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Does payment method matter in cross-border acquisitions?

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ABSTRACT

In this study, we focus on 1300 completed deals (545 cross-border and 755 domestic deals) by Canadian acquirers between 1993 and 2002 to examine the effect of payment methods in the context of cross-border M&A deals. Our results show a significant and positive effect for stock-financed deals in the cross-border acquisitions. This result is robust to a set of commonly used control variables in the literature. In order to find a justification for such positive reactions for stock financed deals, we investigate the long-term operating performance of cross-border cash- and stock financed deals. Our results do not show any significant difference. It appears that market is overenthusiastic about the cross-border stock financed deals and overestimates the synergy gains. Market corrects for this overreaction for cross-border stock financed deals in the subsequent periods. We carry out a detailed buy-and-hold abnormal return (BHAR) analysis to evaluate the long term stock returns for these firms. Our results show that cross-border stock financed deals significantly underperform in the long-run compared to the cross-border cash financed deals. Further, we examine the role of stock payment in mitigating information asymmetry in cross-border deals and alleviating the risk arising from making acquisitions in a foreign market with lower corporate governance rating. Our results show that stock payment is viewed as a possible remedy for reducing information asymmetry and lowering corporate governance related risk in cross-border acquisitions.

1. Introduction

Mergers and acquisitions (M&As) are quite complex and are significant strategic events for the acquiring and target firms. Scores of studies have documented various aspects of M&A activity including trends in M&A activity, characteristics of the transactions, and corresponding gains or losses to shareholders. Perhaps, one of the most important issues in M&A that requires significant considerations and efforts of acquiring firms' managers is the form of payment and its appropriate mix. Once an acquiring firm's[3] management is convinced about the benefits of a deal and decides to go ahead with the acquisition, they need to determine the method of payment (such as cash, stock, or mixed) and the financing structure. Extant literature shows that payment method matters to the shareholders and shareholders of acquiring firms view cash offers more positively than stock offers. Fuller, Netter, and Stegemoller (2002), among others, argue that due to information asymmetry and valuation uncertainty surrounding a stock acquisition, the market views stock financed deals less favorably than cash financed acquisitions. However,

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[3] Following Moeller and Schlingemann (2005), we focus our analysis only on the acquiring firms' returns and the valuation consequences for the acquiring firms' shareholders.

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there are some important advantages of stock financed deals vis-à-vis cash financed deals — such as 'monitoring by existing shareholders of the target firm' (Kang & Kim, 2008), 'corporate memory retention' (Uysal, Kedia, & Panchapagesan, 2008), and 'alleviation of asymmetric information problem' (Chen & Hennart, 2004). These factors are likely to play more significant roles in cross-border acquisitions. In this study we focus on the impact of payment methods in the context of cross-border acquisitions.

Acquiring firms are interested in foreign targets for a number of reasons such as to achieve geographic diversification, new market penetration, lower labor costs, accelerated growth, follow customers and to tap intangible assets. Cross-border acquisitions pose significant challenges to the acquiring firms. It is more difficult to integrate and control a foreign target compared with a domestic one.[4] Cash payments in M&A deals are often associated with drastic changes in the target firm's management (Dennis & Dennis, 1995), which could be detrimental to the integration process. Further, cash acquisition will also eliminate the existing shareholders of a target firm. In the case of a cross-border acquisition, it is more important to have 'local' shareholders monitoring the activities of the newly acquired firm (Kang & Kim, 2008). Local investors have access to soft information which is of great importance for stock valuation (Uysal et al., 2008). Therefore, in the context of cross-border acquisitions, market may react differently with respect to the method of payment. Our study examines this important issue with an extensive sample of Canadian M&A events. To the best of our knowledge, this is the first study to investigate this issue, at least in the Canadian context.

In this study, we focus on 1300 completed deals (545 cross-border and 755 domestic deals) by Canadian acquirers between 1993 and 2002. We find significantly positive abnormal returns for Canadian acquiring firms' shares around the announcement date. Similar to Eckbo and Thorburn's (2000) results, however, we do not find any significant difference in acquirers' returns for payment methods. In the case of cross-border acquisitions, our results show a significant and positive effect for stock financed deals. This result is robust to a set of commonly used control variables in the literature. Still most of the cross-border deals (90%)[5] by Canadian acquirers use cash as a payment method. The results are puzzling, as most of the acquiring firms do not use stock as a payment method irrespective of the positive perception of such cross-border deals around the M&A announcement dates. Do the cross-border stock financed deals really give more benefits to the acquiring firm shareholders in comparison with cash financed deals? In order to find a justification for such positive reactions for stock financed deals, we investigate the long term operating performance of cross-border cash- and stock financed deals. Our results do not show any significant difference. It appears that market is overenthusiastic about the cross-border stock financed deals and overestimated the synergy gains. Does market correct for this overreaction in the subsequent period? We carry out a detailed buy-and-hold abnormal return (BHAR) analysis to evaluate the long term stock returns for these firms. Our results show that cross-border stock financed deals significantly underperform in the long run compared with the cross-border cash financed deals. Further, we examine the role of stock payment in mitigating information asymmetry in cross-border deals and alleviating the risk arising from making acquisition in a foreign market with lower corporate governance rating. Our results show that stock payment is viewed as a possible remedy for reducing information asymmetry and lowering corporate governance related risk in cross-border acquisitions.

Our study contributes to the literature in several ways. *First*, we examine Canadian acquiring firms and thus present out-of-sample evidence with a different developed country capital market. We take the view that differences in the size of the economy and in the capital market and regulatory environment may lead to different results. Most of the prior studies focus on USA and UK acquisition markets, where most of the M&A deals take place. However, Canadian M&A market is also considerably large and vibrant. As reported by Crosbie & Co., a Toronto-based merchant bank, total transaction values of the announced deals during 2007 was $370 billion with 1941 deals in Canadian M&A market. This was a record in Canadian M&A history with 60 transactions in excess of $1 billion. By examining Canadian acquiring firms, we present out-of-sample evidence with a different developed country capital market. Dutta and Jog (2009) identify a number of important differences between the Canadian and the U.S. M&A markets and show that market reactions to M&A announcements differ between these two markets.[6] Therefore, a detailed examination of Canadian M&As is likely to present interesting insights to the investors' perception on M&A events. *Second*, we focus on the performance implications of the payment methods in cross-border deals. Most of the earlier studies focus on either cross-border deals or payment methods with respect to the M&A deals. Joint investigation of these two deal characteristics leads to interesting findings. Though cash financed deals are viewed positively by shareholders and market participants, stock financed deals have some unique advantages in the context of cross-border acquisitions. *Third*, we check for a consistency in market reactions to cross-border stock financed M&A deal announcements. We find that the market reactions to M&A announcements are significantly positive for cross-border stock financed deals. Such positive reactions could be attributed to the expectation of significant positive synergistic gains from the cross-border stock financed deals. In order to validate this view, we examine the long-term operating performance of cross-border acquisitions with respect to different types of payment methods (Moeller & Schlingemann, 2005) and find that cross-border stock financed deals do not show any significant improvement in acquirer's long-term operating performance. It appears that market is overenthusiastic about the cross-border stock financed deals around the deal announcement dates and overestimates the synergy gains. Market corrects for this overreaction for cross-border stock financed deals in the subsequent periods. Our study reinforces the importance of evaluating both short-term and long-term

[4] In a recent study, Uysal et al. (2008) find that acquirer returns in geographically closer transactions (target location within 100 km) are more than twice that in geographically farther transactions. The higher return to local acquirer is not explained by related, either horizontal or vertical, industry transactions, and appears to be related to information advantages arising from geographical proximity.

[5] This percentage includes pure cash- and mixed- (i.e. cash + stock) financed deals. 63% of the deals are concluded with pure cash payments. The statistics is based on the SDC Platinum database.

[6] M&A studies using U.S. data generally report either negative or insignificant abnormal returns for the acquiring firms around the announcement date (Bruner, 2004). This is contrary to the notion of the synergy motive that leads to acquisition activities. In contrast, previous Canadian studies consistently report significantly positive abnormal returns around the announcement date (Eckbo & Thorburn, 2000; Yuce & Ng, 2005).