International Journal of Hospitality Management 28 (2009) 579–585

Contents lists available at ScienceDirect

International Journal of Hospitality Management

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

Merger abnormal returns and payment methods of hospitality firms

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ARTICLE INFO

Keywords:
Hospitality acquirers
Stock performance
Merger and acquisition
Abnormal return
Payment methods
Merger size

ABSTRACT

The study aims to examine the long-term abnormal returns to hospitality acquirers as well as the association between excess returns with financing methods and size. The study applies regression analysis with secondary data examining 19 hospitality acquirers from 1996 to 2007. Using hospitality sector specific indices, the study shows that hospitality acquirers receive positive abnormal returns 12 months post-merger and that there is negative association between cash payment and acquirers' excess returns.

Published by Elsevier Ltd.

1. Introduction

Merger and acquisition have been an effective asset development strategy for corporate America since the early-1900s. Historically, four major waves of such activities have contributed to the economic infrastructure and corporate development changes in the United States. The involved industries have shifted from heavy manufacturing and mining areas to the more service driven sectors (Gilson et al., 1995).

The twenty first century unfolds with some ups and downs in the levels of merger and acquisition activities. The sluggish developments in 2001 and 2002 were later reversed by the surge of financial sponsors and CEOs confidence in strategic acquisitions since 2003. The robust increase continued to 2006. More and more merger and acquisition activities have become an effective corporate strategy to supplement international growth and "soul searching" for core business. During 2005, the Americas accounted for 48% of global merger and acquisition activities with the total dollar volume of 1298.8 billion (Barshay and Falk, 2006).

Up till recent economic slowdown, the hotel industry enjoyed steady improvement in its operating revenues and profit margin, resulting in strong stock performance. The ascent in real estate values attracted a broad range of investors interested in the underlying assets of hotel companies. Consequently, the combination of unprecedented appreciation in hotel assets and strong cash flows led to an abundance of consolidation in the hospitality industry, and most recently, a number of leveraged buy-out transactions such as Fairmont Hotel and Four Seasons.

The industry today appears much less fragmented. Canina (2001) estimated that from 1982 through 2000, the lodging industry had 57 acquisitions with total market value in the target company's stock over $53 billion. The Hotel and Real Estate Investment Trust sectors (REITs) have also experienced profound transformation in recent years. One of the major developments has been consolidation at various scales and levels. Overall, the last two decades witnessed a record growth of merger and acquisition in the hospitality industry that peaked in the late-1990s.

Accompanied by asset exchange is the payment change in the transaction. In the 1960s, common stock or equivalents were dominant; while in the mid-1970s, cash replaced equity to become the principal payment method in the transaction. In 2005, 60% of global merger and acquisition activities were entirely cash transactions, as compared to lows of 27–28% in the 3 years from 1998 to 2000 (Barshay and Falk, 2006). The combination of cash and stock remains a common form of payment even though less popular. It represents 28% of global merger and acquisition activities in 2005, down from the high of 48% in 2001 (Barshay and Falk, 2006).

Significant determinants in payment selection include marginal tax rates, the magnitude of capital gains, the strength of the economy, and the stock itself (Gilson et al., 1995). Historically, the relationship between the premiums paid in a successful acquisition and the acquirers' stock prices over time is negative (Gilson et al., 1995). In other words, the higher the premiums are paid to the target company, the weaker the stock performance of the acquiring company will be in the long run.

The effect of merger on acquiring firms from previous studies has yet decided. One of the most controversial aspects is the effect

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0278-4319/$ – see front matter. Published by Elsevier Ltd.
doi:10.1016/j.ijhm.2009.03.007

of payment methods on acquiring firms. Extant literature has advised that the methods of payment are important factors for abnormal returns to both bidding and target firms. However, there are limited studies that provide direct correlations between the bidding firms' differential returns and the different methods of payment. In fact, the empirical results are often conflicting (Travlos, 1987). One reason is that the method of payment in corporate acquisitions is influenced by a plethora of factors such as characteristics of both acquirers and targets, of the industries and sectors, and of the particular market environment (Martin, 1996).

This paper aims to take an introductory step examining the direct link between the financing method of cash or stock and its effect on the returns of hospitality acquirers. Four additions are made to the extant studies of M&A in the hospitality industry. First, the study summarizes and compares competing payment hypotheses in a broader scope within different industries and event windows; second, the study applies hospitality indices as market benchmarks. As this paper elaborates in the following parts, sector indices are better measurement for hospitality M&A studies; third, this study breaks down the analysis into four different time periods of 3, 6, 9, and 12 months post-merger. The comparison between the four periods provides a clearer picture of the overall trend of studied variables; fourth, this study establishes a direct link between the excess percentage return and the payment method 3, 6, and 9 month post-merger. The results of this paper provide empirical answers for more profound questions as to why hospitality acquirers expand through M&A and how a particular financing method affects returns within 12 months post-merger.

2. Abnormal returns and payment methods

2.1. Abnormal returns

Intuitively, acquiring firms benefit from merger due to technical, pecuniary, and diversification synergies. In general, most studies on the short-term returns apply an "event-study" framework, or "residual analysis". This theory suggests that the expected return on a security is the sum of risk free rate of interest using Treasury Bill rate and a risk premium (Michel and Shaked, 1985).

Industry-specific empirical researches are diversified. It is noticeable that these studies differ in the sample time periods, definitions of event date, models used to generate abnormal returns, time frames prior to and post-merger, payment methods, merger sizes, and merger types.

On the merger announcement effect to the acquiring firms, some recorded significant positive gains (Dodd and Ruback, 1977; Asquith et al., 1983; Canina, 2001) while others indicated significant negative losses (Dodd, 1980; Asquith, 1983; Sheel and Nagpal, 2000; Hsu and Jang, 2007). Franks et al. (1991) studied the long-term post-merger performance during 1975–1984. Using multifactor benchmarks, the authors found that different benchmarks generated significantly different measures of post-merger performance to the acquiring firms.

2.2. Theories and empirical results of payment methods

The signaling hypothesis originated from the Myers and Majluf's asymmetric information model (1984). The model suggests that method of payment may provide valuable information to the market. Angelo et al. (1984) are among the first who argued that payment method in the merger transaction was a signal of the true value of the bidding firm. If the acquiring firm has information concerning its intrinsic value, which is not fully represented in the preacquisition stock price, the management can choose to finance the acquisition in the most beneficial way for its existing shareholders (Travlos, 1987). Generally, overvalued acquirers have an incentive to offer stock and undervalued acquirers pay with cash. Specifically, if the future market value of outstanding stocks of the acquiring firm is assessed as lower than the current price, acquirers will choose stock as the media of exchange (Wansley et al., 1987). Cash financing is chosen when acquiring companies has a favorable valuation for its future stock performance. Therefore, the methods of payment may release information of the future prospects of the acquiring company to the market. Stock offerings signal a negative sign. Empirical studies on the signaling hypothesis are widely tested. On one hand, evidence from a number of researchers (Conn and Nielsen, 1977; Bradley, 1980; Asquith et al., 1983; Wansley et al., 1987; Travlos, 1987; Franks et al., 1988) suggested that cash offers accumulate positive gains for the acquirers and equity offers result in capital loss. On the other hand, a more recent study by Slovin et al. (2005) found stock exchange created significantly larger combined gains shared between the sellers and buyers in inter-corporate asset sales.

Similar to the signaling hypothesis (Myers and Majluf, 1984), investment opportunities hypothesis by Jung et al. (1996) argued that managers with high growth opportunities preferred stock financing due to its fund use flexibility compared with debt financing. As debt financing puts a limit on the management to reinvest the cash flow, firms with valuable investment opportunities issue equity to finance mergers. To test this hypothesis, Martin (1996) found that bidding firms preferred stock financing when experiencing both recent stock price mark-up and high growth opportunities.

In this study, Martin (1996) tested the risk-sharing hypothesis that exploits the availability of the detailed information about the target. The results suggested that stock financing was preferred when the target size and ratio the of target size to the bidder size increased. Hansen (1987) modeled the risk-sharing hypothesis with the choice of payment under the conditions of asymmetric information between the bidder and the target. The study argued that stock financing allowed the bidder to share the risk with the target in a relatively large merger transaction. Likewise, if the target size was insignificant and the impact of the transaction was less visible, cash transactions were more likely to be considered.

The mode of acquisitions was found to be an important factor in the choice of payment methods (Martin, 1996). In a study of 846 corporate acquisitions, Martin (1996) found that cash financing, which is seen as one of the preemptive strategies by the bidders, was often related to tender offers.

In a vein similar to the mode of acquisitions, overpayment hypothesis argues for smaller gains or losses to the bidding firms with cash offers. The theory suggests that cash offers often pay higher premiums for target companies due to several factors: competition, tax effects, regulatory requirements, and the increasing popularity of cash acquisitions. Target companies are more likely to choose cash bidders with higher premiums. From the bidder's side, cash offers are an effective corporate finance strategy to preempt a potential competing bidder. Shareholders of the target companies demand higher premium for cash offers due to capital gains tax. In an equity acquisition, there are no immediate capital gains; therefore, investors are not subjected to capital gains tax liability when they accept stocks of the acquiring company. These taxes are deferred until investors choose to sell and realize the gains. Whereas in the cash acquisition, investors' gains must be realized for tax purposes, thus resulting in a tax liability at the capital gains tax rate (Franks et al., 1988). However, the empirical support for the overpayment theory is inclusive (Gordon and Yagil, 1981; Wansley et al., 1987; Sung, 1993). Sung (1993) focused on the overpayment hypothesis and the effects of overpayment with a sample of 159 cash offers and 63 stock exchange offers during 1974–1980. The study found significant negative abnormal returns to the bidders with both cash and stock offers in 1980s and