



Does ownership concentration improve M&A outcomes in emerging markets? Evidence from India

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ABSTRACT

Using firm level data from India, we examine the impact of ownership concentration on post-M&A performance of firms. Our analysis has implications for both the M&A literature, which emphasises the role of agency conflict between managers and owners of widely held companies as a key reason for M&A failures, and the corporate governance literature, especially in the context of emerging market economies. A cautious interpretation of our results suggests that while ownership concentration may reduce the manager–owner agency conflict, it may nevertheless precipitate other forms of agency conflict such that ownership concentration may not necessarily improve post-M&A performance. In particular, our results have implications for the literature on the agency conflict between large (or majority) shareholders and small (or minority) shareholders of a company, especially in contexts such as emerging market economies where corporate governance quality is weak.

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1. Introduction

In this paper, we extend the literature on (and hence add to our understanding of) two different, yet related, phenomena. Our main contribution is to the literature on mergers and acquisitions (M&As). In the early literature on M&As, a large proportion of the empirical studies concluded that M&As fail to add value or contribute to the financial well being of the acquiring firm.¹ A dominant explanation of the inability of the average M&A to add to the performance of the acquiring firm is the well-known agency conflict – i.e., divergence of interests – between managers and owners, whereby managers of the firm take decisions that are not necessarily in the best interests of the shareholders (Shleifer and Vishny, 1988).²

The premise that M&As do not create value for the acquiring firm, on average, has since been brought into question. Netter et al. (2011), for example, have argued that this observation about the outcome of M&As could be an artefact of the samples that

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¹ This conclusion was drawn by the majority of studies that used event study analysis (Agrawal et al., 1992; Asquith, 1983), and also the majority of those that undertook comparison of pre- and post-M&A financial performance (Ghosh, 2001; Ravenscraft and Scherer, 1989).

² Alternative explanations include managerial hubris (Roll, 1986), organisational differences between target and acquiring firms (Datta, 1991), and pre-commitment to the M&A irrespective of likely outcomes to the merger (Haunschild et al., 1994).

were used in the earlier literature, which focused on M&As involving larger publicly traded companies.³ We extend this literature by examining another aspect of the stylised discussion, namely, the aforementioned agency conflict between managers and owners. We examine the impact of concentration or ownership in the hands of insiders such as business promoters and directors on M&A outcomes in India, where such concentration of ownership is commonplace, generally by way of family businesses and business groups. We hypothesise that concentration of ownership in the hands of insiders will ameliorate agency conflict between managers and owners, and therefore have a positive impact on post-M&A firm performance, either because the insiders will then have a greater incentive to monitor the managers or, as is more likely in the context of India, these insiders themselves will then be involved in making strategic and managerial decisions for the firms. Our analysis extends that of Yen and Andre (2007), and complements the growing literature on the relationship between management ownership and firm value in emerging market economies, which indicates that a firm's value may be positively affected by concentration of ownership in the hands of insider-managers (Ryu and Yoo, 2011).

Our analysis also has implications for the wider literature on corporate governance. It has long been argued that in contexts (largely ignored in Yen and Andre's analysis)⁴ where ownership concentration coexists with weak corporate governance mechanisms, the agency conflict between managers and owners is merely replaced by another type of agency conflict, whereby (the generally concentrated) ownership structures persist to facilitate expropriation of small or minority shareholders by the large or majority shareholders such as promoters and families (Villalonga and Amit, 2006; Young et al., 2008).⁵ In the words of Villalonga and Amit (2006), in such firms, *Agency Problem I* (between managers and owners) is mitigated, but it is replaced by *Agency Problem II* (between large or majority shareholders and small or minority shareholders). Fan et al. (2011), however, have argued that it is conceptually difficult to attribute the persistence of certain ownership structures solely to expropriation, and that there could be other reasons for such persistence such as potential financing benefits (Almeida and Wolfenzon, 2006; Almeida et al., 2011). In an argument similar to that of Netter et al. (2011), it has also been suggested that the popular wisdom about expropriation in family businesses and business group affiliated firms that have concentrated ownership is an artefact of sample selection. Hamelin (2011), for example, does not find any evidence of expropriation in small business groups.

If the popular wisdom about the aforementioned *Agency Problem II* in firms with concentrated ownership is accurate, strategic decisions such as M&As that divert a firm's resources away from disbursement among shareholders would be expected to lead to (sometimes unobservable) benefits to the majority shareholders,⁶ without adding to firm performance that can benefit all shareholders in the long run. Therefore, should we observe that concentration of ownership in the hands of insiders such as promoters and directors improves post-M&A firm performance (as hypothesised), it would be a refutation of any presumption of a causal link between ownership concentration in the hands of insider-majority shareholders and presence of agency conflict between large (or majority) shareholders and small (or minority) shareholders. In other words, if the null hypothesis about the positive impact of ownership concentration on M&A outcomes cannot be rejected, it would be reasonable to conclude that while ownership concentration reduces *Agency Problem I* (between managers and owners) that may be responsible for adverse M&A outcomes in a large number of cases, it does not necessarily trigger *Agency Problem II* (between large or majority and small or minority shareholders) that often co-exists with non-pecuniary benefits for large or majority shareholders and is to the detriment of the small or minority shareholders.

By juxtaposing the two types of agency problems, and drawing on evidence from India, an emerging market economy where ownership concentration by way of family ownership and business group affiliation is ubiquitous and where corporate governance quality is weak, we also enhance our understanding of the basic structural and behavioural differences between firms in emerging markets and developed economies. As argued by Fan et al. (2011), this is one the key directions in which future research should be extended.

Our results suggest that during the 1995–2000 period, post-M&A profitability of the average firm in India was positively correlated with high degrees of ownership concentration (i.e., greater than 50% of the shares) in the hands of its directors. We also find that in the 2001–2004 period, while ownership concentration in the hands of foreign promoters enhanced post-M&A profitability – in contrast to the findings of Zhou et al. (2011), ownership concentration in the hands of Indian promoters did not have any impact on post-M&A firm performance. A cautious interpretation of the more reliable regression results for the 2001–2004 period is that while ownership concentration may reduce *Agency Problem I* (between managers and owners), it may increase *Agency Problem II* (between large or majority and small or minority shareholders), such that ownership concentration in the hands of insiders may not necessarily improve M&A outcomes. This interpretation, which is reasonable for a context with low quality of corporate governance, is inconsistent with the limited evidence (almost entirely from developed countries) about the impact of ownership concentration on M&A outcomes (Yen and Andre, 2007), and with the evidence about the relationship between ownership concentration and firm value (Ryu and Yoo, 2011). However, it is consistent with the view of Fan et al. (2011) that emerging market firms may be fundamentally different from developed country firms, such that firm characteristics such as ownership concentration may have quite different implications for these two types of firms.

³ Netter et al. (2011) demonstrate that the typical empirical study on M&As in the US used a sample of 3000–4000 M&A events. The full set of SDC M&As for the 2002–09 period, by comparison, included over 310,000 M&A deals, of which about 128,000 involved US acquirers.

⁴ Of the 287 acquiring firms in the sample of Yen and Andre (2007), 244 were from three developed countries: Australia (25), Canada (77) and the United Kingdom (142). India accounts for 6 firms in their sample, and developing countries account for a total of 22 acquiring firms.

⁵ For a detailed review of the literature, see Bhaumik and Gregoriou (2010).

⁶ Indeed, while this does not amount to direct expropriation of minority shareholders, by way of tunnelling, for example, since the M&A leads to diversion of current or future resources that could have been returned to (among others) minority shareholders, it would de facto be expropriation.

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