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Exchange rate exposure and valuation effects of cross-border acquisitions

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Abstract

This study examines the relevance of exchange rate risk in the context of cross-border acquisitions. Using a sample of 156 foreign acquisitions of US firms, we find a reduction in exchange rate exposure following acquisition announcements. We also compare the valuation effects generated by a single-factor market model to those of a two-factor model that controls for the exchange rate effect. Our results show that, on average, abnormal returns generated by the two-factor model are significantly lower than those of the single-factor market model.

Keywords: Exchange rate exposure; Cross-border acquisitions; Event study

JEL classification: G14; G34

1. Introduction

Previous studies that examine the valuation effects that accrue to acquirers upon announcement of cross-border acquisitions do not consistently find positive or negative valuation effects. Doukas and Travlos (1988) study US acquisitions of foreign firms and find the acquirers gain when they do not have established operations in the target firm's country. Morck and Yeung (1992) also find some evidence that US acquirers gain upon announcement of foreign acquisitions. Kang

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(1993) and Pettway et al. (1993) examine Japanese acquisitions of US firms and show positive gains for the acquirers. Eun et al. (1996) investigate foreign acquisitions of US firms and find the gains to the acquirers vary depending on the nationality of the acquirers. They show British acquirers experience significant losses, but Japanese acquirers experience significant gains. Cakici et al. (1996) analyze cross-border acquisitions and find foreign acquirers of US firms benefit more than US acquirers of foreign firms. Recently, Eckbo and Thorburn (2000) show foreign (US) acquirers of Canadian firms do not generate significant valuation effects.

In a perfectly competitive market for cross-border acquisitions, the valuation effects for acquirers are expected to be insignificant. That is, if targets are fairly priced, acquisitions will have a net present value of zero and there will be no abnormal return (AR) to the acquiring firms.[1] Although the evidence cited above seems to indicate that the market for cross-border acquisitions is not perfect, the methodology for quantifying the valuation effects may confound the assessment. In the context of cross-border acquisitions, this study proposes that an exchange rate factor be included in the model used to generate expected returns. By excluding exchange rate effects, the estimated ARs could misstate the valuation effects.

The valuation effects in the aforementioned studies are typically estimated using a single-factor market model. However, an exchange rate factor is likely to be important in the context of assessing the impact of cross-border events on shareholder wealth. In a more general context, an increasing number of empirical studies support the importance of exchange rate risk due to its impact on cash flows and stock prices (e.g. Choi and Prasad, 1995; Chow et al., 1997; He and Ng, 1998; Miller and Reuer, 1998; Martin et al., 1999; Shin and Soenen, 2000). In particular, Dumas and Solnik (1995), De Santis and Gérard (1998) and Doukas et al. (1999) find that investors price foreign exchange risk and the premium charged varies with time. In addition, the latter two papers also find that the foreign exchange risk premium is a significant portion of the total premium that investors charge.

Our study first highlights the relevance of exchange rate risk by investigating whether there are shifts in exposure following cross-border acquisition announcements.[2] Consistent with our hypothesis, we find that, on average, there is an absolute reduction in foreign exchange exposure following the acquisition announcements. Moreover, firms characterized as either net exporters or net importers each experience a significant reduction in their exposure.

Based on the studies noted above, we incorporate an exchange rate factor in the traditional market model to assess the valuation effects that arise from the cross-border acquisitions. Comparing our model's results to those of the single-factor market model, we show that, on average, the ARs generated using the two-factor

[1] Most studies of domestic acquisitions in the US find significant wealth effects for the targets but not for the acquirers, which is consistent with the existence of a perfectly competitive market for domestic acquisitions.

[2] For an overview of the literature addressing merger-related parameter shifts in general, see Kiymaz and Mukherjee (2001).