Emerging Markets Review 19 (2014) 18–48

Contents lists available at ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr

Idiosyncratic volatility and mergers and acquisitions in emerging markets

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ARTICLE INFO

Article history:
Received 20 January 2014
Received in revised form 23 March 2014
Accepted 3 April 2014
Available online 13 April 2014

JEL classification:
D82
G15
G34

Keywords:
Idiosyncratic volatility
Mergers and acquisitions
Emerging markets

ABSTRACT

Given the recent findings in the literature that idiosyncratic volatility reflects stock price informativeness, we analyze the impact of idiosyncratic volatility on many acquisition parameters. We find that idiosyncratic volatility is positively related to acquisition premium; the relationship is more significant in deals that occurred in information-poor economies where acquirers have difficulty gathering information about the targets. These deals typically involve bidders from emerging markets and those that have less experience in the target country. Idiosyncratic volatility is also positively related to acquisition completion rate, the likelihood of the bidder acquiring majority control, but is negatively related to takeover probability.

1. Introduction

The role of idiosyncratic volatility has received considerable attention in the literature in terms of its effect on market efficiency and stock price in both developed and emerging markets with conflicting conclusions especially in relation to emerging markets. For example, beginning with Morck et al. (2000), studies have concluded that higher idiosyncratic volatility is a reflection of better stock price informativeness and efficiency of the market in incorporating private information into the stock prices (for example, Chen et al., 2007; Durnev et al., 2003, 2004; Ferreira and Laux, 2007; Jin and Myers, 2006; Wurgler, 2000). These researchers claim that through informed trading, private information (i.e., firm specific information) is impounded into stock prices thereby ensuring that the stock price better reflects the fundamental value of the

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http://dx.doi.org/10.1016/j.ememar.2014.04.001
1566-0141/

company. However, several other authors argue that idiosyncratic volatility is merely the consequence of investor sentiments and that the phenomenon reflects market inefficiency (Jiang et al., 2009; Rajgopal and Venkatachalam, 2011).

Many of these authors arrive at their conclusions by focusing on country level institutional environment and the variation in stock price synchronicity in different markets using data on country market indices. In this paper, we take a different approach and examine the effects of firm level idiosyncratic volatility in mergers and acquisitions (M&A). We argue that if idiosyncratic volatility reflects the firm's stock price informativeness (or noise), then it would play a significant role in various M&A parameters since private information about the target firm is critical to the managers of bidding firms when making acquisition decisions. Accordingly, the central research question we explore in this study is whether idiosyncratic volatility is perceived as valuable information or noise by “corporate” investors — acquiring firms.

Emerging markets provide an interesting setting for this research since it has been documented that these markets exhibit higher stock price synchronicity and a very distinct institutional environment compared to that observed in developed markets. Emerging countries are characterized by complex ownership structures such as concentrated ownership structure, cross-holdings, business groups and pyramidal ownership structure; therefore the controlling owners could extract private benefits of control at the expenses of outside investors (Bertrand et al., 2002; Johnson et al., 2000). Under such conditions, owners of firms have incentives to withhold and/or selectively disclose value-relevant, private information to outside investors in order to conceal the valuation implication of their self-serving behaviors (Fan and Wong, 2005; Kim and Yi, 2006). As a result, the cost of acquiring private information is likely to be higher and the profitability of informed trading is likely to be lower in emerging markets as compared to developed markets. This suggests that stock prices will be less informative in emerging markets due to the lack of informed trading of private information by arbitragers.

The study is also motivated by three additional observations. First, prior studies primarily focus on the empirical connections between idiosyncratic volatility and various information efficiency measures (for example, Durnev et al., 2004; Morck et al., 2000). These authors argue that private information can be impounded into stock prices through informed trading by arbitragers. However, there is no empirical evidence that shows whether informed traders such as corporate investors actually value and take actions to use this private information in their investment decisions. We argue that one of the informed trading channels is mergers and acquisitions where informed traders have to act on this information. Acquiring firms' managers have stronger motivation for collecting target firm specific information before making an M&A decision in emerging markets. Second, many studies have been conducted at the country level and the argument has been that the lack of legal protection of informed trading can affect informational efficiency, resulting in negative correlation between stock return synchronicity and property right protection and economic development of a country. However, until recently, none of the studies focused on cross sectional variations in idiosyncratic volatility among firms. Huang et al. (2013) examine the impact of financial market liberalization on the pricing of idiosyncratic risk in emerging markets and Nartea et al. (2011) studied the impact of idiosyncratic volatility on stock returns in the Southeast Asian markets. Our study complements these recent studies by providing results on the phenomenon using firm level granularity focusing on the information role of idiosyncratic volatility in the corporate mergers and acquisition decisions. Third, we extend the literature on idiosyncratic volatility in decision making to “corporate” investors such as acquiring firms by testing whether acquirers value idiosyncratic volatility of target firms and incorporate it into acquisition decisions.

Our key results can be summarized as follows. Using acquisition data from twenty emerging countries over a seventeen year period, we find that idiosyncratic volatility of target firms plays an important role in mergers and acquisitions in emerging countries. Consistent with the private information and informed trading explanation of idiosyncratic volatility, we find a positive relationship (a high correlation) between target firms' idiosyncratic volatility and merger premiums. The relationship is significant mostly in acquisitions made by acquiring firms that face information disadvantage in collecting firm-specific information on the target firm. Our results suggest that stock price informativeness is more valuable to acquiring firms that are subject to higher information constraints. We further show that target firms' idiosyncratic volatility is also positively correlated with acquisition completion rate and negatively correlated with the time taken to consummate the deal. We argue that transparency in the target firm's stock price, which results from informed trading of private information by market participants and