Journal of Economics and Business 59 (2007) 380–405

Journal of Economics & Business

Ownership structure and operating performance of acquiring firms: The case of English-origin countries

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Abstract

This paper provides empirical evidence on the relation between concentrated ownership and the long term operating performance of acquiring firms. We investigate the performance around 287 takeovers in English-origin countries other than the US by following the classification of La Porta et al. [La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. W. (1998). Law and finance. *The Journal of Political Economy, 106*(6), 1113–1155]. Our principal finding is that the relationship between concentrated ownership and the level and change in operating cash flow returns after takeovers is non-linear. Value creating deals are associated with higher levels of concentration consistent with decreasing agency costs as the dominant shareholder's wealth invested in the acquiring firm increases. We also find, although all acquiring firms are from English-origin countries, that greater investor protection, as measured by the updated anti-director rights index in Djankov et al. [Djankov, S., La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2006). *The law and economics of self-dealing*. Working Paper], has a positive impact on operating performance from acquisitions. We do not find a link between performance and their new anti-self-dealing index.

JEL classification: G12; G14; G34

Keywords: Mergers and acquisitions; Concentrated ownership; Operating performance; English-origin countries; Anti-self-dealing index; Anti-director rights index

1. Introduction

Stemming mostly from the agency model of Jensen and Meckling (1976) but also from much earlier work such as Berle and Means (1932), corporate governance research has generally

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0148-6195/$ – see front matter
doi:10.1016/j.jeconbus.2007.04.003

emphasized the role of control mechanisms in dispersed ownership structures as found in the US. However, La Porta, Lopez-de-Silanes, and Shleifer (1999), among others, show that dispersed ownership is only common in larger firms and in countries with good shareholder protection. Since concentrated ownership in a firm has its own specific costs and benefits, a growing body of empirically work investigates the unique characteristics of such firms (Bebchuk, Kraakman, & Triantis, 2000; Claessens, Djankov, & Lang, 2000; Faccio & Lang, 2002). Following the investor protection classification scheme of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998), subsequent cross-country research also focuses on comparing corporate performance among countries with different legal characteristics (Gugler, Mueller, & Yurtoglu, 2004; Fauver, Houston, & Naranjo, 2003; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002). While English-origin countries[1] are often lumped together and viewed as examples of dispersed ownership and greater investor protection, concentrated ownership is quite prevalent in many of these countries and the level of investor protection and the risks of self-dealing does vary among the group (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2006).

One of the most important drivers of corporate performance over the last decade is without a doubt the level of mergers and acquisitions (M&A). The most recent merger wave which begins in the mid-1990 and reaches its peak in 2000 is not only confined to the US market but is truly global (Gugler, Mueller, Yurtoglu, & Zulehner, 2003). One additional feature of the recent M&A wave is that takeovers are larger than ever. Companies invest billions of dollars in making acquisitions but most empirical studies show that shareholders of acquiring firms experience wealth destruction on average or at best break even (Agrawal, Jaffe, & Mandelker, 1992; Goergen & Renneboog, 2004; Franks & Harris, 1989; Jensen & Ruback, 1983).

A recent stream of research focuses on ownership structure, governance and the value creation of specific corporate decisions such as M&A. Concentrated ownership introduces new dimensions to the issue. In countries with low investor protection, some argue that M&A are a tool used by controlling shareholders to facilitate tunneling that benefit them at the expense of minority shareholders (Bae, Kang, & Kim, 2002; Bigelli & Mengoli, 2004). In countries with better corporate governance, dominant shareholders may not be in a position to benefit from tunneling but they may choose to reduce risk by making sub-optimal investment decision (Ben-Amar & André, 2006; Faccio & Stolin, 2006; Holmen & Knopf, 2004).

To date, most research examines the relationship between acquisition performance and ownership structures by adopting traditional market based event study methodology since it assumes that stock prices immediately reflect the benefits from the deal (Andrade, Mitchell, & Stafford, 2001; Franks & Harris, 1989; Goergen & Renneboog, 2004; Limmack, 1991; Sudarsanam, 1996). However, Hitt, Harrison, Ireland, and Best (1998) argue that the nature of the short term market performance methodology may not fully capture anticipated benefits from an acquisition. Following the work of Healy, Palepu, and Ruback (1992), financial researchers take a longer term perspective and examine the change in operating cash flow returns to better understand value creation and its drivers.

Our study adds to the ongoing debate about the benefits and costs of concentrated ownership and further examines the effects of governance, legal investor protection and anti-self-dealing measures on value creation following M&A. We extend the research of Ben-Amar and André

[1] La Porta et al. (1998) include the following countries in the English-origin category: Australia, Canada, Hong Kong, India, Ireland, Israel, Kenya, Malaysia, New Zealand, Nigeria, Pakistan, Singapore, South Africa, Sri Lanka, Thailand, United Kingdom, United States and Zimbabwe.