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Minority shareholders' wealth effects and stock market development: Evidence from increase-in-ownership M&As

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A B S T R A C T

This paper examines, using a global M&A data set, the relationship between the target firm's minority shareholders' returns and a country's stock market development in deals in which large shareholders increase their ownership stakes. For the purpose of this study, we use two measures of stock market development: (1) turnover over GDP, and (2) turnover over market capitalization. We provide evidence supporting the view that minority shareholders in target firms gain significantly more in countries with high stock market development than their counterparts in less-developed markets. Our results are robust to several firm and deal characteristics and provide evidence to policy makers that the degree of stock market development is a key determinant in improving minority shareholders' welfare.

1. Introduction

Several studies have provided evidence that the positive reaction of the target firm's stock price to a takeover announcement is a global phenomenon.[1] Recent evidence also documents that large shareholders are very common worldwide, especially in countries with relatively less-developed stock markets (La Porta et al., 1999; Faccio and Lang, 2002; Claessens et al., 2000). While acquirers usually own no or very few shares in target firms before the acquisition announcement (Betton et al., 2009), there are cases in which the acquirer not only owns a sizable stake in the target firm but is the firm's controlling shareholder (Bae et al., 2002; Holmen and Knopf, 2004). Bates et al. (2006) find that minority shareholders are still able to exercise significant bargaining power and obtain a decent return in US freeze-out bids, even if there is no change of control at stake.[2] However, this cannot be ruled as a universal phenomenon given the different degree of countries' stock market development (La Porta et al., 1997).[3] Hence, in this paper, we examine the relationship between the target firm's minority shareholders' returns and stock market development in deals in which controlling shareholders increase their ownership stakes.

To examine the gains earned by minority shareholders across the world, we focus on merger and acquisition (M&A) deals in which controlling shareholders acquire all or some of the remaining minority shareholdings in listed companies they already control. Throughout the paper, we define these deals as *increase-in-ownership* transactions. In contrast to acquisition proposals made by unrelated parties, target minority investors in increase-in-ownership M&As are less likely to be endangered by entrenched managers willing to fight off offers, but they are clearly at a disadvantage against a bidder who already controls the company (Shleifer and Vishny, 1997).

Controlling shareholders often claim that their increase-in-ownership transactions are necessary to restructure their individual portfolios or business groups and that such deals are value-increasing projects. Even if the bidder already controls the target firm, it often needs greater or even full control to exploit

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[1] For the US market, see for example Andrade et al. (2001). Andrade et al. (2001) report an average target reaction of 13% for stock acquisitions and 20.1% for cash acquisitions in the event window (−1, +1) surrounding the acquisition announcement. European evidence is provided by Martynova and Renneboog (2006), who find an average market reaction of 12.28% for target firms in the event window (−1, +1).

[2] Bates et al. (2006) report an average announcement period excess return of 14.9% for US freeze-out bids.

[3] For example, Huang and Zu (2009) document the existence of a dramatic discount on block share prices in China.

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synergies and reduce costs.[4] For example, in increase-in-ownership deals aimed at delisting target firms, the delisting of the target permits the controlling firm to save on the cost of compliance with the securities laws (Carney, 2006).[5] Moreover, many controlling shareholders believe that dealing with minority shareholders may prevent their companies from quickly responding to competitive pressures.[6] Large shareholders sometimes increase their ownership stake to prevent block creation by other shareholders, who may be hostile (Jenkinson and Ljungqvist, 2001). Finally, there could be cases in which minority shareholders, lacking a liquid market in which to trade their shares,[7] demand and put pressure on the large shareholders to buy them out.[8]

Using an exhaustive sample of 1174 increase-in-ownership acquisitions across 46 countries over the period 1989–2005, we provide evidence that increase-in-ownership transactions do create considerable value for target shareholders. Consistent with Bates et al. (2006), minority shareholders in target firms earn an average announcement excess return of 11.95% in the 5-day period around the acquisition announcement (−2, +2). However, when we partition the sample at the country level, we find a significant variation in the abnormal returns around the acquisition announcement. Thus, these deals provide an ideal testing ground for exploring the reasons why minority shareholders obtain a relatively larger premium.

Previous literature suggests that a different degree of investor protection may be the reason for these differences in bidders' behavior when they already control the target firm. The legal approach to corporate governance proposed by La Porta et al. (1997, 1998) emphasizes the role played by the legal system, including both laws and their enforcement, in protecting outside investors (La Porta et al., 2000). La Porta et al. (1997, 1998, 2000) also report that protection of outside investors is positively correlated with stock market development and find that common law countries have both the strongest protection for outside investors and the most developed markets. Though investor protection and stock market development are closely related, the latter captures issues beyond investor protection. Rajan and Zingales (2003) argue that investor protection alone cannot explain the reversals in a country's financial development and the fact that stock market development indicators are time-varying. In their view, the strength of political forces in favor of financial development plays a key role in developing strong financial markets, and the country's financial development is the outcome of ideology and the economic interests of voters and pressure groups (Aganin and Volpin, 2005). Indeed, Rajan and Zingales (2003) argue that government action can either foster or hamper the stock market, depending upon the balance of powers between pressure groups.

Another important side of stock market development not fully captured by investor protection is market openness. Rajan and Zingales (2003) also discuss the role of a country's openness to trade and capital flows in promoting financial development. However, such promotion can take place without conceding too much power to minority investors. In fact, Aganin and Volpin (2005) provide the example of Italy, a relatively open market with poor investor protection. Finally, Guiso et al. (2008) argue that trust affects participation in the stock market, and thus its development.

Generally, in countries with well-developed stock markets, a significant fraction of the country's population owns stock (Pagano and Volpin, 2006). Larger participation of investors in firms' equity serves as a guarantee of exposure to the media in cases of outrageous expropriations by controlling shareholders (Miller, 2006). This is certainly not the case in countries with less-developed markets, where violations often go unnoticed, barring active lobbying by foreign funds in the international press (Dyck et al., 2008). Given these considerations, we argue that stock market development, which summarizes and incorporates the impacts of the determinants mentioned above, is an important driving force of the returns realized by target shareholders around increase-in-ownership acquisitions. This effect captures sides beyond investor protection.

In this paper, we employ two measures of stock market development used in the financial and economic development literature (Levine and Zervos, 1998) to test its impact on the abnormal return earned by target shareholders around increase-in-ownership acquisition announcements: (1) turnover over GDP, and (2) turnover over market capitalization. These two measures capture trading activity, or to put it differently, actual participation in the stock market. For the purpose of this study, they are both superior to the ratio between stock market capitalization and the country's GDP for two main reasons. First, market capitalization includes the value of the large shareholder's blocks that in general trade infrequently, particularly when they are owned by families or individuals (Holderness and Sheehan, 1988; Klasa, 2007).[9] These blocks represent a large proportion of a country's market capitalization, especially outside of the US (La Porta et al., 1999; Faccio and Lang, 2002; Claessens et al., 2000). Second, as argued by Rajan and Zingales (2003), large increases in the value of a few companies can affect stock market capitalization even if few people are trading and few firms are raising equity in this market.

We find that target minority shareholders gain significantly more in developed markets than in less financially developed countries. The return differential ranges from 4.75% to 10.38% and is statistically significant for the two proxies of stock market development. The multivariate analysis confirms this result and provides further evidence of the strongly significant positive rela-

[4] For example, Sandvik AB (Sweden) claimed that owning (at least) a 75% stake in Sandvik Asia (India) was "necessary in order to ensure control of proprietary technology, provide flexibility of operations and enable it to comply with group philosophy" (AFX News, November 25th, 1997). The acquisition of the remaining 50% of Internet Auction Co. Ltd. (Korea) by Ebay Inc. (USA) was explained as follows: "it wants to buy the rest of the Korean company to more strongly align ownership and management and to boost operational flexibility in the Korean marketplace" (*Daily Deal*, November 25th, 2003). Scott Greenberg, National Patent's chief financial officer, commented on the acquisition of General Physics that "by owning 100 percent, it will allow us to throw more resources behind the company" (*The Washington Post*, September 26th, 1996).

[5] The effects of higher costs of being public have been analyzed in great detail in the US following the introduction of the Sarbanes-Oxley Act in 2002 (see, for example, Marosi and Massoud, 2008).

[6] Just to give a few examples in which competitive pressure was cited among the reasons for completing the deal (acquirer in parenthesis): Eaux des mineral de Vittel (Nestle') in 1991; Comau (Fiat) in 1999; Electrabel (Suez) in 2005; Nitto Chemical Industry Co. Ltd. (Mitsubishi Rayon Co. Ltd.) in 1997; Acer Computer Intl. (Acer Inc.) in 1999; Magellan Petro Australia Ltd. (Magellan Petroleum Ltd.) in 2005. In the Nitto case, for example, it was reported that the two firms "hope that by putting together their technological and human resources, they will be able to increase their overall competitiveness" (Jiji Press Ticker Service, 22 December 1997).

[7] Lack of liquidity was the main reason leading to the acquisition of the remaining outstanding shares in Ogden Projects by Ogden Corp. in 1994. R. Richard Ablon, President & Chief Executive Officer of Ogden, said, "It has become increasingly apparent that the limited public float in shares of OPI common stock make this security less and less attractive to the investing public. It has been and continues to be difficult to develop a broad investor base for OPI common stock, particularly since Ogden has no intention of reducing its current ownership interest. We believe that the proposed transaction is an effective way to merge the two companies (Business Wire, 6 June 1994).

[8] Minority shareholders' pressure was the driving factor that lead to the buyouts of minorities in Cie d'Investissement de Paris (France) by BNP, a French bank, in May 1995, and in Rhin et Moselle Assurance, a French company, by a subsidiary of Allianz SE (Germany) in November 1996.

[9] Holderness and Sheehan (1988) compare the likelihood of a control change between firms that are majority-owned by families and those majority-owned by corporations. They find that firms in which the majority shareholder was an individual investor (or family) were less likely to be acquired. Klasa (2007) finds only 84 observations for the sale of the family's controlling stake in the US over a long period (1984–1998).