Emerging Markets Review 16 (2013) 203–222

Contents lists available at SciVerse ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr

Analyzing the likelihood and the impact of earnout offers on acquiring company wealth gains in India

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ARTICLE INFO

Article history:
Received 13 August 2012
Received in revised form 10 May 2013
Accepted 13 May 2013
Available online 26 May 2013

Keywords:
Acquisitions
Cross border acquisitions
Earnout offers
Cash offers
Stock offers
India

ABSTRACT

The study seeks to assess the likelihood and impact of earnout offers on the acquiring company wealth gains in cross border acquisitions in India. The study highlights two cases where earnouts are preferred choices of the acquirer. Firstly, in those cases where the target company is in hi-tech and services sector employing high level of intangible assets that are difficult to value. Secondly, in those cases where the acquirers are mature and already have some international exposures. The results of the event study indicate that earnout offers create significantly higher wealth gains compared to the cash offers only and not the stock offers.

1. Introduction

The fundamental requirement in any merger and acquisition transaction is that the acquirer must know the value of the resources at the target's disposal. However, the information gap on the part of the acquirer regarding the true value of the target's resources pose the risk of adverse selection for the acquirer in an asymmetric information market. This risk is more pronounced in the case of cross border acquisitions (Contractor et al., 2007; Datar et al., 2001; Reuer et al., 2004) and has been defined as liability of foreignness by Zaheer (1995). The reason being, unfamiliarity of the foreign acquirer with the local industrial environment makes it difficult for the foreign acquirer to assess the true value of assets at the disposal of the target company. Chang and Tsai (2013), Donohoe (2006) and Mantecon (2009) also argue that information disadvantage on the part of a foreign acquiring company is the often cited reason for the losses of the firms engaged in international operations.

A priori research suggests that an acquiring company uses stock as a mode of payment to manage the risk of adverse selection in case of imperfect information market (Faccio and Masulis, 2004; Hansen, 1987;

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1566-0141/$ – see front matter
http://dx.doi.org/10.1016/j.ememar.2013.05.004

Loughran and Vijh, 1997; Martin, 1996; Travlos, 1987). The reason being, stock has a contingent pricing effect that enables the acquiring company share the risk of mis-valuation of the target's resources with the target's shareholders in the post acquisition period, through shared ownership.

Although, the acquiring companies can use stock financing as a hedge to mitigate the risk of adverse selection in case of cross border acquisitions, nevertheless in certain circumstances the acquirer may not be able to use the stock as a mode of payment. For instance, target companies are often reluctant to accept the stock of the acquiring company as a mode of payment when the acquiring company belongs to an emerging market[1] and hence, the acquiring company may have to forcibly employ cash (Conn et al., 2005; Moeller and Schlingemann, 2005; Tebourbi, 2005). The reason for such reluctance is the vagaries of the stock market in the emerging markets that make the stock of the acquiring company an unattractive proposition for the target shareholders (Mathew and Jain, 2006).

Thus, a situation may arise, in a cross border acquisition, where the acquirer who faces the risk of mis-valuation is unwilling to offer cash as it will shift the entire risk to the acquirer in the post acquisition period. On the other hand, the target is not willing to accept stock due to the skepticism regarding the valuation of the acquirer's shares as a currency of exchange. In such cases, the risk of losing the deal due to valuation disagreement between the target and the acquiring companies can be resolved by entering into a two part payment contract known as an earnout offer.

An earnout is a contractual agreement in which the acquiring company makes payment to the target in two or more parts, namely, an upfront payment made at the time of entering into the contract and a deferred payment or an earnout that is linked to the attainment of pre-specified performance milestones by the target company at pre-specified time periods. The amount of upfront payment reflects the mutually agreed upon portion of transaction value while the earnout reflects the extent of disagreement between the target company and the acquiring company (Kohers and Ang, 2000).

An earnout offer enables an acquiring company to share the risk of overpayment ex post with the target company by making the part payment contingent upon future performance benchmarks. Linking part payment to future performance targets also signals the inherent strengths of the target company because only that target company, which believes in its own potential to create value in the post acquisition period would accept such an offer where part payment is premised on its ex post performance.

Besides information asymmetry, acquiring companies are also motivated to employ earnouts as a tool to retain the managers of the target company who may possess the expertise and the specific knowledge in relation to the operations of the company that can otherwise not be duplicated (Kohers and Ang, 2000). Datar et al. (2001) state that in cross border acquisitions the acquirer may prefer to retain the target's owners/managers due to possession of the country specific expertise. Earnouts try to align the managerial objectives with organizational objectives by retaining the target managers and linking their earnings to their future performance. This in turn resolves the agency problem as highlighted by Reeb et al. (1998) which arises due to the difficulty faced by foreign acquiring companies in overseeing the actions of the overseas managers.

During the years 2005–2007, the value of outbound cross border acquisitions pursued by Indian companies rose dramatically from $1876.99 million in the year 2005 to $29,083.37 million in the year 2007, which was the highest value of outbound acquisitions among the emerging economies represented by the BRIC countries.[2] Further, during the years 2005–2007, Indian companies have financed a large number of their outbound cross border acquisitions via earnout mechanism. However, earnout offers are restricted only to outbound cross border acquisitions pursued by the Indian companies. Instances of domestic acquisitions or the inbound cross border acquisitions being financed via earnout mechanism are quiet rare in India. As far as domestic acquisitions are concerned, there is only one deal whereby WNS acquired Marketics Technologies and employed earnouts as a mode of payment. In case of inbound acquisitions, there are two instances (Greater Pacific Capital Plc. acquired Azure Knowledge Capital Private Limited; Serco Group Plc. acquired Intelenet Global Services) where deal value is structured in terms of

[1] Madhok and Keyhani (2012) have further refined the concept of liability of foreignness and have coined the term “liability of emergingness” for those firms which belong to emerging economies when such firms diversify their operations, internationally, especially in developed markets. They attribute the liability of emergingness to the handicaps and the resultant costs incurred by the firms from developing markets in their country of origin due to factors like underdeveloped markets, weak institutional environments, infrastructure bottlenecks, lack of strategic resources viz. technical and managerial expertise, etc. This in turn reduces the credibility of such firms in the eyes of host country stakeholders and restricts the mutually beneficial deals.

[2] World Investment Report on mergers and acquisitions by UNCTAD for the years 2005, 2006 and 2007.