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Cross-border acquisitions in a transition economy: The recent experiences of China and India

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ABSTRACT

This paper investigates the causes and consequences of inward cross-border acquisitions in emerging countries. The focus is on business deals made by firms in China and India, where government ownership ratios remain high. Our empirical analysis yields two important findings. First, the Chinese and Indian firms targeted by foreigners have statistically higher cash-reserve ratios and growth opportunities that do not attract domestic acquirers. This result suggests that both target characteristics are required to influence the inward investment decisions of foreign firms. Second, shareholder value created through cross-border acquisitions is higher for foreign acquirers than for domestic acquirers. This finding implies that investment returns on foreign acquisitions in high-growth emerging markets in which governments promote state-owned share releases are higher than returns from domestic takeovers. It also explains why the number of cross-border deals has recently increased in these countries.

1. Introduction

There is a vast body of literature on corporate mergers and acquisitions, including several empirical studies on their causes and consequences. Some suggest technological innovations, industrial deregulations, and changes in demographic structures as the major causes thereof. Others report that acquisitions bring about both positive and negative impacts to industries involved in the deals in the post-acquisition period. Most of the existing literature uses datasets of U.S. firms, since the United States has the largest corporate acquisition market in the world. However, clearly, there is an increasing merger "wave" hitting not only other industrialized countries, but also emerging countries; the latter, in particular, is likely to promote economic transition through the release of state-held equity.

In East Asia, the number of acquisitions by foreign firms dramatically increased following the 1997–98 financial crisis. One of the causes cited was the enhanced purchasing power of foreign acquirers following the local currency devaluations and falling local stock prices in the region. Other triggers included the widespread privatization of state-owned enterprises and the deregulation of capital transactions. More than 10 years after the crisis, however, the number of corporate acquisitions continues to increase, especially in emerging countries. Remarkably, emerging economies that experienced no currency crisis have recorded even larger numbers of mergers and acquisitions. One possible reason for this dramatic increase is that foreign firms have become more aggressive purchasers of the released shares of state-owned enterprises, and

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at the same time, governments in emerging economies such as China and India have been promoting inward invitational investment policies by deregulating existing legislation.

According to the United Nations Conference on Trade and Development, total international direct investment exceeded US $1244 billion in 2010, with a significant portion of the increase attributed to high-growth emerging economies. In fact, cross-border corporate acquisitions accounted for 9.8% of the total international direct investment flow in that year. The Chinese 12th Five-Year Plan of 2011 illustrates how an emerging-country government regards the recent acquisition trend and why China promotes an inward foreign direct investment stimulus policy. Specifically, the Plan mentions that the Chinese government expects inward cross-border acquisition to bring with it advanced technology, stronger managerial discipline, and wider international delivery channels, in addition to large quantities of equity funds. This information suggests that other emerging-country governments are also likely to encourage corporate acquisitions in order to stimulate stagnating state-owned firms in the short term.

In this paper, by focusing on international acquisition deals made in China and India, we analyze the effects of international corporate acquisitions on economic development in emerging countries where there are still many government-owned firms. Since the existing literature cannot be used to explain fully the recent cross-border acquisition trends in emerging countries with transition economies, we believe that studies that concentrate on these economies are valuable. This paper has three objectives. The first is to verify the timing of the cross-border deals and the common characteristics of the target firms that foreign acquirers prefer in these countries. We will test empirically the factors that influence a foreign acquirer's investment decision by examining the characteristics of targets in China and India. The second is to determine how the capital market evaluates the announcement of cross-border acquisitions in these countries. In particular, we will examine the types of cross-border acquisition that bring about large shareholder value. The third is to verify and assess the universal common characteristics of foreign acquirers that create large shareholder value for both acquirers and targets. Using acquisition-deal data matched to firms' financial statements, this study will identify the causes and consequences of cross-border acquisitions in China and India and compare the findings with studies that analyze major industrialized countries.

2. Related literature

The balance of payment statistics of the International Monetary Fund defines the following two types of international investment as foreign direct investment: greenfield foreign direct investment (hereafter, "greenfield FDI") and cross-border acquisition. Previously, traditional greenfield FDI accounts constituted a large share of total foreign direct investment, but the share of cross-border acquisitions has dramatically increased in recent years. In line with this development, a number of studies concerning cross-border acquisitions have been published, including those of Nocke and Yeaple (2007), Giovanni (2005), Head and Ries (2008), and Erel, Liao, and Weisbach (2012).

The theory-based study of Nocke and Yeaple (2007) observe that the degree of production factor mobility across a national border determines whether a firm will choose to partake in cross-border acquisition or greenfield FDI. Specifically, the firm will choose cross-border acquisition to access the foreign market when one of the production factors therein is internationally immobile. The number of empirical studies in this field has increased; one of those studies—Giovanni (2005)—suggests that the degrees of capital market development and of financial legal system development are two determinants of cross-border acquisition. In other words, firms in countries where the capital market and financial legal system are more fully developed are more likely to be targeted for international acquisition deals. Head and Ries (2008) compare cross-border acquisition and total foreign direct investment empirically, and they conclude that the determinants of cross-border acquisitions differ from those of foreign direct investment. Chari, Ouimet, and Tesar (2010) use cross-country data to investigate shareholder value gains from international acquisition; they find that acquiring control over a target can bring high abnormal returns, especially for firms from developed countries. The more recent study of Erel et al. (2012) analyzes whether or not a public listing of an acquirer or target influences the determinants of an acquisition deal; that paper concludes that equity prices are influenced when acquirers are publicly listed and that changes in the exchange rate are influenced, regardless of stock listing.

There are also many studies that analyze acquisition deals between two domestic firms. Recent literature using the cases of U.S. sample firms point out that whether or not acquisitions will add to corporate value maximization depends on the following three factors. First, an acquisition enables the acquirer to obtain new technology and higher productivity, as suggested by both Andrade, Mitchell, and Stafford (2001) and Mitchell and Mulherin (1996).[2] Second, the acquirer expects the corporate acquisition to improve the managerial discipline of the targeted firm, as noted by Morck, Shleifer, and Vishny (1988) and Lang, Stulz, and Walking (1989). Third, shareholders' potential right to eliminate nonperforming managers leads to an increase in corporate value, regardless of eliminations via acquisition; this has also been suggested by other studies.

The aforementioned literature review also suggests that few analyses, except Chari et al. (2010), verify whether the determinants of cross-border acquisition and domestic deals differ in emerging countries. The current paper records the

[2] Andrade et al. (2001) and Mitchell and Mulherin (1996) each point out that a merger wave hits a limited number of industries during a short-term period; however, when industrial sectors experience technological innovation, deregulation, and other catalyzing factors lead to a dramatic change in industry productivity, a merger wave will likely follow.