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# Financial market integration and the value of global diversification: Evidence for US acquirers in cross-border mergers and acquisitions ☆

Bill B. Francis [a,1], Iftekhar Hasan [a,b,2], Xian Sun [c,*]

[a] *Lally School of Management and Technology, Rensselaer Polytechnic Institute, 110 8th Street, Pittsburgh Building, Troy, NY 12180-3590, United States*
[b] *Bank of Finland, Helsinki 00101, Finland*
[c] *Office of the Comptroller of Currency, US Department of Treasury, Risk Analysis Department, 250, E-Street, SW, Washington, DC 20219, United States*

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**Abstract**

In contrast to the previously documented cross-border discount, we find that there is positive cross-border effect for US acquirers during late 1990s and early 2000s. This is especially particular the case for those that acquire/merge with targets from segmented financial markets where acquirers experience significantly higher positive abnormal returns than those that acquire targets from integrated financial markets. Furthermore, firms acquiring segmented-market targets are also characterized by significantly higher post-merger operating performance improvement. The results indicate that the observed positive cross-border effect is mainly due to the increase in the number of transactions involving targets from segmented markets, in which the average firm experience significant financial constraints. We contend that value is created by a combination of firms with different financial market integration status, in which funds are provided to high cost firms. The finding that the value creation is even higher within the group of acquirers with a lower cost of capital provides additional support for our conjecture.


*JEL classification:* G15; G31; G34

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## 1. Introduction

The 1990s and early 2000s saw a tremendous increase in the volume of cross-border mergers and acquisitions (M&As) by US firms. This increase is in part due to the fact that firms have gone away from traditional "Greenfield" investments. It is also due to the growth in international financial markets which has allowed firms to pursue investment opportunities both at home and abroad. A new and important aspect of these M&As is that a significant number of the firms that are acquired or are merged with are from segmented capital markets. For example, the number of transactions involving target firms from segmented markets increased from 41 during 1990–1995 to 174 over the 1996–2003 time period, with the total transaction value of these deals increasing from $2.5 billion to $17.6 billion. Focusing on the extent to which a country's financial market is integrated into world capital markets we examine the effect of cross-border M&As on acquirers' shareholders wealth in both the short and long-run.

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* Corresponding author. Tel.: +1 202 874 3821.
*E-mail addresses:* francb@rpi.edu (B.B. Francis), hasan@rpi.edu (I. Hasan), xian.sun@occ.treas.gov (X. Sun).
[1] Tel.: +1 518 276 3908.
[2] Tel.: +1 518 276 2525.

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Empirical evidence as to the effect of cross-border M&As on acquirers, market value is mixed. Doukas and Travlos (1988), Doukas (1995), Kiymaz (2004) and La Porta et al. (2000), among others, find that cross-border M&As are value enhancing. In contrast, researchers such as Moeller and Schlingemann (2005) and Denis et al. (2002), find that cross-border M&As decrease acquirers' value. Moreover, this evidence is based on data from earlier years and given the recent changes that have occurred, it is still an open question as to the impact of cross-border M&As on stockholders wealth.

More important for the current paper, is that there is little or no empirical evidence on acquirers' gains (losses) from M&As involving targets from financially segmented markets. This is probably due to the fact that there were restrictions on the type of foreign investment in these countries till the mid 1990s (Henry, 2001). And what evidence that does exist (see, e.g., Moeller and Schlingemann (2005)) is based on the time period when these restrictions were just lifted. This therefore, calls into question whether the results based on this time period holds once liberalization has had time to be fully absorbed in the economy. Using a broad sample of target countries and a more recent sample period, we provide a comprehensive analysis on the impact of global diversification across countries on cross-border M&As.

Re-examining the impact of cross-border M&As on acquirers shareholders wealth is important for at least three reasons. First, as pointed out earlier, cross-border acquisitions have become an increasingly important source of investment opportunities and restructuring for US corporations. For e.g., during the 1990 to 2003 time period US corporations had cross-border acquisitions of over $742.9 billion[3] compared to $54.3 billion from 1985 to 1989.[4] Second, Piotroski and Srinivasan (2007) and Li (2007) have recently shown that following the Sarbanes and Oxley act, the cross-listings of foreign firms in the US have declined considerably. This is the case especially for firms from segmented capital markets. This suggests that foreign firms that are seeking access to US capital markets are more likely to agree to be acquired by a US corporation. This implies that M&As will become an increasingly important mechanism by which foreign firms will gain access to US capital markets, especially those from segmented markets.

Third, it enhances our understanding of international integration beyond that which is possible by examining the domestic investment of firms within countries that undertook liberalization. This is because if liberalization is successful, then the need to cross-list or choosing to be acquired to get access to lower cost of funds in integrated market, as we argue, would not be necessary because the price of risk would be equalized across countries. It should be noted that if in fact we find support for our argument that firms from segmented markets that agree to be acquired do so in order to access integrated capital markets, then it suggests that cross country diversification may improve the portfolio performance of US investors. This is a benefit that has been questioned given the increased globalization of capital markets.

Moeller and Schlingemann (2005) find that over the 1985–1995 time period there is a cross-border discount, defined as the difference between abnormal returns of cross-border and domestic M&As, to US acquirers. However, there are several reasons why we believe that this characteristic of the wealth effects of cross-border M&As might have changed starting in the mid 1990s.

In the late 1980s and early 1990s, many emerging markets instituted reforms that liberalized their financial markets, thereby allowing foreign firms to acquire domestic firms. Although liberalization is synonymous with integration, these countries financial markets were at best only partially integrated into world capital markets. This is the case because liberalized markets take time to be fully integrated into the world capital markets. Thus, as pointed out by Errunza and Miller (2000) despite liberalization, firms from these markets still face a higher cost of capital compared to firms from integrated markets, all else equal.

We therefore hypothesize that one of the main reasons for the increase in cross-border acquisitions by US firms, especially by firms from segmented markets, is to provide funding to financially constrained firms either through internal capital markets or indirectly through access to external capital markets.[5] By overcoming these financial constraints these firms are then able to undertake positive NPV projects which they would otherwise have to forego. To the extent that stock markets are efficient, these benefits that are created via an acquisition or merger should be reflected in positive abnormal returns following the M&A announcement.

Instead of agreeing to be acquired by US firms, firms from segmented markets may also cross-list (Lins et al., 2005). The cross-listing option, however, may not be available for a significant number of firms from segmented capital markets for several reasons. First, both NYSE and NASDAQ require firms that cross-list to have average pre-tax income of $100 million for the last three years prior to cross-listing. Therefore, a lot of firms, especially private ones, would probably not meet this requirement. Although firms could instead choose the pink sheet or the over the counter market (OTC) cross-listing option, these options do not provide the same benefits as they do not result in a significant reduction in a firm's cost of capital (Hail and Leuz, 2006). Second, the cost of cross-listing on a US exchange in integrated market is quite significant as evidenced by the $100,000 listing fee. In addition, for a significant number of firms, especially those from segmented markets, there would be an additional cost in the form of

[3] Securities Data Corporation Mergers and Acquisitions Database.

[4] Survey of US Department of Commerce.

[5] The recent work of Baker et al. (2006) also shows that FDI flows (in the form of cross-border M&As) are likely to be driven by the availability of relatively low-cost capital in the source country, particularly when there are capital account restrictions in the host country.