



## Can acquisitions change firms'

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### ABSTRACT

This study re-investigates whether firms experience systematic risk changes due to acquisitions by examining changes in pre- and post-acquisition Betas. The study extends findings of prior studies by examining high-tech and basic-tech acquisitions separately and by examining whether acquirers' and targets' acquisition and alliance experience influence changes in risk due to acquisition announcements. Beta is a measure of market-specific risk and indicates the degree of variation in the stock systematically attributable to changes in market conditions. Beta characterizes a stock's usual relationship with the market. The study uses robust regression techniques and finds that Betas decrease following acquisition announcements supporting the findings of some prior studies. The study finds that changes in Beta are quite different for high-tech and basic-tech acquisitions, and that acquirers' and targets' alliance and acquisition experience influences changes in Beta.

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Acquisition activity steadily increased by number and dollar volume throughout the recent decades (Source: Securities Data Corp). During the 1980s 36,622 US firms were acquired and during the 1990s 103,016 US firms were acquired (Source: Securities Data Corp). Recent statistics show that acquisition activity remains intense, counting 42,077 US firms acquired between January 2000 and July 2004 (Krug & Aguilera, 2005). The Institute of Mergers, Acquisitions, and Alliances reported that worldwide acquisition activity totaled nearly 50,000 deals in 2007, and deal volume has remained high since then. Acquisitions play an important role in the corporate landscape as large numbers of firms continue to use acquisitions as a vehicle for growth, to expand firm size, to bring in emerging technologies, and for product or service diversification, among many other motives.

The purpose of this study is to investigate how acquisitions affect firms' risk. Firms' risk is an important characteristic and plays an important role in estimations of returns and firm valuations. A firm's risk is often represented by Beta, which characterizes a stock's usual relationship with the market. Beta is a measure of the covariance of the stock's returns with those of the market, divided by the total variance of the portfolio of stocks that represent the market portfolio (Markowitz, 1952). Beta represents market-specific or systematic risk, as it is an indication of the degree of variation in a stock systematically attributable to changes in market conditions. This study re-examines findings of prior studies by investigating whether firms experience changes in risk, or Beta, due to acquisitions. The study also extends the findings of prior studies by examining whether there are differences in risk-reduction for high-tech and basic-tech acquisitions examines whether acquirers' and targets' acquisition and alliance experience influence changes in Beta due to acquisitions.

The large volume of acquisitions throughout recent decades has helped make acquisitions the focus of many studies. Many researchers have examined abnormal returns<sup>1</sup> to acquisitions with most finding that acquisitions rarely benefit acquirers' shareholders. Although few researchers, such as Bradley, Desai, and Kim (1988), found that average returns to shareholders of acquirers are at best slightly positive, most researchers have found that acquisitions result in negative returns to acquirers (Asquith, 1983; Asquith, Bruner, & Mullins, 1983; Byrd & Hickman, 1992; Fowler & Schmidt, 1989; Halebian & Finkelstein, 1999; Jennings & Mazzeo, 1991; Morck,

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<sup>1</sup> To the extent that the event is unanticipated, the magnitude of abnormal performance at the time the event actually occurs is a measure of the impact of that type of event on the wealth of the firms' claimholders" (Brown and Warner, 1980, pg 205, Brown and Warner, 1985).

Schleifer, & Vishny, 1990; Sirower, 1997; Varaiya & Ferris, 1987; among other studies). Moreover, negative returns to acquirers are progressively worse for longer-term periods following event announcement or as the event-window increases (Agrawal, Jaffe, & Mandelker, 1992; Magenheimer & Mueller, 1988). Specifically, Loughran and Vijh (1997) find that in a five-year period following acquisitions, acquirers have significantly negative abnormal returns.

Importantly, in an examination of returns to mergers of US and British firms, Conn and Connell (1990) found that returns to acquirers are highly sensitive to pre- and post-merger announcement event periods. Risk-adjusted returns based on historical risk estimations of Beta, may bias measures of post-announcement returns.<sup>2</sup> In a later study specifically examining shifts in market model regression parameters of acquiring firms, Connell and Conn (1993) found pronounced shifts in estimated values of alpha and Beta (risk) from pre- to post-acquisition periods and noted that these shifts result in parallel shifts in estimated pre- to post-event excess returns. As a result, they concluded that most event studies may suffer from bias, as there are likely changes in risk characteristics of firms due to acquisition events. Thus, the effect of acquisitions on firms' risk is an important factor to consider when interpreting abnormal returns to acquisition announcements.

Few researchers have examined the effect of acquisitions on firms' risk. Studies such as Mandelker's (1974) and Jensen and Ruback's (1983) posit acquisitions may lead to changes in firms' risk through changes in firms' mix of products or through diversification of their cash flows. Yet compared to the proliferation of studies that examine abnormal returns to acquisition announcements, few studies have examined changes in risk due to acquisition announcements (Amihud, DeLong, & Saunders, 2002; Brooks, Feils, & Sahoo, 2000; Connell & Conn, 1993; Dodd & Leftwich, 1980; Langetieg, Haugen, and Wischern, 1980; Lubatkin & O'Neill, 1987; Mandelker, 1974; Shrieves & Lubatkin, 1990 are exceptions). Among studies where researchers have investigated whether the risk of acquirers shifts due to acquisition events, there remains ambiguity regarding whether acquisitions result in increases or decreases in risk. For example, Mandelker (1974) found that acquisitions result in decreases in risk whereas Langetieg, Haugen, and Wischern, (1980), found that acquisitions result in increases in risk. As pointed out by Connell and Conn (1993), further research is needed that examines potential causes of the pre- to post-acquisition announcement shifts in the risk characteristics of firms.

The study contributes to existing literature in several ways. First, the highly sensitive nature of cumulative abnormal returns to the period used to estimate market model parameters indicates there is ambiguity about the wealth change for shareholders of acquiring firms (Connell & Connell, 1990: 705, 708). Although Connell and Conn (1993) investigate how market model parameters shift pre- and post-acquisition, they imply that further research ought to consider the factors that influence such changes. Further insight on how acquisitions affect firms' risk and what characteristics correlate with changes in risk due to acquisitions may lead to further insight for researchers and managers. A better understanding of relevant variables may influence firms' and managers' acquisition choices, while helping investors increase the accuracy of their reactions to acquisition announcements and providing opportunities for researchers to gain further insight on important aspects of acquisitions.

Second, few researchers have examined acquirers' acquisition experience (Fowler & Schmidt, 1989; Halebian & Finkelstein, 1999; Hayward, 2002; Lubatkin, 1983; Zollo and Singh, 2000) and its effect on acquirers' acquisition performance yet none have examined whether experience relates to changes in risk. Furthermore, researchers have not considered another component of inter-firm experience such as alliance experience nor have they considered the role of targets' inter-firm experiences. Of the studies that examine acquisitions, many identify acquisition integration or the process of unifying the acquirer and target as a crucial part of the acquisition process and critical determinant of acquisition success (Capron, 1999; Datta & Grant, 1990; Haspeslagh and Jemison, 1986; Hitt, Harrison, & Ireland, 2001; Shanley, 1994). Although studies acknowledge integration risk as highly relevant in acquisitions, to date there are no published studies that examine factors that account for firms' inter-firm exchange experiences when examining risk, which may be relevant factors for integration.

Third, researchers have linked changes in risk due to acquisitions to the level of target and acquirer relatedness or business commonality. Researchers have explained that less relatedness may be indicative of less perfectly correlated cash flows and differences in cash flow streams may lead to differences in a firm's relationship with the market portfolio, resulting in a change in risk. This study includes a measure of business commonality but also accounts for acquirers' and targets' stock price relatedness. Literature on diversification indicates that firms in different businesses are more likely to have less correlated returns as their returns reflect firm-specific events and this may lead to a decrease in covariance of a combined firm. This study contributes to the discussion of diversification by investigating whether price relatedness of acquisition partners correlates with changes in risk due to acquisitions.

Finally, the study further distinguishes its findings from those of prior studies by examining high-tech and basic-tech acquisitions separately and by examining whether acquirers' and targets' acquisition and alliance experience influence changes in risk differently in high-tech and basic-tech acquisitions. The dependent variable is the change in risk before and after an acquisition announcement. The following section develops hypotheses about factors that influence changes in risk. These hypotheses propose that acquirers' and targets' acquisition and alliance experience affect changes in risk. Ensuing sections describe methodology, present results, and draw conclusions.

<sup>2</sup> An abnormal return is the difference between a stock's actual return and its expected return. A stock's expected return is often derived from market model estimations and is often a linear function of a stock's Beta or its usual relationship with the market. If Beta changes post-acquisition not factoring the change in Beta into estimates of expected returns for days following acquisition announcements may under- or over-estimate expected returns for those days and lead to inaccurate estimates of abnormal returns. For example, if Beta decreases due to acquisitions and if an abnormal return calculation does not account for the decrease in Beta, then taking a difference of a higher expected return from the actual return will lower the abnormal return or lead to negative abnormal returns. Lower than actual estimates of cumulative abnormal returns may lead investors or managers to believe acquisitions result in lower or negative abnormal returns in the post-acquisition period when in fact, the measure of abnormal return did not account for the decrease in Beta resulting from the acquisition.

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