



# Determinants of target selection and acquirer returns: Evidence from cross-border acquisitions

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## ABSTRACT

We examine cross-border acquisitions of private and public targets by U.S. firms by employing self selection models. We are particularly interested in the roles of country-level liquidity and transparency in cross-border acquisitions. Our results show that a typical acquisition deal of a private target is smaller in size, uses cash less frequently for payment, and involves more high-tech firms than that of a public target. Most importantly, we find that acquiring firms are more likely to buy private targets in lower-transparency countries, but the level of market liquidity in the target firm countries has little effect on the target selection. Furthermore, after accounting for the endogeneity bias associated with target selection, country liquidity is no longer a key determinant of acquirer returns in cross-border acquisitions. Our results are robust to alternative specifications of dependent variable and self selection models.

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## 1. Introduction

The traditional literature of mergers and acquisitions has well documented that target firm shareholders experience significant positive gains at the time of acquisition announcement, while acquiring firm shareholders, on average, obtain zero or negative returns. More recent literature has, however, shown that returns to acquiring firms at the time of acquisition announcement depend on the listing status of the target firm.<sup>3</sup> These studies show that the shareholders of acquiring firms experience a positive change in wealth when acquiring privately-held targets, but no change or a negative change in wealth when acquiring publicly-held targets. For example, Koeplin, Sarin, and Shapiro (2000) find that private firms are purchased at an average of 18% (book multiples) or 20–30% (earnings multiples) discount compared to public firms. Kooli, Kortas, and L'Her (2003) also show that the median private target discount is 20% (cash flow multiples) and 34% (earnings multiples). Similarly, Officer (2007) shows that unlisted targets sell at a discount of 15% to 30% on average relative to public firms, and almost 70% of the unlisted targets are acquired at multiples less than comparable publicly traded firms.

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<sup>3</sup> See, e.g., Chang (1998), Koeplin et al. (2000), Fuller et al. (2002), Kooli et al. (2003), Shen and Reuer (2005), Faccio et al. (2006), Officer et al. (2009), Officer (2007), Cooney, Moeller, and Stegemoller (2009).

This positive market reaction to acquisitions of private targets compared to those of public targets is dubbed as private target discount. While existing studies report consensual evidence of positive announcement returns for firms acquiring privately-held targets, empirical evidence is limited to the acquisitions of domestic target firms, failing to offer evidence on cross-border acquisitions of public and private targets by U.S. firms. Furthermore, existing studies focus primarily on the target firm's characteristics alone, rather than the characteristics of both acquiring firms and target firms, to explain the private target discount. For example, Fuller, Netter, and Stegemoller (2002) conclude that the private-target effect depends on the characteristics of target firms and bids rather than those of acquiring firms as the same firm makes several bids to a different type of target firms and uses different payment methods. A study by Capron and Shen (2007), however, provides evidence that acquiring firm returns are not just all driven by the choice between public and private targets, but also depend on acquiring firms' attributes as well as target firms'.

In this paper, we extend the existing literature on acquisitions of private and public target firms with two major contributions. First, we focus on foreign private and public target firms for our analysis. Our study is the first to investigate the different valuation effects of U.S. firms acquiring foreign private and/or public targets from forty countries by explicitly taking into account country-level factors. Erel, Liao, and Weisbach (2012) show that an imperfect integration of capital markets across countries can lead to a merger in which a higher-valued acquirer purchases a relatively inexpensive target. Drawing from the literature, we measure and consider country-level liquidity needs and information asymmetry (or transparency) as potential factors to explain the private target discount. Our attention is on whether these two country-level factors play key roles in explaining the variations in wealth changes associated with the acquisitions of private targets relative to those of public targets in the presence of other characteristics of deals and acquiring and target firms. In order to account for repeated buyers and variations in time, we employ robust error regression models clustered at both acquiring firm and year levels.

Second, we employ self selection models to account for self selection in the acquiring firm's decision to purchase a private vs. public target, as well as OLS regression models for comparison purpose. Previous studies on the analysis of private target discounts fail to control for endogeneity bias and thus unobservable private information that would influence corporate acquisition decisions.<sup>4</sup> In the conventional OLS regression analysis, the changes in firm value (or stock market response) associated with acquisition announcements are assumed to have no influence on a firm's decision to select a private vs. public target. If the firm's decision, however, depends on the changes in its anticipated value, the assumption that publicly known information influencing the firm's decision to select a private vs. public target is exogenous is incorrect (Maksimovic & Phillips, 2002).<sup>5</sup> To correct for endogeneity bias, we use the maximum likelihood version of the Heckman (1979) self-selection model. As a preliminary test, we examine whether private target selection is the acquirer's choice. If the selection is not randomly done, the choice and return equations need to be estimated simultaneously. Wald test of independent equations yields significant chi-square statistics, rejecting the null hypothesis of independent equations and thus supporting the existence of self selection bias.

Employing 672 cross-border acquisitions of U.S. firms during 1996–2002, we show that a typical acquisition deal of a private target is smaller in size, uses cash less frequently for payment, and involves more high-tech firms than that of a public target is. In addition, firms acquiring private targets are smaller in size, have higher Tobin's  $q$ , and have a higher cash to total assets ratio but a lower free cash flow to total assets ratio than firms acquiring public targets.

Consistent with previous studies, our results show that acquiring firms on average earn significantly larger announcement-period returns with the acquisitions of private targets than with those of public targets. The univariate tests reveal that acquiring firms generate higher returns when purchasing targets in lower-liquidity countries, regardless of the target type. In contrast, the level of transparency in the target country causes little difference in the acquirer returns. A further examination of the number of targets shows that when buying firms in low-liquidity countries, acquiring firms do not show any preference in the target type. On the contrary, when buying firms in low-transparency countries, acquiring firms are more likely to buy private targets than public targets. Combined together, these results indicate that while country liquidity plays an important role in affecting acquirer returns, country transparency plays as a key determinant of target firm selection.

The results from self selection models are in general consistent with those from the univariate tests, but are sharply different than those from the OLS regressions. Our results show that after accounting for the endogeneity bias, country liquidity is no longer significant and hence is not a key determinant of acquirer returns in cross-border acquisitions. Our results also reveal different roles of country liquidity and transparency in selecting a target type that acquiring firms are more likely to buy private targets in lower-transparency countries, but the level of liquidity in the host countries has little effect on the target selection. Our regression results are robust to alternative specifications of dependent variables and self selection models.

Our paper is organized as follows. In the next section, we offer literature review and develop our testable hypotheses. We present sample and data in Section 3 and empirical methods and results in Section 4. Section 5 concludes our study.

## 2. Literature review and development of hypotheses

A large body of existing studies documents evidence that the acquisition of public targets, on average, creates a zero or negative value for the shareholders of acquiring firms (see, e.g., Mulherin & Boone, 2000; Fuller et al., 2002; Moeller, Schlingemann, & Stulz,

<sup>4</sup> The only exception is a study by Capron and Shen (2007) in which a Heckman (1979) two-step estimation procedure is used to correct for endogeneity bias.

<sup>5</sup> The self selection problem has been noted for the cause of biased estimates in various fields of finance. For example, in the diversification literature, Campa and Kedia (2002) argue that firms self-select into becoming diversified and that self-selection explains the diversification discount found in earlier studies. Their evidence suggests that the diversification discount is not driven by firms' diversification activities, but by private information that leads firms to become diversified.

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