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Identifying M&A targets and the information content of VC/PEs

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ABSTRACT

The information gap in the M&A market hinders acquirers from effectively identifying high-quality targets. We examine whether VC/PEs convey information content in the M&A market and whether acquirers can use such information to identify high-quality targets. We show that VC/PEs have significant information content and can signal high-quality target companies via “certification”. When acquirers lack acquisition experience and targets are located in inferior information environments, VC/PE “certification” is more significant. The better reputation a VC/PE has, the more information it conveys. Syndicate VC/PEs convey stronger information than independent VC/PEs. We also find that acquirers do not pay higher premiums for high-quality targets. Overall, our results suggest that VC/PEs have value relevance in the M&A market, confirming their “certification” role. We present means for acquirers to select high-quality targets and investors to build efficient portfolios.

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1. Introduction

As newly revised regulations that encourage mergers and acquisitions (M&As) (e.g., “Measures for the Administration of Material Asset Reorganization of Listed Companies” and “Administrative Rules on Acquisition of Listed Companies”) are implemented, an increasing number of listed companies are striving to achieve rapid transformation and enhance core competitiveness through M&As. Thus, identifying high-quality targets has become a crucial issue for listed companies.

Although some companies possess innovative technologies, heterogeneous resources and new business models, they also face many challenges in the growth process, including a lack of funds, limited product

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development capability and restricted market expansion potential. These issues largely restrict the future growth of the companies (Zhu and Fei, 2010). As a result, when companies are unable to solve bottlenecks, they tend to seek help from more “well-off” companies. For the acquirers, these candidates can generate synergistic effects through resource complementation or enhancement, bring new profit growth and strengthen the acquirers’ core competitiveness. Hence, they are considered high-quality targets. Nevertheless, capturing useful information to identify these targets can be a difficult task, as many growing companies, especially start-ups, exhibit problems such as low information transparency, limited records of past transactions and the uncertainty of new product development (Elfring and Hulsink, 2003). In particular, due to confidentiality, target companies are often reluctant to disclose detailed information about core technologies and resources before confirming M&A transactions. Consequently, the information gap that arises during M&As poses a great challenge to acquirers when searching for high-quality targets. Research has found that venture capitalists (VCs) and private equity firms (PEs) can decrease the information asymmetry between companies and investors at the time of initial public offering (IPO) by providing “certification” (Megginson and Weiss, 1991). Can VC/PEs also decrease the information gap and play the role of “certification” during M&A transactions?

In the recent years, due to the reform of the IPO system by Chinese regulators and the “Barrier Lake Effect,” the exit channel for VC/PEs has changed and M&As have gradually become an important exit channel. According to Wind, there were only seven cases of VC/PE exit through M&As in 2004 and an average of thirty-one cases per year until 2012. However, in 2013 and 2014, the number of exit cases through M&As jumped tremendously to 120 and 560, with total amounts of RMB12.835 billion and RMB68.562 billion, respectively. The difference in book returns between IPO exit and M&A exit is shrinking. Therefore, M&As are becoming one of the main ways for VC/PEs to exit and are expected to become the “new norm” in the near future. This offers us the opportunity to investigate whether VC/PEs have information content in the Chinese M&A market. When VC/PEs send positive signals to the market, this indicates that VC/PEs play a “certification” role in the M&A market. This also decreases the information gap in the M&A process and provides practical guidance for acquirers to identify high-quality targets.

In this paper, we use Chinese A-share listed companies engaged in M&A transactions during 2013–2014 as our initial research sample and manually collect information about the transaction sellers backed by VC/PEs. Our main results are as follows. First, VC/PEs have strong information content in the M&A market and deliver positive signals to the market. Investors react positively to M&A transactions with VC/PE-backed target firms, which supports the finding that VC/PEs play a “certification” role in the M&A market. Second, when acquirers lack acquisition experience and targets are located in a poor information environment, the “certification” role of VC/PEs is more significant. Third, the better the reputation a VC/PE has and the more VC/PEs a target firm has, the stronger the information content is and the more favorably the market reacts. Fourth, after examining whether acquirers pay higher prices when acquiring VC/PE-backed targets, we find that acquirers obtain high-quality targets without having to pay higher premiums.

Our study makes several contributions. First, from the perspective of non-financial information, we examine the effect of the information embedded in VC/PEs on the value of targets during M&As. The literature related to the effect of target-related information on M&A value focuses mainly on the effect of financial information quality on M&As (Raman et al., 2013; Pan and Yu, 2014; McNichols and Stubben, 2015) rather than how non-financial information affects M&A value. Masulis and Nahata (2011) find that acquiring VC-backed target firms yield higher cumulative abnormal returns (CARs), as the agency conflict between VCs and other stockholders can lead to lower target pricing. Different from Masulis and Nahata (2011), we emphasize the VC/PE signaling mechanism in the M&A market. We find that VC/PEs have significant information content in the Chinese M&A market and can signal the high quality of target companies. Our findings also differ from those of Gompers and Xuan (2012), who find that acquiring VC-backed targets presents lower CARs based on U.S. data.

Second, from the M&A perspective, we provide evidence that VC/PEs perform a “certification” function. Since Barry et al. (1990) and Sahlman (1990) proposed the VC/PE “certification/supervision model”, a large number of studies have empirically examined it in the IPO setting and found support for it using European and American data (Barry et al., 1990; Megginson and Weiss, 1991; Brav and Gompers, 1997). Bertoni et al. (2015) discover that VC/PEs also play a “certification” role in the financing activities of many young

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