



# Partial acquisitions in emerging markets: A test of the strategic market entry and corporate control hypotheses

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## ABSTRACT

In this paper, we examine the motivations of acquirers undertaking partial acquisitions in emerging markets by testing two competing hypotheses: the market for corporate control hypothesis and the market entry hypothesis. We find that targets of cross-border acquisitions outperform targets of domestic acquisitions in the pre-acquisition period. While cross-border acquisitions have no significant impact on target firms' operating performance, targets of domestic acquisitions experience significant improvements in operating performance and substantial changes in ownership structure after the acquisition. The evidence suggests that domestic partial acquisitions in emerging markets serve as a market for corporate control, while cross-border partial acquisitions are motivated by the strategic market entry rationale.

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## 1. Introduction

The past decade has witnessed a significant increase in merger and acquisition (M&A) activities in both developed and developing, or emerging, markets. A significant number of these transactions have involved cross-border acquisitions undertaken by multinational firms. According to the United Nations Conference on Trade and Development (WIR, 2007), the value of cross-border acquisitions increased by 88% to \$716 billion from 2004 to 2006, and the number of deals rose by 20% to a total of 6134. Although the majority of the cross-border M&As took place in developed countries, an increasing number are taking place in emerging countries (WIR, 2007).<sup>3</sup> The four leading emerging countries—Brazil, Russia, India, and China—are in the list of the most attractive cross-border M&A destinations in the world (WIR, 2007).

There appears to be two competing motivations behind these acquisitions in emerging markets: the market for corporate control and the strategic market entry hypotheses. The market for corporate control hypothesis, which states that poorly performing companies become takeover targets in a competitive takeover market, has been extensively examined within the context of domestic acquisitions in developed markets. In the context of cross-border acquisitions, an alternate hypothesis—the

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<sup>3</sup> According to the SDC Platinum database, domestic (within-country) acquisitions also reached US \$2500 billion in 2007, thus surpassing the record set in 2000.

strategic market entry hypothesis—is suggested as an important motive. However, there is little empirical examination in the literature comparing these two competing hypotheses.<sup>4</sup>

Accordingly, we focus on domestic and cross-border acquisitions in emerging markets in order to test these two competing rationales. Emerging markets are an ideal choice for our study for a number of reasons. First, due to the significant market potential in these countries, foreign companies are actively looking for opportunities to enter these markets, most of which have only become open to foreign investors in the last few decades (Bekaert and Harvey, 2000). The strategic market entry hypothesis is, therefore, more relevant in emerging markets than in developed countries. Second, firms in emerging markets are a natural choice for this study as they have more serious information asymmetry problems for foreign acquirers than firms in developed countries (La Porta et al., 2000). Domestic acquirers have already established themselves in the local market and have more information and networking advantages over foreign acquirers (Shimizu et al., 2004). Thus, it may be relatively easier for them to identify inefficiently managed companies in the local market. It is also less costly for domestic acquirers to restructure the target firms, as they have fewer cultural and communication barriers and are also more familiar with the legal and governance systems in the country than are foreign acquirers. We, therefore, expect domestic acquisitions in emerging markets to serve as a market for corporate control that disciplines poorly performing managers. This line of reasoning leads us to conjecture that target firms in domestic acquisitions are more likely to be operationally inefficient than their peer firms.

On the other hand, because emerging markets are characterized by high information asymmetry, foreign acquirers usually have less knowledge and experience in doing business in the local markets and may have less knowledge about the value of the target firm (Balakrishnan and Koza, 1992; Reuer and Koza, 2000). In addition, cultural barriers—including differences in language, political, and economic systems—make it more difficult for foreign firms to start new businesses in emerging markets, a phenomenon Zaheer (1995) calls a “liability of foreignness”. Consequently, more and more foreign companies choose cross-border (partial) acquisitions as an important strategy to enter these new markets.<sup>5</sup> Thus, they would be more inclined to acquire a well-established, large and strongly performing partner to obtain access to important strategic resources (such as networking relationships, human resources, distribution channels, and brands) and to gain access to the local market. Accordingly, under the strategic market entry hypothesis, we expect the targets in cross-border acquisitions to be better performers than those acquired by domestic bidders.

We examine these two competing hypotheses using both domestic and cross-border partial acquisitions in emerging markets. Using a sample of partially acquired firms allows us to examine the impact of the acquisitions on the target firms' performance and other firm characteristics, since the sample firms continue to list on the stock markets after the acquisitions. Most studies on partial acquisitions focus on domestic U.S. acquisitions (for example, Madden, 1981, and Mikkelsen and Ruback, 1985). However, studies on partial acquisitions in emerging markets are non-existent. In this paper, we use a comprehensive sample consisting of 20 emerging countries from 1990 to 2007 to examine these issues.

Our results indicate that domestic acquisitions and cross-border acquisitions may indeed have different motivations. Consistent with the market for corporate control hypothesis, domestic acquirers tend to acquire poorly performing firms and restructure them after the acquisitions. In contrast, foreign acquirers tend to acquire strongly performing firms, thus lending support for the strategic market entry hypothesis. We also find that in the three years following partial acquisitions, targets of domestic acquisitions experience significant improvements in operating performance and changes in ownership structure. In contrast, target firms in cross-border acquisitions, which were already performing well, do not experience such changes. We also examine the long-term stock performance of these partially acquired target firms and find that consistent with the efficient market hypothesis, there is no evidence of significant abnormal returns after adjusting for dependence and skewness in the data.

The rest of the paper is structured as follows. In the next section, we review the relevant literature and present our hypotheses. In Section 3, we describe our sample and data sources. Empirical methods and results are presented and discussed in Section 4. A summary and conclusion are provided in Section 5.

## 2. Background review and hypothesis development

Unlike full acquisitions where target firms are delisted from the stock market, partially acquired firms remain independent after the transaction. This makes it possible to track their post-acquisition performance and characteristics. Earlier studies, such as Madden (1981) and Mikkelsen and Ruback (1985), find a significantly positive wealth effect for acquirers and target firms following the announcements of partial acquisitions in the U.S. market. Eysell (1990) analyses the financial performance of target

<sup>4</sup> Foreign acquisitions are usually considered as a “double-edged sword” by emerging countries. On one hand, those countries are eager to attract foreign acquirers who bring in new capital, technology, management skills, and jobs to boost the local economy (Farrell, et al., 2004). On the other hand, those countries are also wary of multinational corporations who only exploit cheap labour and natural resources and pursue short-term gains rather than long-term business development of the local economy. Some critics from leading emerging countries, such as China, are even warning that foreign companies are entering the emerging markets with an intention to buy out the large companies in order to permanently eliminate competition or establish monopolies in key industries. They fear that once foreign acquirers have established a monopoly, they will manipulate the market and threaten the national economic security (Wang, 2007).

<sup>5</sup> Some studies—including Brouthers and Brouthers (2000); Hennart and Reddy (1997); Kogut and Singh (1988); Harzing (2002) and Barkema et al. (1996)—examine the factors influencing the choice of mode of entry (such as acquisitions, joint venture, green field investment, export, and alliance). However, there is no empirical study that examines the impact of cross-border acquisitions (as a market entry strategy) on target firms' performances.

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