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The wealth effects of acquiring foreign divested assets

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ABSTRACT

We compare the wealth effects of acquiring assets from a divesting firm (i.e., acquisitions of divested assets) with the acquisitions of an entire organization (i.e., acquisitions of non-divested targets) abroad. We hypothesize that the ability to select the most valuable assets and leave the unwanted ones behind affords bidders greater flexibility in acquisitions of assets as opposed to acquisitions of non-divested targets. We apply event study methodology on a sample of 2137 cross-border M&As from 1986 to 2009 to test our hypothesis. Consistent with our proposition, we find that bidders fare better in acquisitions of divested assets. Our various market-based measures of performance are overwhelmingly in favor of these kinds of acquirers. Consistent with the wealth effects, we also find that the cost of capital charged to buyers of divisions/subsidiaries/assets of an organization is lower compared to buyers of whole/parent corporations abroad. Overall, our findings suggest that bidders who are in a position to bid for specific divisions or subsidiaries or assets of a foreign corporation rather than acquire the whole corporation can extract larger benefits.

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1. Introduction

In this paper, we examine the wealth effects of acquiring assets that are being divested (i.e., acquisitions of divested assets) as opposed to acquiring a controlling stake in the selling corporation (i.e., acquisitions of non-divested targets). Under acquisitions of divested assets we include purchases of a target that is being sold by its parent company; asset purchases; purchases of a discarded division/subsidiary/business unit/asset of a seller's business; and there is no investment in the target's parent company common stock. On the other hand, in acquisitions of non-divested targets, the bidder buys the whole business of the seller (i.e., the entire organization of the parent company, including all its subsidiaries) or buys a majority equity stake in the selling parent company. The buyers are U.S.-listed firms while the sellers are not listed in the U.S. and are incorporated overseas. Furthermore, a bidder's country of incorporation and that of the target are different.

Sellers usually divest business units that they consider as nonstrategic and/or unprofitable. But to a buyer, an acquisition of a discarded unit from another business represents an opportunity to increase its market share or to bring a supplier in-house or to gain access to a new technology and other capabilities. For instance, when Ford agreed to sell Jaguar and the Land Rover to Tata in 2008 and Volvo to Geely in 2010, it also promised to continue providing them with such things as engine and powertrain technology, which would largely benefit the acquirers.[1] Concurrently, the discarded unit can gain access to the buyer's home market (e.g., Volvo gaining access to China's rapidly growing car market) and improve its revenue, and opening the possibility that the target is more viable under new ownership. Thus, there exists the opportunity for bidders to earn a good return on investment in divested units/subsidiaries/assets.

An acquisition of a part of an organization – as opposed to the whole corporation – is more viable under certain conditions. For instance, a successful company that wants to capitalize on its existing strength (like its brand name) and is looking to expand geographically and tackle the competition will favor an asset purchase. Post-acquisition the bidder will be able to discontinue the brand of the target firm and take over its market. Conversely, a business that is looking to capitalize on new competencies (e.g., the brand, core competency and customers of another company) will opt for acquisitions of entire corporations.

In an acquisition of a non-divested target, the buyer becomes a shareholder of the target company and, as a result, assumes both

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[1] The Economist (2010) Ford sells Volvo to Geely, March 28th. Accessed www.economist.com.

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the target's assets and liabilities. On the other hand, an asset purchase comes free of debt and other liens. Thus, buyers who are only interested in one part of the business of a firm – or a highly indebted firm for that matter– and want to avoid dealing with its shareholders or to avoid litigations and other extraneous issues will favor an asset purchase. Thus, the form of the deal selected may well depend on the intentions of the parties at the time of the merger and acquisition (M&A). However, little is known on the wealth effects of the form of the deal to guide investors in international M&As.

There are some studies in the domestic context that suggest the benefits from an acquisition depend squarely on the form of the deal. For instance, Hazelkorn, Zenner, and Shivdasani (2004) find that investors react positively to acquisitions of private targets as well as to acquisitions of either the assets of a business or a unit of a publicly traded company. Rosenfeld (1984), Jain (1985), Zaima and Hearth (1985), and Sicherman and Pettway (1987) find positive announcement period abnormal returns in acquisitions of divested assets.

The market for divested assets has developed globally as buyers and sellers are better able to find a suitable counterparty than if they were just restricted to their domestic market. Thus, we contribute to the literature by analyzing the performance of buyers in international M&As based on the form of the deal.

We use the event study methodology to assess the effect of the form of the deal on the bidders' wealth. More specifically, we calculate the excess stock returns following a bidder's decision to purchase a target. We then compare the returns based on the form of the deal, i.e., acquisitions of divested assets versus acquisitions of non-divested targets.

We find that from the bidder shareholders perspective, cross-border acquisitions of divested assets are wealth enhancing. The announcement period abnormal returns are positive and higher for acquisitions of divested assets when compared to acquisitions of non-divested targets. When the size of the target relative to the buyer is higher, buyers tend to opt for acquisitions of assets. The same is true for buyers with a higher proportion of foreign sales-to-total sales and cash-financed acquisitions. However, bidders tend to invest in the equity or buy the whole corporation of high-tech targets rather than to strip the business of its assets.

In multiple regressions we find that bidders' wealth in M&As is inversely related to their size and the amount of cash they hold. This finding is consistent with the agency theory in the sense that managers of larger firms and firms with lots of cash are more likely to engage in wasteful acquisitions.

Consistent with their short-term stock performance, bidders of divested assets continue to outperform bidders of non-divested targets in the long run. Likewise, buyers of targets in the same industry and those that improve their cash position post-acquisition tend to perform better. The size of the target, though, inversely affects bidders' long run stock performance.

Consistent with the findings on the stock returns, bidders of divested assets experience a lower increase in their cost of equity post-acquisition. Taken together, our findings suggest that the flexibility afforded to buyers in acquisitions of divested assets is a source of extra wealth.

The rest of the paper proceeds as follows. We review the related literature and formulate our hypotheses in Section 2. Sample descriptive is presented in Section 3. In Section 4, we describe our methods used. We discuss our findings in Section 5. We conclude the paper in Section 6.

2. Literature review and hypotheses development

A number of studies on mergers and acquisitions (M&As) find that bidding firm shareholders rarely gain and that the wealth effect of M&As is either zero or negative (see Andrade, Mitchell, & Stafford, 2001; Jarrell, Brickley, & Netter, 1998; Jensen & Ruback, 1983) for a history of bidders' stock returns in M&As over the years). Doukas and Travlos (1988) document similar findings for shareholders of U.S. firms expanding internationally via M&As. There are a number of explanations put forth as to why bidding firm shareholders do not gain from M&As (see, for example, Dong, Hirshleifer, Richardson, & Toeh, 2006; Harford, 1999; Jensen, 1986; Jovanovic & Braguinsky, 2002; McCardle & Viswanathan, 1994; Myers & Majluf, 1984; Roll, 1986; Travlos, 1987).[2] Some studies, though, suggest that not all M&As are received in the same manner. More specifically, there are studies – mostly in the domestic context – that suggest the way a deal is structured will affect investors' perception of the deal. For example, Rosenfeld (1984) and Jain (1985) find that investors are more favorable to acquisitions of divested assets.

In a divestiture/asset sale, a firm sells one or more of its divisions or subsidiaries or other assets that it considers to be nonstrategic and/or unprofitable. Many divestiture transactions are small and often attributable to marginal adjustment of the seller's business portfolio (Lee & Madhavan, 2010). To a buyer though acquiring the divested assets of another business represents a growth opportunity to explore. According to Denning (1988), "The value-enhancing nature of divestiture may result from the divested unit being better managed by its acquirer or from an increased economic synergy between the unit and the acquirer" (p. 34).

In the domestic context, Jain (1985) analyzes 304 bidding firms of divested assets and finds a significant positive abnormal return on the day preceding the acquisition announcement. Zaima and Hearth (1985) analyze 70 bidding firms and find positive, but statistically insignificant, abnormal returns for various intervals. Rosenfeld (1984) study 30 bidding firms and finds statistically significant positive gains in shareholders' wealth from 30 days prior to 30 days following the announcement. Sicherman and Pettway (1987) find insignificant positive abnormal returns over the same 61-day period for a sample of 147 acquisitions.

In cross-border M&As, Gleason, Mathur, and Singh (2000) study 244 foreign divestments by U.S. multinational corporations and find positive excess returns to the announcements of acquisitions of divested units of 0.48% over the two consecutive days ending on the day of the M&A announcement. Their sample, however, is limited to transactions between U.S.-listed firms and does not cover targets owned by non-U.S. listed firms – a void that we attempt to fill with this paper. Borisova, John, and Salotti (2011) find that in the two-day window around the announcement, foreign bidders of U.S. divested assets achieve positive abnormal returns (average of 1.15%) due to the growth opportunities and synergies provided by entering a new market. In contrast, our study analyzes the cross-border acquisitions of divested assets by U.S. firms. It also allows us to analyze how bidders select the form of the M&A deal across different countries.

2.1. Hypotheses

Fuller, Netter, and Stegemoller (2002) find that bidder shareholders gain when it buys a subsidiary from another firm. They explain that bidders receive better prices when they buy unlisted

[2] The explanations are as follows: acquiring managers suffering from hubris are overconfident and tend to overpay (Roll, 1986); bidder's performance is poor (Travlos, 1987); bidders are overvalued, especially when they use equity as the method of payment (Dong et al., 2006; Myers & Majluf, 1984); bidder's lack of internal growth opportunities (Jovanovic & Braguinsky, 2002; McCardle & Viswanathan, 1994); empire-building by bidder's management (Jensen (1986)); bidders are more likely to use excess cash to fund poor acquisitions than to return the cash to shareholders (Harford, 1999; Jensen, 1986).

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