contrary to stylized facts reported in US studies, neither do we find negative abnormal long-term abnormal stock market returns once we account for methodological discrepancies nor do we find negative long-term operating performance in the post-acquisition periods for the acquirer following an acquisition event. We also find that the Canadian market reacts positively to acquisition announcements but corrects for this reaction within a short period of time. Overall we find that Canadian acquisitions do not show value destruction or overpayment.

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1. Introduction

Over the last two decades mergers and acquisitions (M&A) related issues have drawn considerable interest from practitioners and academics. As a result, scores of empirical studies have documented various aspects of M&A activity including trends in M&A activity, and characteristics of the transactions and corresponding gains or losses to shareholders. While a majority of the existing empirical evidence focuses on the stock returns immediately surrounding announcement dates, a smaller body of research has examined long-run post-acquisition returns (Martynova and Renneboog, 2008). Most of these long-term studies based on US data conclude that acquiring[1] firms experience significant negative abnormal returns over a one to three year period after the merger (Agrawal et al., 1992; Moeller et al., 2003). However, as noted by Fama (1998) and Mitchell and Stafford (2000) many of these empirical studies resort to different methodological choices (event-time vs. calendar-time approach) and that various factors (such as payment methods, merger, or tender offer) may affect the conclusions of these papers. Moreover, many of these studies are based on overlapping US data and suffer from data mining biases. This has motivated us to undertake this study using comprehensive data on Canadian acquiring firms to provide an out-of-sample study, and to test the results with more modern and robust methodologies and statistical techniques. Our sample consists of 1300 acquisitions during the period of 1993–2002 and uses both event-time and calendar-time approaches and multiple benchmarks to analyze the long-term post-acquisition stock and operating performance of acquiring firms.

Our results show that there are no significant long-term negative abnormal returns for Canadian acquirers, once we carefully account for methodological issues. Our results are robust across factors including: (i) mode of acquisition (tender or merger), (ii) target type (public or private), (iii) related or unrelated target, (iv) payment type (stock, cash or mixed), (v) growth or value acquirer, (vi) board independence, (vii) level of managerial ownership, and (viii) relative size of the deals.

Our study contributes to the literature in several ways. First, in this study we examine Canadian acquiring firms, and thus present out-of-sample evidence with a different but well-developed country capital market and a different regulatory regime. For example, one of the most important differences in these two countries is the form of M&A antitrust regulation. Antitrust regulation is stricter, more developed, and less favorable to acquiring firms in the US than in Canada. While in the US, courts may proceed against acquisitions on market concentration grounds alone, Section 92(2) of the Competition Act (of Canada) expressly prohibits a finding of merger harm – i.e., a substantial lessening of competition – solely on the basis of concentration or market share (Green, 1993, p. 193). Furthermore, compared to Canadian firms, US firms more

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[1] In this study we use 'bidder' and 'acquirer' interchangeably, as we consider only the completed deals in the study.

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frequently adopt anti-takeover strategies such as shareholder's rights plan, poison pills, and shark repellent. In Canada, anti-takeover plans are typically rendered ineffective by the securities commission(s) at the request of the bidder (Brealey et al., 2006). Also, cash payments represent the majority of Canadian acquisitions, whereas stock payments represent the majority of US deals (Eckbo and Thorburn, 2000; Loughran and Vijh, 1997) and thus have implications on the choice of the target. Overall, such differences between the US and Canadian markets could affect the target selection process, the propensity of M&A activities, the price paid, and, more importantly, post-acquisition performance.[2]

Second, we pay considerable attention to the methodological issues to ensure that results about long-term abnormal returns are consistent across different methodological choices. Accordingly, we use both an event-time approach (buy-and-hold abnormal return) and a calendar-time approach Fama French (F–F hereafter) three factor regression and incorporate various adjustments to test statistics to mitigate methodological problems in our study. As stated earlier, we further investigate the robustness of the results by examining the impact of a set of deal- and firm-specific factors (such as corporate governance of acquiring firms and target type) on the long-term abnormal returns of acquiring firms.

Third, we check the consistency of our results with respect to short-term market reactions to an acquisition event around the announcement date and long-term operating performance. Earlier studies that report long-term abnormal returns assume that the market gradually reassesses the quality of acquiring firms as the results of the acquisition become more clear (Rau and Vermaelen, 1998). We examine this issue by calculating abnormal returns around the announcement dates. Our results show that initial overreactions in the Canadian market are followed by negative corrections and cumulative abnormal returns become insignificant within 15 days of an announcement date. This result is consistent with long-term stock performance outcomes that do not show any abnormal negative returns during the three years after the effective date of an acquisition. Our results also show that there is no significant difference between three year post-acquisition and three year pre-acquisition operating performance of Canadian acquiring firms.

Fourth, we believe that our study is the most comprehensive study of the recent Canadian M&A environment. Despite vibrant M&A activity in Canada, studies examining the long-term stock performance of Canadian acquiring firms are scarce.[3] Strictly speaking, there are only two studies in this area.[4] Eckbo and Thorburn (2000) report the performance of Canadian and US bidder firms acquiring Canadian targets over 1964–1983 period. The study reported a decline in stock return performance for the bidders in the post 12-month period, but the results were not statistically significant. Andre et al. (2004) reported significant underperformance for Canadian acquirers but they used a very limited sample size (143 events for non-overlapping stocks) and only calendar-time methodology. They also use Fama–French factor returns (in a Canadian context) that are not publicly available; therefore it is not clear whether their results are due to a small sample size as well as their construction of factor returns. Our study thus fills a large gap in the Canadian literature.

The remainder of the paper is organized as follows: Section 2 presents the literature review, Section 3 presents data and methodology, Section 4 presents results and discussions, and finally, Section 5 presents a summary and conclusions.

[2] For example, Hagendorff et al. (2008) have shown that bidding banks realize higher returns when targeting low protection economies.

[3] As reported by Crosbie & Co., a Toronto-based merchant bank, the total transaction value of the announced deals during 2006 was $257 billion with 1968 deals.

[4] There are two other recent studies by Yuce and Ng (2005) and Ben-Amar and Andre (2006) which focus on short term results only.

2. Literature review

In a somewhat recent paper, Agrawal and Jaffe (2000) have presented a detailed review of past influential studies on the long-term post-acquisition performance of acquiring firms. They concluded that, "in our opinion, the work starting with Franks et al. (1991) shows strong evidence of abnormal under-performance following mergers. Except for Franks et al. (1991) itself, each paper shows at least some evidence of under-performance" (p. 50). We do not intend to repeat their work here and only present a summary of relevant studies below (Table 1).

As can be seen, most of the studies presented in Table 1 (dominated by US studies and many with overlapping sample periods) report negative long-term abnormal returns. However, two issues are worth mentioning with respect to these studies. First, the introduction of the Buy-and-hold methodology has resulted in a great deal of controversy in the reported results. As reported by Mitchell and Stafford (2000), once the biases in the buy-and-hold abnormal return (BHAR) methodology were corrected, the long-term abnormal returns were found not to be statistically significant. Second, studies using a comprehensive set of benchmarks and methodologies generally presented inconclusive evidence or no abnormal returns. For example, Franks et al. (1991), using multiple benchmarks, concluded that the observation of long-term underperformance is likely due to benchmark errors. Fama (1998) investigated a set of past studies that examined the long-term abnormal performance following a corporate event (such as IPO, mergers, stock-split) and concluded that "consistent with the market efficiency hypothesis that the anomalies are chance results, apparent overreaction of stock prices to information is about as common as under-reaction. And post-event continuation of pre-event abnormal returns is about as frequent as post-event reversal" (p. 304). Notwithstanding such arguments, evidence of negative long-term underperformance in the US as presented in some of the detailed and careful studies (such as Rau and Vermaelen, 1998) remains a puzzle.

A smaller set of other studies examined the impact of a number of deal- and firm-specific factors on acquiring firms' abnormal returns. The rationale behind these factors and the relevant empirical evidences are summarized below (Table 2).

As can be seen (Table 2), many conjectures and theories proposed in the literature may have potential influence on empirical findings and thus need to be accounted for in empirical studies. However, one may argue that these factors would influence the short-term returns around the announcement date and the stock price would be adjusted accordingly in the short-run. As a result, there should not be any systematic long-term stock market underperformance (or over performance) for the acquiring firms.

3. Data and methodology

3.1. Data

This study considers all Canadian M&A deals that occurred between 1993 and 2002 and involved a TSX-listed bidding company. We obtain our dataset from the SDC Thomson Financial Database. Our data meet the following criteria: (i) the deals were completed, (ii) the acquiring firm was not from the financial industry, (iii) acquiring firms with multiple acquisitions during 1993–2002 period were considered, and (iv) deals with all sizes of transaction value were considered.[5] Stock return data was collected from the CFMRC (Canadian Financial Market Research Center) database.

[5] Out of 1300 acquisitions considered in the study, only 88 acquisitions have transaction values less than $1 million CDN.

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