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Financing decisions and gains from cross-border acquisitions by emerging-market acquirers

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ABSTRACT

This study examines the valuation effect of the source of cash for acquisition financing and a set of determinants of bidder gains in the context of the cross-border acquisitions (CBAs) by emerging-market acquirers (EMAs) during 2000–2010. Our findings suggest that the CBAs create value for the EMAs but the value creation does not persist. We also found that the investors in emerging markets are aware of the agency cost of free cash flow and the market timing behavior of managers and thus react accordingly. Investors react more positively to large CBAs, the CBAs pursued by EMAs with prior local experience, the CBA of targets residing in a relative higher operational risk and the CBAs involving distant national cultures.

1. Introduction

During the past two decades, cross-border acquisitions (CBAs), have been conducted by many multinationals from major emerging economies including Brazil, China, India, Malaysia, Russia and others. Seen as a strategic corporate initiative that enables emerging-market multinationals to tap into a new foreign market, to acquire strategic capabilities and resources and to diversify risk, the CBA has increasingly risen in number and volume. The number of CBAs by emerging-market acquirers (EMAs) increased significantly from 295 in 1993 to 795 in 2003 and to 1374 in 2013, while the financial value of these CBAs increased from US $5 billion to US $17 billion and to US $175 million during the same period — staggering rises of

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240% and 929% in value respectively (WIR, 2014). Furthermore, the value of outbound CBAs in 2013 accounts for as high as 44% of the total FDI outflows from emerging economies, emphasizing the importance of the CBA as a major mode of entry for the EMAs. The rising trend towards the CBAs by emerging-market firms, the differences between the EMAs and the acquirers from developed economies in terms of their shareholder expectations, management perspectives, strategic motivations for CBAs and institutional environment (Bhagat et al., 2011), together with a lack of conclusive findings in this area[1] create a significant need for a better understanding of the motivation, the process and the characteristics that are unique to the CBA transactions conducted by the EMAs.

The contribution of the current study is two folds. First, it contributes important understanding to the valuation effect of the financing decision made by EMAs for their CBAs. It is widely accepted that financing decision affects firm value. It is yet the least-explored aspect in an acquisition process. Most of the studies concerning determinants of bidder gains from CBAs simply added into their models a dummy variable for the payment method. The payment method, however, does not allow us to establish a direct link between actual sources of financing and firm value (Schlingemann, 2004). Although there have been some efforts to introduce more related financing variables such as the free cash flow in order to account for the possibility of the link between a poor use of the cash holding and firm value, none of the studies has systematically focused on the associations among financing decision, investment opportunity and firm value. Adding to the extant literature related to the financing of CBAs and firm value, in this study, EMAs are classified into firms possessing either low or high level of investment opportunities, using the Tobin's q ratio[2] as a proxy. The financing activities, reflected in the changes in the EMAs' stocks and flows of cash obtained from internally-generated source, debt and equity issues, are tracked back to identify the sources of cash available prior to their acquisition announcements. Investor reactions, captured by abnormal returns during acquisition periods, are then examined, compared and contrasted among the subgroups of the EMAs characterized by the interaction of their levels of investment opportunities and their sources of cash for CBA financing.

Second, since the theoretical explanations and empirical findings concerning whether CBAs create or destroy value for EMAs and what are the key determinants of gains remain fragmented, we further include in this study the examination of the gains from CBAs and their determinants previously studied in the extant cross-border mergers and acquisitions literature.

The present study is organized as follows: Section 2 reviews the theories and empirical evidence related to the impacts of the CBA financing decision and the firm-specific, deal-specific and country-specific factors on acquisition gains. Section 3 discusses the data and methodology used in the study. Section 4 presents the empirical results and discussions. Finally, Section 5 concludes the study with final remarks.

2. Theoretical background and empirical evidence

2.1. The financing of CBAs and firm value

After a comprehensive review of the extant literature, we found that no research has been dedicated to the precise examination of the source of CBA financing as an influencing factor on firm value in the context of the acquirers from emerging economies. In many instances, the form of payment has been used as a proxy or substitute for the source of acquisition financing (Bhagat et al., 2011; Nicholson and Salaber, 2013; Rahahleh and Wei, 2013). Schlingemann (2004) however argued that the approach does not allow for a direct examination of the impact of financing on firm value because the cash paid for a CBA can be sourced through internally-generated funds, newly-issued debt or equity, and thus should result in different firm valuations. Although a few researchers included the free cash flow (Changqi and Ningling, 2010; Du and Boateng, 2015) as a financing variable in their studies and found its negative effect on firm value, none of the studies has systematically examined the valuation effect of different sources of CBA financing. In addition, the studies

[1] See Lebedev et al. (2014) for a comprehensive review of key findings in the mergers and acquisitions literature intra and across developed and emerging economies concerning motivation, internationalization process, performance, integration and propositions and future research directions.

[2] Tobin's q ratio (Tobin, 1969) is the ratio between the market value and replacement value of the same physical asset. It has become common practice in the finance literature, however, to calculate the ratio by dividing the market value of a company by its book value. As in this research, the q ratio is a proxy for a firm's investment opportunity.