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Cross-border mergers and acquisitions and default risk

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ABSTRACT

We examine the impact of cross-border mergers on acquirers' post-merger default risk using a sample of 375 US acquiring firms from 1997 to 2011. After controlling for cultural, institutional, geographic and managerial factors between the US and target firm countries, we find that on average, cross-border transactions decrease the level of default risk of the acquiring firms. Our results are consistent with the asymmetric information hypothesis that managers take advantage of the overvaluation and volatility of their stock prices. We also observe that the geographic distance and industrial relatedness play significant roles in affecting post-merger default risk but find limited evidence indicating the relevance of institutional environments and cultural factors on changes in default risk. Managers use cross-border mergers to manage the extant risk of their firms. However, their incentives to use cross-border mergers to manage risk are mitigated by option compensation.

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1. Introduction

In recent decades, with the acceleration of global financial market integration, mergers and acquisitions (M&A), both domestic and cross-border, have been rising steadily. International transactions account for a significant portion of the total mergers and acquisition deals, reaching to 45% of total merger volume in 2007 (Erel, Liao, & Weisbach, 2012). Moreover, in more advanced economies, cross-border mergers account for more than 80% of the total foreign direct investments (Goergen & Renneboog, 2004). Cross-border mergers and acquisitions encompass much more complex issues compared to domestic M&A transactions, including differences in political and economic environments, quality of accounting and information disclosures, cultural and corporate governance norms, and bilateral trade relationships between countries. A crucial issue, in this context, is whether cross-border deals result in an increase (or decrease) in default risk, post-merger. Therefore, in this paper, we examine the post-merger default risk of a sample of US cross-border acquirers.

One of the main reasons purported in the literature for a company undertaking a merger is the diversification of its operations that would lead to reduced cash flow variability and consequently reduced risk. Mergers and acquisitions indeed have impact on the risk profile of firms, and even the possibility of their bankruptcy. While most studies in the M&A literature use accounting or equity-based measures of risk, such as z-score or beta, two recent studies employ direct measures of risk, namely the default risk. More specifically, Vallascas and Hagendorff (2011) use Merton's distance to default model, which combines both accounting and market data, and Furfine and Rosen (2011) who use the Expected Default Frequency which is developed by MoodysKMV, a commercial data service company. Vallascas and Hagendorff (2011) investigate the impact of European bank mergers on bidders' default risk. On average, for a sample of 143 acquiring banks, they find no material impact of bank mergers and acquisitions on the level of default risk. However, Furfine and Rosen (2011), using a large sample of more than 3600 firms, document that domestic mergers in the US, on average, increase default risk of the acquiring firms. The observed positive relationship between mergers and the default risk of acquiring firms is in direct contrast to the traditionally held conjecture that mergers and acquisitions, through diversification effect, could lead to a reduction of risk for the combined firms, e.g., Amihud and Lev (1981). Furfine and Rosen (2011) test various hypotheses and contend that their findings are in line with asymmetric information hypothesis, i.e., managers of acquiring firms are able to hide risk-increasing takeovers from outside shareholders; they further find support for the notion that private benefits by managers, due to an increase

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in the option-based portion of their post takeover compensation, lead to higher risk taking by managers of acquiring firms in the US.

While the literature examining various aspects of domestic M&A is ample, there are, by comparison, fewer studies that investigate international mergers and acquisitions. The majority of studies in the field of M&A deal with the effects of these transactions on stock returns and corporate valuation. Briefly, prior studies on cross-border mergers report that acquirers can achieve higher valuation by purchasing foreign targets in related industries (Dos Santos, Errunza, & Miller, 2008) or by acquiring targets in emerging markets or countries that generally have weaker corporate governance regime (Bris & Cabolis, 2008; Moeller & Schlingemann, 2005; Rossi & Volpin, 2004). The opportunity to create value via cross-border mergers can also arise from what is termed as "wealth effects". A stronger domestic currency or higher domestic stock market valuation, relative to foreign currencies or foreign stock markets, motivates firms to take on cross-border mergers as the price of foreign targets becomes less expensive (Erel et al., 2012; Froot & Stein, 1991). Alternatively, transitory valuation errors could also lead to international transactions; especially when the stock price of acquiring firms is overvalued. The stock misevaluation could encourage these firms to issue shares to acquire (undervalued) targets (Rhodes-Kropf & Viswanathan, 2004; Shleifer & Vishny, 2003).

Our study contributes to the literature by examining cross-border mergers of industrial firms. Although post-merger default risk changes have been examined for domestic mergers, there is limited work on cross-border mergers of industrial firms. While international mergers and acquisitions generally involve complex factors such as foreign political and economic considerations, different accounting and information disclosure regimes, and cultural and corporate governance issues, at the same time, these transactions could offer multiple advantages such as cheaper raw materials and labor costs, enhanced production efficiencies, favorite tax treatments, or a combination of these reasons that are not available in the domestic markets. We could therefore expect a substantially different relationship between risk and international takeovers than that observed in the domestic case by Furfine and Rosen (2011).

Changes in default risk following cross-border mergers, using the same measures as in our paper, have been examined only in the banking sector. There is as yet no comprehensive study focusing on industrial firms. Thus, the objective of our study is to extend the above analysis to the case of cross-border mergers and acquisitions. There are indeed critical differences between cross-border mergers in the banking and industrial sectors. Banks are highly regulated and therefore regulators frequently act in ways to prevent mergers that increase risk (Buch & DeLong, 2008; Elyasiani & Jia, 2008; Koetter et al., 2007). Managerial risk-taking incentives are to some extent driven by the regulatory environment in the banking industry. Due to deregulation following Gramm–Leach–Bliley Act of 1999, performance contracts have become more option-based to encourage managers to take advantage of new investment opportunities that are more risky than traditional banking activities (DeYoung, Peng, & Yan, 2010). Further, CEO-risk taking incentives are designed to shift risk from bank shareholders to regulators and bond holders (Bebchuk & Spamann, 2009) and are further exacerbated by implicit bail-out polices and deposit insurance. These moral hazard problems are largely absent in the cross-border mergers in the industrial sector.

We investigate the relationship of default risk, a direct measure of risk, and cross-border mergers for a sample of US firms acquiring foreign firms for the period of 1997 to 2012. We find that, in contrast to the results obtained by Furfine and Rosen (2011) for domestic mergers, cross-border mergers do indeed reduce the overall default risk of acquiring firms which are in line with the findings of Vallascas and Hagendorff (2011) for cross-border bank mergers and acquisitions. We find that geographic distance between the two countries and industry diversification affect default risk, and that national cultures play a negative, though marginal role, on default risk. We are further able to report that the determinants on the change in the acquirers' default risk are relatively different from those of domestic mergers reported by Furfine and Rosen (2011). For instance, we note that the CEO's compensation is insignificantly related to the change in default risk. However, consistent with Furfine and Rosen (2011), we document that idiosyncratic risk, a proxy for information asymmetry, is positively related to the default risk. Finally, we report that mergers financed with shares are negatively related to the default risk, albeit not statistically significant.

The rest of the paper is organized as follows. In the next section, we review the relevant literature and draw testable implications based on theoretical underpinnings. In Section 3, we describe our data. In Section 4, we discuss our methodology for measuring default risk and rationale for the selection of variables in our analysis. In Section 5, we report and discuss our empirical findings and their implications. Our conclusions are offered in the final section.

2. Literature review and theoretical underpinnings

Mergers and acquisition are traditionally viewed to result in risk reduction for the combined entity (Amihud & Lev, 1981; Galai & Masulis, 1976). This insight is valid when the bidder and target have roughly equally risky cash flows and asset diversification resulting in total risk reduction. In reality, however, when the risk is measured as a default risk, the evidence is mixed. Furfine and Rosen (2011), as mentioned earlier, find strong empirical evidence that domestic mergers result in an increase in post-merger default risk. In the context of bank M&A deals, where default risk is important, empirical evidence for the US indicates that the post-merger default probability is lower due to portfolio diversification (Emmons, Gilbert, & Yeager, 2004), geographic diversification (Hughes, Lang, Mester, & Moon, 1999), and activity diversification (Van Lelyveld & Knot, 2009). In the case of European bank mergers, Vallascas and Hagendorff (2011) find that on average, these transactions are risk neutral.

Mergers and acquisitions, especially those which involve cross-border deals, are complex transactions. A host of deal, acquirer, and institutional factors influence the post-merger default risk of the combined entity. We therefore survey the relevant literature and draw testable implications based on underlying theory. We segment our discussion into three categories: deal characteristics, managerial incentives and cross-border sources of risk.

2.1. Deal characteristics

First, there could be a transfer of risk from the target firm to the bidder (Furfine & Rosen, 2011; Vallascas & Hagendorff, 2011). Second, the risk transfer could occur due to the target belonging to an industry that is more risky than the bidder's industry (Furfine & Rosen, 2011; Maquieira, Megginson, & Nail, 1997). Third, deal characteristics such as the use of cash versus stock could potentially influence the post-merger risk thereby impacting default risk. In cash financed deals, leverage is typically higher than stock financed deals and since leverage is related to default risk, cash deals are expected to result in increased default risk.

2.2. Managerial incentives

Managerial actions could result in a post-merger change in default risk. Extant research has uncovered at least four potential actions managers of acquiring firms could take that influence the post-merger risk of the combined entity. One of the actions managers could take is to increase the post-merger leverage of the combined firm (Ghosh & Jain, 2000; Morellec & Zhdanov, 2008). A second possibility is that option-based managerial compensation could potentially incentivize managers to take on more risk in the post-merger period (Grinstein & Hribar, 2004; Hagendorff & Vallascas, 2011). There is some evidence in the

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