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Political risk and the factors that affect international bids

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ABSTRACT

This study examines the determinants of bidder returns, target premiums and the likelihood of winning a bid in cross-border acquisitions. We identify how risk associated with the target home country affects these outcomes. Expected improvement in efficiency is the more powerful factor explaining the variation in premiums, while returns to bidders reflect the information asymmetry. Foreign targets are more likely to accept first or lower bids if target countries are culturally close to the U.S. Targets in poor-governance nations are more likely to accept a lower bid, explained by the ability of a good-governance nation acquirer to create benefits for the target.

1. Introduction

The subject of cross-border acquisitions has been a focus of financial research for several decades. It is still relevant today, although barriers to international diversification have fallen. The complexity of the mergers and acquisitions process is amplified for cross-border acquisitions by a variety of additional risks and costs, which creates a non-trivial cross-border effect (Moeller & Schlingemann, 2005). Identification and careful assessment of these additional factors are crucial for managerial decision making with the goal of value maximization. In addition, awareness of these additional risks and costs should help analysts in creating more accurate estimates and help investors in making optimal portfolio choices.

Researchers have developed theories according to which returns to bidders, premiums paid to targets and the success of a bid can be explained, on one hand, by flows of information and, on the other hand, by expected synergies and improved efficiency. The distinction becomes important in the case of cross-border acquisitions. Which set of factors is more important may affect both the success of a bid offer and the amount of the

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premium paid for the target. For instance, information flow is an important factor in determining premiums paid for the target, so premiums will be lower for targets in high-risk, low-transparency economies. Conversely, we can consider that synergies and improvements in efficiency are determining factors. Then the association of a high-risk (or low information) country target with a U.S. acquirer will increase future cash flows and such targets may receive higher acquisition premiums to reflect the improved value potential.

The focus of this paper is to identify which of these two sets of factors have a more pronounced effect on outcomes of cross-border acquisitions. We conduct a series of tests to identify how risk associated with the target home country affects bidder returns, target premiums and the likelihood of winning a bid. We find that expected improvements in efficiency is the more powerful factor explaining the variation in premiums paid for the target, while returns to bidders reflect the information asymmetry surrounding cross-border acquisitions.

This paper contributes to the body of knowledge regarding cross-border acquisitions in three ways. First, we examine how political risk factors affect the premiums paid to targets in cross border acquisition contests. Second, we expand the literature on the previously documented corporate governance spillover effect (Martynova & Renneboog, 2008) by examining governance differentials, which are the function of a broad range of country characteristics, including investor protection, the level of corruption, bureaucratic powers, ethnic tension, among other political risk factors.

Third, we analyze the effect of the target's country risk on the outcome of the auction process, and the likelihood of a successful bid. While auction theory in general and its application to auctions of firms is a developed area of research, there has been no attempt to apply the accumulated knowledge to cross-border acquisitions. We find that in cross-border auctions the motivation behind the target's selection of the winning bid varies depending on country risk. There appears to be collusion between the target and the winning bidder when the target is located in a high-risk country, since the probability of a low bid winning increases with the increase in the target country's corruption. The first bid is more likely to succeed when the target country culture has similarities with the U.S. culture, and this result, in application to cross-border acquisitions, is consistent with D'Aveni and Kesner (1993), who demonstrated that inter-related social networks and possible cronyism may influence the target management's decisions and prompt an acceptance of a lower bid (under a realistic assumption that the first bid is likely to be a lower bid under auction framework).

2. Literature and background

2.1. Country risk and target premium

Existing literature recognizes that the nature of the business environment in the target firm's home country should be included among explanatory factors in the studies of variations of the outcomes of cross-border activities (Cao & Madura, 2011; Diamonte, Liew, & Stevens, 1996; Francis, Hasan, & Sun, 2008; Glambosky, Gleason, & Madura, 2010; Kiymaz, 2009; Kwok & Reeb, 2000; Mantecon, 2009; Martynova & Renneboog, 2008; Moeller & Schlingemann, 2005). Previous research offers a variety of methods to measure how conducive the economic, political and cultural environment in a particular country is to efficient business management. Variables used in prior research include *Enforceability of Contracts* (Djankov, Glaeser, Porta, Lopez-de-Silanes, and Shleifer (2003)), *Anti-Self-Dealing* (Djankov, Porta, Lopez-de-Silanes, and Shleifer (2008)), *Corporate Governance Regulation Indices* comprised of *Shareholder Rights Index*, *Minority Shareholder Protection and Creditor Rights Index* (Martynova & Renneboog, 2008) and *Index of Economic Freedom* compiled by the Heritage Foundation (Francis et al., 2008; Mantecon, 2009). Most studies find significant impact of the differentials of the various measures of country risk and governance features on outcomes of cross-border restructuring efforts.

The results, however, are not entirely consistent and vary depending on the sample and the specification of country risk proxies. For example, Martynova and Renneboog (2008) find that returns to both bidders and targets increase with the increase of the (positive) differential between good governance measures of the bidder's and the target's home countries. The authors find support for the beneficial spillover hypothesis, since investors' expectations of the improvement in the target's performance translates into overall increase in wealth. Francis et al. (2008) demonstrate similar outcomes. On the other hand, Kiymaz (2009); Moeller and Schlingemann (2005) and Glambosky et al. (2010) find that bidders gain higher returns when acquiring firms in countries with relatively low risk.