



Rule of law or country level corporate governance: What matters more in emerging market acquisitions?



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ABSTRACT

A study of post-acquisition performance of cross border acquisitions involving emerging market firms shows that when developed market firms acquire emerging market firms, rule of law in the target country has a significant favorable impact on post-acquisition performance; while country level corporate governance has no impact. Contrarily, when emerging market firms acquire developed market firms, country level corporate governance in the target country has a significant adverse impact on post-acquisition performance, while rule of law has no impact. We provide evidence that if rule of law in the emerging market target country is less evolved but not dismally low, the developed market acquirer can seize the opportunity to enforce better discipline at the firm level in the target firm and thereby enhance post-acquisition performance. However, in the case of emerging market firms' acquisitions, lower the difference in country level corporate governance, superior gains are assured. The study provides evidence that location level factors affect post acquisition performance differently for ADTE and AETD acquisitions and ADTE acquisitions give importance to rule of law, while AETD acquisitions emphasis on corporate governance factors to ensure value creation in acquisitions and the results are robust after controlling for country effects and year effects.

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1. Introduction

This study examines the impact of the location level rule of law and corporate governance on performance gains in cross-border acquisitions involving emerging market firms. More specifically, it examines how differently do the location level rule of law and corporate governance impact acquisition outcomes when acquirers from developed markets acquire targets in emerging markets (ADTE) vis-à-vis when acquirers from emerging markets acquire targets in developed markets (AETD). While cross border acquisitions into emerging markets lead to performance gains for developed market acquirers (Sharma and Raat, 2016), this study augments the literature by exploring if location level country factors can augment value creation in M&A in and out of emerging markets.

Rossi and Volpin (2004) have shown that differences in law and enforcement of law "...explain the intensity and the pattern of mergers and acquisitions around the world." In developed markets, the legal system and rule of law, covering both the promulgation of security laws and enforcement of these laws, are well evolved and embedded in the governance system of the country. In emerging markets, however, it is well documented that inability of Governments to enact laws to protect the rights of shareholders and, more importantly the lack of rigor with which such laws are enforced is a primary

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cause for concern. In this scenario, when a developed market firm acquires an emerging market firm (ADTE), would the inferior rule of law in the domicile country of the emerging market target impact the developed market acquirer's ability to deliver superior post-acquisition performance?

On the other hand, when an emerging market firm acquires a developed market firm (AETD), the emerging market acquirer would want to 'bootstrap' to the better country level corporate governance environment in the target country (Martynova and Renneboog, 2008) and benefit from any positive performance impact thereof. This approach, however, is fraught with the risk that the emerging market acquirer will be required to cope with the more stringent governance environment in the domicile country of the developed market target. Could that potentially impact post-acquisition performance adversely?

These questions have not been explored in academic research despite emerging markets' share of cross-border acquisitions (inbound and outbound) having gone up from 14.79% to 27.78% during the period 2005–2010, with a corresponding diminution in the share of developed markets (WIR, UNCTAD, 2011). This rather dichotomous situation wherein firms from emerging markets (with an inferior rule of law and inferior country level corporate governance) are increasingly engaging in inbound and outbound cross-border acquisitions involving firms from developed markets (with superior rule of law and superior country level corporate governance) raises questions hitherto not explored adequately in academic research. Country specific advantages and host country characteristics are important antecedents of M&As in and out of emerging economies (Lebedev et al., 2015) and they have different acquisition preferences and location level choices (De Beule and Duanmu, 2012; Dailami et al., 2012) and differ even across emerging economies (Deng and Yang, 2015). Home country macroeconomic factors can provide comparative advantage to improve outward cross border flows (Boateng et al., 2014). That indeed is the motivation for this study.

Our study differs from other previous studies in several ways. *First*, we distinguish between rule of law and country level corporate governance and study their impact separately on cross-border acquisitions involving emerging market firms. *Second*, our sample of 151 acquisitions comprises two mutually exclusive data sets, 111 where the acquirers are from developed markets and targets are from emerging markets (ADTE) and another 40 where the acquirers are from emerging markets and targets are from developed markets (AETD); this allows us to examine how differently rule of law and country level corporate governance impact post-acquisition performance in the two contrasting scenarios. *Third*, we use industry adjusted operating performance measures instead of event studies and abnormal stock returns to assess acquisition gains since prior research point to several potential issues in using the abnormal stock returns as a performance measure particularly in an emerging market context (Morck et al., 2000; Leuz et al., 2003; Bhattacharya et al., 2003; Antoniou et al., 2011; Rao-Nicholson et al., 2016).

The empirical findings in this study reinforce our premise that *when firms from developed markets acquire firms from emerging markets* (ADTE), rule of law in the emerging market target country significantly impacts post-acquisition performance. Neither the rule of law in the developed market acquirer country nor the country level corporate governance in both the acquirer country and the target country has any significant impact. On the other hand, *when firms from emerging markets acquire firms from developed markets* (AETD), the findings are quite the opposite. The country level corporate governance of the developed market target country impacts post-acquisition performance significantly and negatively. Neither the level of corporate governance in the emerging market acquirer country nor the rule of law in both the acquirer country and the target country has any significant impact on post-acquisition performance, even after controlling for pre-acquisition performance and other deal characteristics. The findings are robust even after controlling for country effects and year effects and indicate that ADTE acquisitions give importance to rule of law, while AETD acquisitions emphasize on corporate governance factors to ensure value creation in acquisitions.

The rest of the paper is organized as follows: In the next section, we assess the potential impact of rule of law and corporate governance on post-acquisition performance in cross-border acquisitions involving emerging market firms and develop our hypotheses. In Section 3, we explain the sample selection process and Section 4 discusses the sources of data, measurement of variables and methodology. Section 5, reports our results and findings followed by Section 6, where we draw our conclusions and bring out the implications and possible future research direction.

2. Development of hypotheses

2.1. Rule of law

Rule of law captures “perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence” (Kaufmann et al., 2010). The efficacy of the legal system and the quality of law enforcement by the Government of a country are correlated to the depth of financial markets and the stability of return on financial (stock) assets (Koubi, 2008). Hewko (2002) argues that “. . . efficient and transparent legal systems reduce transaction costs for economic actors, including foreign investors. Since transaction costs increase the costs of direct investment, foreign investors should be averse to investing in countries with such higher costs and, thus, will gravitate toward states with more ‘effective’ or ‘efficient’ legal regimes.”

While it is generally understood that in developed markets a slew of securities laws and legal protection to shareholders create a favorable environment for superior firm performance, in emerging markets weak legal systems and inferior rule of law are often offset through ownership concentration (Shleifer and Wolfenzon, 2002; Denis and McConnell, 2003). However,

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