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Returns to acquirers of privatizing financial services firms: An international examination

Kimberly Gleason, James E. McNulty, Anita K. Pennathur *

Florida Atlantic University, Davie, FL 33314, USA

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Abstract

While the literature reports improved performance for privatizing firms, banking markets are different. Many privatizing financial services firms face unique problems such as an overhang of problem loans and weak credit cultures and legal systems. We investigate the returns to successful bidders in privatization acquisitions of financial services firms, examine short-horizon performance, and test whether such acquisitions result in a change in risk for the bidding firm. Our results show that the cumulative abnormal returns to shareholders of bidding firms are positive, perhaps reflecting initial optimism that the foreign firm acquiring the privatizing firm would share in the success associated with privatization. Bidders also experience an increase in their total risk following the acquisition.

JEL classification: G14; G15; G21; G34

Keywords: Privatization; Banks; Acquisitions; International markets

* Corresponding author. Address: Department of Finance, College of Business, 2912 College Avenue, LA 483, Davie, Fl 33314, USA. Tel.: +1 954 236 1272; fax: +1 954 236 1298.
E-mail address: pennathu@fau.edu (A.K. Pennathur).

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1. Introduction

Is wealth created when countries open their borders to foreign financial services firms by allowing them to acquire newly privatized banks? To answer this question, we examine the short-run impact on the stock price from announcements of acquisitions of privatizing financial services firms. While there is a substantial body of literature on the performance of post-privatization entities, including those in this issue, and while several studies have investigated US and cross-border bank acquisitions, our study is the first to investigate short-horizon returns and changes in systematic risk for acquirers in financial services privatizations. We examine the returns to both US and foreign firms acquiring privatizing financial services firms, and we include both bank and non-bank acquirers.

Acquisitions of privatizing financial services firms present unique opportunities and challenges that have not been examined to date. In an extensive review of the literature, Megginson and Netter (2001) find that privatizing non-bank entities improve, sometimes dramatically, in terms of performance and efficiency. However, as Verbrugge et al. (1999) discuss, banking markets are different for two major, and a number of subsidiary (but closely related) reasons: (1) banking systems play a crucial role in economic growth since banks possess unique resources to identify positive net present value projects and fund them at reasonable cost (e.g. Levine, 1997); (2) an efficient banking and financial system requires a well functioning legal system (e.g., La Porta et al., 1997), but entrenched political constituencies often represent major obstacles to this objective. In fact, as they note, the state, which regulates the banking system, is often a major source of opposition to a non-politicized financial system.

In addition, (3) there are efficiency, safety and transparency issues in banking that are quite complex; (4) reflecting the transparency issue, there is often a significant problem loan portfolio in the privatized banks, which is partly unrecognized in financial reports; and (5) banking requires unique managerial talent, which is often lacking in former government-owned banks.

In their study of acquisitions of former state-owned enterprises (SOEs) in transition economies, Uhlenbruck and De Castro (2000) report that SOEs that are privatized through purchase by foreign firms (the method under consideration here) fare better than any other method of privatization. Such acquisitions require a prolonged and expensive commitment, and post-privatization performance is related to the strategic fit between the merging firms, as well as continued government involvement. The authors do not, however, examine wealth effects of the merger announcements. Our analysis of 97 privatizations indicates that short-run returns from acquiring privatized financial services firms are positive and are greater for non-bank bidders (e.g., finance companies such as General Electric Capital) than for bank bidders, indicating that in contrast to most studies of domestic bank acquisitions, which generally find negative or insignificant returns to acquirers, non-bank acquirers generate wealth. In addition, we document that US acquirers report an increase in total risk and a reduction in systematic risk after such acquisitions. Thus, our results have relevance for regulators, policymakers, and the international business community.