Chapter 2: Literature Review
This chapter summarizes the review of literature; which forms the basis of identifying gaps in literature and formulating research hypotheses that have been examined in this research study.

This study focuses on cross border mergers and acquisitions by Indian firms. Typically a merger involves the combining of two entities to form a new entity or merging of one entity into an existing entity. The share holders of the pervious entities usually continue to hold shares in the merged entity. In case of an acquisition, one entity (target) is purchased by an acquiring entity with payment in the form of cash or shares of the acquiring entity. Share holders of the target may not continue to hold shares in the surviving entity. This research study encompasses both mergers and acquisitions and also includes minority stake acquisitions where Indian firms have acquired stakes in international targets. For the purpose of this study the term cross border acquisitions is used in the broad sense to cover both mergers and acquisitions and includes all stake acquisitions where the acquiring or surviving entity in a merger is an Indian entity.

In line with the scope of this study, the review commences with a survey of literature on mergers and acquisitions in developed markets, and then narrows down to survey literature on mergers and acquisitions by Indian firms. It then seeks to explore factors that motivate firms to move across their national boundaries to international markets. Having established motivation for venturing abroad, this study explores factors that motivate firms to select acquisitions vis-à-vis green field or other forms of market entry. Finally the literature examines studies on cross border acquisitions by emerging market firms including firms from India.

After understanding motivation for cross border acquisitions, the next set of literature surveyed examines studies on performance of mergers and acquisition. It starts with a review of literature on short term performance and then reviews long term performance. The review first examines literature on developed market studies, and then narrows down to studies on emerging market firms including India. Additional literature that is pertinent for selecting variables used in this study and the method of analysis is discussed in the research design and methodology chapter.

Gaps in literature have been listed after the sections that focus on Indian studies on cross border acquisitions.
The topics that have been reviewed as part of the literature review are as follows:

Section 1: Determinants of M&A

- Determinants of M&A
- Determinants of cross border M&A
- Determinants of Indian cross border M&A

Section 2: Short term stock market performance

- Short term performance of M&A
- Short term performance of cross border M&A
- Short term performance of Indian cross border M&A

Section 3: Long term performance

- Long term stock market performance
- Long term stock market performance M&A
- Long term stock market performance cross border M&A
- Long term stock market performance Indian cross border M&A
- Long term operating returns based performance
- Long term operating returns M&A
- Long term operating returns performance cross border M&A
- Long term operating returns performance Indian cross border M&A

2.1 Studies on Determinants of Mergers and Acquisitions

Over the last century mergers and acquisitions (M&A) have formed a significant component of corporate growth strategies. This section reviews factors that motivate firms to undertake M&A strategies. This study commences with a review of literature on domestic M&A in developed markets, and then moves on to understand antecedents of M&A by Indian firms. Next, this study explores research on factors that motivate firms to internationalize, and specifically internationalize via cross border M&A. It has been recognized that internationalization strategies and motivators in the case of emerging market firms are different from developed markets firms; hence these strategies are reviewed separately. Finally the literature on cross border acquisitions by Indian firms has been summarized.
2.1.1 An overview of Determinants of Mergers and Acquisitions

Acquisitions may be driven by rational choices made by managers in the interest of shareholders such as efficiency gains through synergies, to increase market power, to discipline ineffective managers, buy undervalued firms or to adapt to environment factors. On the other hand acquisitions could be driven by managerial self interest or hubris (Trautwein, 1990; Berkovitch & Narayanan, 1993).

Summarizing literature on antecedents of acquisition decisions Haleblian, Devers, Mcnamara, Carpenter, & Davison (2009) identify value creation, managerial self-interest, environmental factors, and firm characteristics as the primary drivers of merger and acquisition activity.

Trautwein (1990) surveys theories of merger motives and classify the motives into seven groups; of which four groups: - efficiency gains, monopoly power, raider theory and valuation theory are beneficial to shareholders of acquiring firms. The fifth theory is beneficial to the managers of acquiring firms and arises out of empire building and managerial self interest. The sixth group of theories considers acquisitions as a process outcome and the seventh considers acquisition decisions as a response to economic disturbances.

Berkovitch & Narayanan (1993) recognize three primary motivators of acquisition decisions namely; synergy, agency and hubris. They suggest a model which can be used to identify which of the conflicting motives is the primary motive in an acquisition by considering target gains and total gains in an acquisition.

The various motives for acquisition are summarized below:

Value Creation

Synergy – Acquisitions driven by synergy motives are expected achieve a post acquisition value that is more than the combined stand alone firm values. Chatterjee (1986); Healy, Palepu, & Ruback (1992); Berkovitch & Narayanan (1993); Bradley, Desai, & Kim (1988) have found that synergy is a primary motive for acquisitions.

Berkovitch & Narayanan (1993) in a sample of acquisitions between 1963 and 1988, measure the correlation between total gains and target gains to identify acquisition motives. They find that 75% of acquisitions are motivated by a desire to achieve
synergistic gains. Healy et al. (1992) explore the post acquisition performance of 50 large mergers between firms in the United States between 1979 and 1998 using operating cash flow measures and abnormal stock price reaction at the time of acquisition announcement to evaluate acquisition performance. They conclude that acquiring firms have a significant improvement in post acquisition performance. Bradley et al. (1988) examine the magnitude of synergistic gains in successful tender offers by measuring the combined wealth gains of acquirers and target firms. They find that the combined wealth gain to acquirers and targets in tender offers is 7.4% and these gains arise out of the synergistic benefits from better deployment of combined resources.

These studies provide support to the theory that acquisitions are motivated by the intention of value creation.

**Market power** – Acquisitions provide firms a means to increase pricing power and gain competitive advantage (Akdoğan, 2009; E. H. Kim & Singal, 1993; Prager, 1992). Kim & Singal (1993) find evidence of price increase on airline routes served by merging airlines vis-à-vis routes that did not have any mergers. Prager (1992) in a case study on the merger which lead to the formation of the Northern Securities Company, support the market power hypothesis. Chatterjee (1986) analyzes the synergies from acquisitions to understand if these benefits arise out of financial, operational or pricing synergies; by evaluating the wealth gains to rival firms. The benefits from pricing or collusive synergies have been found to provide the highest value. Akdoğan (2009) study the abnormal returns to competitors of acquiring firms and also find support for the competitive power hypothesis.

However, Eckbo (1983) and Stillman (1983) reject the market power hypothesis as a motivator for acquisitions by analyzing the stock price reactions of rivals of targets at the time of acquisition announcement and on announcement of antitrust actions. Song & Walkling (2000) argue that stock prices of rivals of targets go up after an acquisition bid not because of monopolistic gains but because the rivals could become potential targets in subsequent acquisitions, and increase in value is caused by the probability of these rivals being targeted in subsequent acquisition bids.

There is evidence both for and against the market power hypothesis, which requires further analysis. If competition influences acquisition behaviour, then the level of competition in acquiring and non acquiring firms should be different.
Discipline ineffective managers – The 1980s merger wave in the United States is regarded as the period of hostile acquisitions. The management of targets resisted the acquisition bid, while the acquirer went directly to the shareholders with a tender offer to acquire outstanding shares. Typically firms with superior performance acquired firms with inferior performance and managers of targets lost power and prestige when their firms were acquired. (Jensen & Ruback, 1983) suggest that takeovers act as a mechanism to control managerial behaviour to ensure that their actions maximize shareholder value. Barber, Palmer, & Wallace (1995) establish that predatory acquisitions are driven by motivation to discipline ineffective managers in firms that exhibit low Q ratios. Acquisitions act as a means to check agency issues through acquisition of poorly managed firms. Bidder gains are expected to be higher when acquirers have higher Tobin’s Q ratio. (Servaes, 1991).

Finding from these studies suggest that Tobin’s Q has been used as a measure of performance and that Tobin’s Q could influence the likelihood of a firm being an acquirer or target and also the performance of the acquisition.

Benefit from incorrect market valuation - Shleifer & Vishny (2003) present a model of stock market driven acquisitions that suggests that firms with relatively higher stock values tend to be the acquirers and firms with relatively undervalued stock price tend to be the targets. Merger waves have been found to be driven by economy wide over valuation of stocks during stock market upswings (Rhodes, Kropf & Viswanathan, 2004; Ang & Cheng, 2006; Harford, 2005; Chidambaran, John, Shangguan, & Vasudevan, 2009). Bouwman, Fuller, & Nain (2009) argue that acquisitions are driven by managerial herding during high market valuations.

Rhodes, Kropf & Viswanathan (2004) reason that managers of target firms evaluate their own stand alone share value and the extent of synergies before accepting an acquisition bid. During times of market wide overvaluations; estimations errors associated with synergies are likely to be higher, hence managers would attribute a higher synergy value, increasing the chances that a bid is accepted. Chidambaran et al., (2009) support the behavioural theory of merger waves and find that acquisitions are more likely to be financed by stock and involve payment of higher acquisition premiums during periods of high merger activity. They also find that acquirer stock during periods of hot merger
waves are overvalued using measures of price-to-sales ratio, price-to-book ratio and prior 12-months stock returns.

Market cycles influence the number of acquisitions; also firms with higher valuations are more likely to be acquirers.

**Managerial self interest**

Instead of benefiting acquirer firm shareholder, mergers and acquisitions could be driven by managerial self interests. Managers could act in their own interest to increase compensation, secure their jobs or to gain power through empire building (Gorton, Kahl, & Rosen, 2009; Shleifer & Vishny (1988); Datta, Iskandar-Datta, & Raman (2001)).

While the previous set of drivers arise from agency issues; managers could also make bad acquisitions not intentionally but due to managerial overconfidence (Roll, 1986).

Jensen (1986) argue that managers act in their own interest and make non value enhancing acquisitions if their personal interests conflicts with the goal of shareholder wealth maximization. They argue that managers would prefer to make value destructive acquisitions rather than pay out excess cash in the form of dividends. Datta et al. (2001); Shleifer & Vishny (1988) suggest that managers over pay for acquisitions and make non value enhancing acquisitions if their interests are not aligned with shareholders interests, and have suggested the use of equity based compensation to align interests of managers with shareholders.

Even if managers intentions are not clouded by agency problems they sometimes overpay or make non value enhancing acquisitions by overestimating the synergies from acquisitions (Roll, 1986; Pangarkar & Lie, 2004). Roll (1986) suggests that the hubris hypothesis be considered as a plausible explanation for why acquisitions take place and the economic results from acquisitions. He suggests that manages may overestimate the economic value of the combined firm and overpay on an average.

Acquisition driven by managerial self interest would typically exhibit negative total post acquisition gains (Porter & Singh, 2010) and in the case of acquisitions driven by hubris; the average increase in the target firm's market value would be offset by the average decrease in the acquiring firm value ((Roll, 1986).
Acquisitions could be driven by managerial self interest and hubris; an examination of total gains, and bidder and target gains should help identify whether an acquisition is driven by managerial self interest.

**Environmental factors**

Mergers and Acquisition waves are driven by changes in regulations, industry specific economic shocks such as deregulations, and changes in input costs, innovations in technology or financing. Mitchell & Mulherin (1996); Andrade & Stafford (2004); Andrade, Mitchell, & Stafford (2001); Harford (2005) empirically test and find that mergers waves are driven by industry level shocks caused by economic changes, deregulation and technology shocks. Studying acquisition activity in the 1980s M. L. Mitchell & Mulherin (1996) reason that corporate takeovers are the least cost means for firms to respond to economic shocks such as deregulation, changes in input costs, innovations in financing and technology that change the industry structure. Andrade et al. (2001) study 4,300 completed deals during 1973 to 1998 and report that more than 80% of merger activity in the 1990s was driven by deregulation which was a dominant factor in merger and acquisition activity at that time. They have called the 1990s as the decade of deregulation.

Acquisitions could be driven by environmental shocks, changes in regulation, technology or financing. Thus, regulations and environmental changes may be considered as drivers of acquisition activity.

**Firm characteristics**

Factors that drive acquisition behaviour are expected to manifest themselves in characteristics that would differentiate an acquiring firm from a non acquiring firm. Empirical studies have reported that the characteristics of firms that make acquisitions differ from firms that do not acquire (Trahan, 1993; Gorton et al., 2009) and that characteristics of target firms are significantly different from non targeted firms (Barber et al., 1995).

Acquirer are typically larger (Gorton et al., 2009; Trahan, 1993); have the capacity to take on additional debt (Trahan, 1993; Huyghebaert & Luypaert, 2010); are better performing firms measured by stock market valuation (Trahan, 1993; Rhodes, Kropf & Viswanathan,
Organizational learning theory suggest that prior acquisition experience, acquisition performance and the interaction of the two promotes further acquisition activity by firms. (Haleblian, Kim, & Rajagopalan, 2006; Collins, Holcomb, Certo, Hitt, & Lester, 2009).

Gorton et al. (2009) argue that firm size and the industry size distribution of firms is an important determinant of acquisition activity. Firms may engage in acquisitions to increase their size to prevent being acquired, or on the other hand they may acquire to become larger to position themselves as possible targets.

Acquiring firms have been found to be larger, with lower leverage, better performing etc. It is expected that acquiring firms would differ in their characteristics from non acquiring firms.

**Industry characteristics**

Beyond the individual firm characteristics, characteristics of the Industry may promote M&A activity. Industry growth rate (Schoenberg & Reeves, 1999) and industry concentration (Schoenberg & Reeves, 1999 ; Huyghebaert & Luypaert, 2010) are important determinants of acquisition activity apart from Industry deregulation (described under environmental factors) at the industry level. Firms in industries with low concentration and high growth rates were found to be associated with a higher level of acquisition activity. (Schoenberg & Reeves, 1999)

Industry concentration, growth rate, performance impact the level of acquisition activity in an Industry.

**Determinants of Mergers and Acquisitions by Indian Firms**

As discussed in the Introduction Chapter, The Indian Government adopted a policy of extensive liberalization from 1991 onwards. These included the Industrial Policy Statement of 1991 which brought widespread changes to the Indian economy to make it more market oriented including an end to the erstwhile “license Raj”. Except for a few industries that were crucial from a strategic, social, security and environmental
perspective, all other industries were freed from licensing requirements. Foreign
ingvestments up to 51% were invited in a list of high priority industries. A number of
restrictive provisions of the MRTP act were also repealed. Firms were no longer required
to seek prior permission for expansion including for mergers and acquisitions. This
opened up the possibility of expanding via mergers and acquisitions to a number of firms
that had been previously inhibited from growing due to regulatory hurdles. Other
regulatory changes during this time frame were the abolishing of office of the Controller
of Capital Issues in May 1992. Firms were allowed to freely price public issues for raising
money from the capital markets after submitting their offer document with the Securities
and Exchange Board of India, which was set up in 1992. Regulations for substantial
acquisition of shares and takeovers were enacted by SEBI in 1994. These regulations
specified disclosure norms and the process to be followed by acquirers while acquiring a
stake in Indian firms.

Liberalization of the regulatory environment in India in 90’s, led to a surge of mergers
and acquisitions in the Indian domestic markets during 1990 to 1999 (Agarwal &
Bhattacharjeya, 2006; Beena, 2000, 2004; Ramakrishnan, 2008). Agarwal &
Bhattacharjeya (2006) investigate mergers by Indian firms for a 30 year period from 1973-
74 to 2002-03 to understand whether mergers take place as a response to industry and
regulatory shocks. They observe that post the 1991 liberalization of regulations; the
likelihood of mergers and acquisitions increased for MRTP firms; a larger percentage of
acquisitions were within the same industry and within the same business group; and were
more likely to be carried out for expansion purposes. Concluding along similar lines
as a result of the liberalized regulatory environment including an absence of anti-trust
regulations post amendments to the MRTP Act. She finds that post liberalization of
inward Foreign Direct Investments into India there was an increase in acquisitions by
foreign firms in India post 1995. She states that firms were motivated by a desire to
increase equity value, firm size and market share; and acquisitions within the same
business group dominate the merger wave. Venkiteswaran (1997) asserts that acquisitions
by Indian firms are motivated by a desire to diversify and gain entry into areas which
were earlier reserved for the public sector; to increase market share; to consolidate
activities at the business group level or to consolidate promoter holdings; and finally to a
smaller extent for financial and tax considerations.
In a study on acquisitions by Indian firms between 1994 and 2004, R. Kumar & Rajib (2007) conclude that acquiring firms from India had low leverage, higher valuation in terms of price/earnings multiples, higher cash flows, and higher liquid assets in comparison with target firms. They did not specifically study determinants of cross border acquisitions by Indian firms. Agnihotri (2013) investigate determinants of acquisitions in three industries in India and find that the volatility of earnings and business group affiliation has a significant influence on acquisitions by Indian firms.

The 1990’s were a period of rapid deregulation of domestic industry and also a period when foreign firm gained entry into India via liberalization of Inward Foreign Direct Investments and reduction of import tariffs. Indian firms faced intense competition from domestic firms in the liberalized environment and also from multinational firms that gained entry into the Indian markets. (Alfaro & Chari, 2009; Gubbi et al., 2009). Firms from emerging markets such as India needed to expand overseas to survive in the highly competitive landscape (Elango & Pattanaik, 2007; Gubbi et al., 2009). Indian firms were able to internationalize and expand overseas when policy for outward FDI was liberalized during 2000’s. The policy liberalization and studies on outward cross border acquisitions by Indian firms is discussed subsequently in the section on growth of cross border acquisitions from India.

Policy liberalization in 1990s lead to an increase in the number of M&A’s in the Indian domestic markets during 1990 to 2000. The 1995 to 2000 period also saw an increase in inward cross border acquisitions wherein international firms acquired stakes in Indian firms following liberalization of inward FDI norms.

2.1.2 Determinants of Cross Border Mergers and Acquisitions

When a firm chooses to make a cross border acquisition, there are two issues of relevance, the first is the decision to internationalize and the second is the mode of foreign entry in the form of an acquisition rather than joint venture, alliances, or green field venture. This section discusses Internationalization theories and also outward investment entry modes of firms. Literature on Internationalization of emerging market firms including India is also included.
**Internationalization Theories**

Examining literature on international business for a fifty year period from 1960 to 2010, Rugman, Verbeke, & Nguyen (2011) find that there have been shifts in the unit of analysis in internationalization research; neo classical economists considered country specific advantages (CSA) as the drivers for internationalization (Vernon, 1966); in the 1960s to early 80s the multinational enterprise (MNE) with firm specific advantages (FSA) was the primary unit of analysis e.g. (Hymer, 1976; Buckley & Casson, 1976; Teece, 1986; Dunning, 1988); in latter part of the period, subsidiaries of the MNE have been the unit of analysis.

Vernon (1966) argues that firms in the United States had certain country specific advantages in terms of access to capital and high income combined with high labour cost which prompted them to be the leaders in innovation in labour saving devices such as washing machines, which were initially produced locally. As demand for products grew in other countries firms took a decision on whether to sit up production facilities abroad based on cost economics or because of the threat of losing the market if local producers were likely to set up their own production facilities.

In his seminal work Hymer (1976) introduces the idea that Multinational Enterprises internationalize due to twin advantages of making profitable use of some strategic advantage enjoyed by the firm and of increasing monopolistic power through reduction of competition. Until (Hymer, 1976) the focus had been on country specific advantages of firms for internationalization rather than the firm. The theory on the internationalization of MNE’s is extended in the eclectic paradigm by Dunning (1988) who argues that ownership advantage alone is not sufficient for internationalization. He proposes that determinants of a firm’s decision to undertake foreign production are explained by the OLI framework. Firms will internationalize if they have certain Ownership advantages that will overcome the cost associated with foreign production; secondly firms will locate in a particular country if firm specific advantages can be combined with Location specific advantage; finally they will want to Internalize production rather than engage in contractual arrangements if the cost associated or possibility of market failures make internalization of the production facilities a better alternative. Buckley & Casson (2009) support the internalization theory and suggest that firms would choose to internalize activities from research and development to marketing of products mainly in knowledge
intensive industries where information asymmetries are high for example in low patent protection countries or for non patentable products; by setting up their own production facilities rather than licensing know how. Firms reduce transaction costs by internalizing market transactions within the firm. Further they suggest that firms make acquisitions rather than setting up Greenfield ventures when it does not make economic sense to add capacity in an industry. The internalization theory is also supported by (A. M. Rugman, 1981) Rugman (1985). Teece (1986) argues that the internalization theory should have a detailed scrutiny of the transaction costs economics for a better understanding of the MNE. He suggests that both internalization and transaction cost approaches are similar and that both are responses to market failures as firms internalize operations when transaction costs are lowered by internalization. Madhok (1997) questions the use of transaction cost theory to explain all international investment decisions and argues that a more prudent approach would be to use an organizational capability perspective which is concerned with the efficient utilization of a firms resources and capabilities and their development. He suggests that foreign direct investments are driven by a desire to acquire new resources and capability and not necessarily for exploiting ownership advantages of firms.

Forssbæck & Oxelheim (2008) extend the OLI framework to include financial characteristics of firms by arguing that firms with stronger financial characteristics can achieve ownership advantages which impact their propensity to undertake FDI. They study cross border acquisition in 44 target markets and find that financial characteristics have a significant impact on the level of FDI by firms.

Another school of thought that developed at that time was the Uppsala model, which was the result of research on the internationalization experience of Scandinavian firms. Johanson & Vahlne (1977) suggest that internationalization takes place in a series of incremental steps; firms gradually increase the level of investment in a country as they gain more knowledge and experience and the time frame for the investment decisions is related to the psychic distance between the nations which is related to the differences in culture, education, development and business practices.

*Foreign Entry Modes*

Firms choosing to internationalize via foreign direct investments could do so by setting up a joint venture, green field venture or alternatively acquiring an existing venture in the
host country. Researchers have suggested that the entry mode choices are a result of an analysis of transaction cost economics (Hennart & Park, 1993); are influenced by cultural difference between the investing and host nation (Kogut & Singh, 1988) or through a simultaneous examination of transaction cost economics, and the cultural and Institutional aspects (Brouthers & Brouthers, 2000).

Hennart & Park (1993) examine the determinants of entry choices in the form of greenfield ventures or acquisition by Japanese firms that invest in the United States by examining transaction cost theory, mergers and acquisition theory, theory of the growth of the firm and capital market imperfection theory. They find that Japanese firms are more likely to enter in the form of greenfield ventures when the scale of American operations are smaller or when they intend to manufacture a product that they already manufacture in the home country. Entry is in the form of acquisitions when entering a concentrated industry with low growth. Kogut & Singh (1988) suggest that cultural and institutional level differences should be considered while examining entry mode choices in addition to transaction costs. They compare foreign direct investments into the United States in the form of greenfield and Joint ventures, to entry mode in the form of acquisitions and find support for impact of national culture on entry modes. They find that entry is less likely to be in the form of acquisition when there are larger cultural differences between the acquiring and host nation. Brouthers & Brouthers (2000) combine the thought processes and develop a module that includes institutional, cultural, and transaction cost variables. They find that a combination of all three sets of factors has a high predictive power for entry mode choices.

Erel, Liao, & Weisbach (2012) reason that acquisitions take place when perceived advantage in the form of production efficiencies, market power, and tax considerations are higher for combined entities. However a cross border deal involves additional frictions in the form of different legal settings (Porta et al., 1998); cultural differences (Kogut & Singh, 1988); internationalization costs (Brouthers & Brouthers, 2000) which could hamper a firm's inclination towards international acquisitions. Hence, they suggest that a firm should perceive sufficient benefits from a cross border acquisition before it chooses to pursue an international acquisition strategy.
Emerging Market Firms Internationalization Strategies

The theories on internationalization discussed in the previous section have been based on studies in the developed markets. Researchers (Hoskisson, Eden, Lau, Wright, & Ming Lau, 2000; Yiu, Lau, & Bruton, 2007; Luo & Tung, 2007; Elango & Pattnaik, 2007; P. J. Buckley et al., 2007; Filatotchev, Strange, Piesse, & Lien, 2007) have suggested that internationalization strategies adopted by emerging market firms are not the same as those found in the developed world; they argue that emerging market firms internationalize in an unconventional manner; hence they have suggested a need for new theory development for emerging market firms.

Hoskisson et al., (2000) in a special research forum on emerging economies have recommended that the research agenda needs to be broadened to include developments in emerging market firms to provide a theoretical and empirical understanding of strategies adopted by emerging economies. They state that emerging markets face strong environmental pressures, which are not uniform across nations and also not simultaneous across markets; hence establishing the need for further research on emerging market internationalization strategies that examine each emerging market separately. They acknowledge the fact that research in emerging economies can be challenging because of data issues, the dynamic nature of emerging economies, inconsistent accounting standards, and heterogeneity of emerging economies.

Yiu et al., (2007) contend that in addition to ownership advantages in the form of technological and managerial abilities, emerging market firms need to develop additional ownership advantages to deal with a constrained institutional environment. They argue that firm specific advantages extend to include relational assets coming from home country networks, which are moderated by the level of competition in the home market and the level of export intensity. Further firms need to transform and become more market oriented by accumulating venturing capabilities through a process of corporate entrepreneurial activities. Luo & Tung (2007) extend the logic on the constrained institutional environment and suggest that firms from emerging markets deal with institutional voids and political hazards in their home markets by using international expansions as a mechanism to springboard to a more transparent and encouraging environment. They contend that international expansion is used by emerging market firms as a springboard to overcome a number of disadvantages including institutional
constraints, latecomer position and competitive weakness. International expansion also allows firms to gain competitive advantages through acquisition of strategic assets, overcome trade barriers in developed markets, expand in other developing markets and also counter attack global players in their home turfs. Emerging markets tend to be more aggressive in their internationalization strategy, not following the more cautious approach, adopted by developed market firms as suggested in the Uppsala model.

Elango & Pattnaik, (2007) apply the Uppsala model and network model to explore how firms from emerging markets develop capabilities to internationalize. In their study, based on 794 Indian firms they observe that Internationalization is positively related to the international experience of their parental groups. They also find that groups with larger network scope, measured as number of different industries in which the group operates, achieve a higher extent of internationalization when firm sizes are small and medium. Filatotchev et al., (2007) argue that along with network linkages with host nations, the corporate governance characteristics of investing firms influences the level of commitment and location choices of outward FDI by newly industrialized that invest in emerging market firms. They find that a larger percentage of family ownership and domestic institutional investment in firms is associated with a lower level of ownership stake in host countries. Location choices of investments are found to be related to the extent of economic, cultural and historic linkages between the parent firm and the investment location.

Recognizing that the theory of FDI has been largely based on the experience of developed countries, P. J. Buckley et al., (2007) contend that there are gaps in literature as theory based on industrialized nations cannot be applied unaltered to emerging market firms. They investigate outward investments by Chinese firms, in the 1984 to 2001 time frame, with the intention of developing internationalization theory applicable to emerging market firms in China. Like Filatotchev et al., (2007) they find that outward investments are positively related to cultural proximity with host nations. Surprisingly, they find that higher level of political risk in the host economy is positively associated with outward FDI from China. They support this finding with the argument that political risk is mitigated by the fact that investing enterprises are state owned, hence having a different agenda and affiliations with host nations that are not prevalent in private enterprises in industrialized nations.
Cross Border Acquisitions by Emerging Market Firms including India

Athreye & Kapur (2009); Deng (2007); Kumar (2009) observe that cross border acquisitions by firms from emerging markets such as China and India are undertaken for strategic reasons. Acquisitions provide firms with access to overseas markets; enable them to be in proximity with clients; protect them against host country protectionist policies; and also gain strategic resources including natural resources, raw materials, technologies and brands. Mergers and acquisitions provide emerging market firms quick access to strategic resources including proprietary technology, R&D capabilities, internationally recognized brands, distribution networks and managerial talent.

Comparing the motives for acquisitions by firms from China and India; the two nations at the forefront of emerging market acquisitions; Nicholson & Salaber (2013) note that while Chinese resource seeking is directed toward natural resources and managerial skills; acquisitions from India are directed towards acquiring advanced technology, knowhow and markets.

Deng (2009) explores the resource seeking motives for acquisitions by Chinese firms and reason that acquisition are undertaken in response to Institutional factors such as government development strategy, political and financial incentives provided by the government and also as a response to institutional constraints in the home market, which can be countered by expanding overseas.

Kumar (2009) discussing the transformation of Hindalco, an Indian aluminium producer into one of the world’s largest aluminium manufacturers; suggests that while firms from the developed world use M&A for cost saving and size synergies; emerging market firms are motivated by a strategy to acquire competencies, brands, knowhow and technology that could transform them into global leaders. Since emerging market M&A are not driven by the desire for cost saving, downsizing, etc integration is smoother and less disruptive.

Deng (2007); note that acquisition are more likely by Chinese firms that are strategically vulnerable because of existing in a highly competitive market. Alfaro & Chari (2009) observe an increase in the level of competition in Indian markets post 1990s; prompted by the reforms process which encouraged new entrants both domestic and international into the Indian markets and expansion of production by existing players by the dismantling of MRTP Act, de-licensing and other policy liberalizations. It is suggested that cross border
acquisitions are an outcome of the increased competition in the local markets. Athreye & Kapur (2009); Gubbi, Aulakh, Ray, Sarkar, & Chittoor (2009) express the view that emerging market firms undertake international acquisitions in order to compete with domestic competitors in the home market by acquiring strategic assets and know how that strengthen their competitive position. They posit that Indian firms were forced to internationalize in order to survive the competitive landscape in the local markets.

Nagesh Kumar (2008) examines the growth of outward FDI by Indian firms from 1988-89 to 2000-01. He suggests that Indian firms used cross border acquisitions for strategic reasons for filling gaps in their capability and obtaining access to technologies, brands, resources etc. The likelihood of outward FDI is positively related to production experience defined as age of the firm, cost effectiveness measured in term of profitability, brand differentiation measured by advertising spend, export intensity, firm size has a non linear effect. Firms that are foreign ownership or dependent on foreign technology are not likely to undertake outward FDI. Nagesh Kumar (2008) also observes that the growth of outward FDI was encouraged by the liberalization of outward FDI policy regime.

Afsharipour (2011) in a review on the legal reforms process in India, observed that the liberalization of outward investments commenced in 1992, when an automatic route for investments up to USD 2 million was set up. This was followed by further liberalization with the enactment of the Foreign Exchange Management Act which was less restrictive than the erstwhile Foreign Exchange Regulation Act. In 2001 the automatic route for outward investments was increased to USD 50 million annually. In 2002 this limit was further increased to USD 100 million. Firms were also permitted to invest the entire proceeds of ADR/GDR receipts for foreign acquisitions. From 2003 firms were allowed to invest up to 100% of their net worth for overseas investments. This limit was increased to 200% of net worth in 2005; 300% of net worth in 2007 and finally to 400% of net worth in 2010.

Observing the increase in overseas acquisitions by Indian firms post 2000; Pradhan & Abraham (2005) examine the motivation for overseas M&As that took place between 2000 to 2003. They comment that Indian firms are motivated to acquire to access international markets, to access international resources in the form of goodwill, brands, technology, marketing and distribution networks and expertise, to achieve operating synergies, to overcome slow growth of home markets, and also to survive in the highly
competitive Indian market post liberalization. Using a data set of 51 acquiring firms (manufacturing firms - 23, software firms - 28), they identify that overseas acquirers from manufacturing industry tend to be older and research intensive and firms from software industry tend to be older, larger and export oriented.

Examining industry level determinants of acquisitions; Agrawal & Sensarma (2007) using data on 83 industry level data points from 2002 to 2004 use a logistic and count data regression model to model the number of mergers, and occurrence of a merger in an industry. They find high cash; high Tobin’s and highly fragmented industries are more likely to undertake mergers and acquisitions.

Outward investments from India have slowed down post the financial crisis. Pradhan (2009) reviewed the level of outward investments from India post the financial crisis during 2008 to 2009, and commented that there has been a decline in outward investments which is likely to be revived with an improvement in global and domestic growth and availability of liquidity with banks and equity markets.

Researchers have commented on how research on cross border acquisitions by Indian firms is at a nascent stage and require further understanding on whether theories that apply to developed markets are applicable in the Indian context (Bhagat, Malhotra, & Zhu, 2011; Gubbi et al., 2009; Nicholson & Salaber, 2013; Ray & Gubbi, 2009).

**Gaps** - Research on cross border acquisitions by Indian firms is at a nascent stage. Cross Border acquisition strategies of emerging market firms including India are different from those of developed market firms. While developed market firms typically internationalize to reap benefits from ownership advantages; emerging market firms use international acquisitions as a springboard to globalize and overcome home country disadvantages. There is need for more theory development and research on the internationalization strategies of emerging market firms such as Indian firms. In a fast growing country like India during the 2000s; firms had a choice of either expanding organically or through acquisitions in the domestic or overseas market. There is a need to understand characteristics of firms that make acquisitions instead of growing organically; and further grow via cross border rather than domestic acquisitions. To the knowledge of the researcher, there is a gap in literature on these questions in the emerging market context and also in the Indian context.
Having established the theoretical background on determinants of acquisitions both domestic and cross border, this study next explores studies on the performance outcomes of acquisitions.

2.2 Studies on Short Term Performance of Mergers and Acquisitions

A vast body of literature has examined the performance of acquisitions. The literature can be divided into two streams – The first steam that forms a majority of finance literature on M&A examines the short term abnormal returns to acquisition announcements. This method assumes market efficiency and measures the market perception of an acquisition announcement. The second stream of literature gauges long term performance two to three years post acquisition using long term stock market performance; and operating performance measures, based on accounting results. This section discusses studies on short term performance of mergers and acquisitions.

Most M&A research has adopted stock market event study based measures to measure short term acquisition performance (King & Dalton, 2004; Krishnakumar & Sethi, 2012; Zollo & Meier, 2007). Event study methodology involves the computation of abnormal returns around M&A announcement dates using the constant mean return mode or the market model (Mackinlay, 1997). While studies have examined the performance outcomes for both acquirer and target firms; the scope of this research is limited to acquirer performance. Results of studies on domestic acquisitions and cross border acquisitions along with research specific to Indian acquisitions are included here.

2.2.1 Short Term Performance of Mergers and Acquisitions

Studies on short term acquisition performance have typically found that acquisitions are value enhancing when computing combined cumulative abnormal returns (CARs) for acquirer and target firm shareholders. However, most of the value gain has been found to accrue to target shareholders. A large number of studies have found that acquisition announcements are either value destructive for acquirers or result in no significant gain for acquiring firms (Jensen & Ruback, 1983; Andrade et al., 2001).

Jensen & Ruback (1983) review studies on abnormal returns to acquirers in tender offers and mergers. They observe that returns to bidders in mergers are close to zero on an average. In a follow up review; Jarrell, Brickley, & Netter (1988) support the findings of Jensen & Ruback (1983) that acquirers receive very modest gains and the likelihood of
stock price decline is almost equal to increase in bidding contests. Similar findings are also reported by Andrade et al., (2001); they report that while acquiring firms do not lose in merger transactions, they also do not gain. Andrade et al., (2001) study acquisitions in the US market during the period 1973 to 1998 and observe that the average three day abnormal returns to acquirers are -0.7%, however these results are not statistically significant. Acquirers that do not use stock for acquisition earn statistically insignificant positive returns. Bouwman et al., (2009) find that acquisitions during a period of high market valuation have higher announcement returns. Surveying the literature on acquisitions between 1980 to 2005; Betton, Thorburn, & Eckbo (2008) find that CARs are positive for small size bidders; when targets are private, for bids during 1991 to 1995 and for acquisitions where payment is in the form of cash. They also report that median CARs are -0.05%, with 49% of bidders having negative CARs.

Netter, Stegemoller, & Wintoki (2011) bring in a new perspective on acquirer returns; they suggest that results of earlier studies have limited validity due to the use of various data filters such as only considering larger deals, dropping deals without deal values, not considering deals with incomplete data etc. They consider a larger set of deals by US firms without using the customary filters, for the period 1992 to 2009 and report results that differ from earlier studies. They observe that US acquirers earn significantly positive abnormal returns for the full sample. Negative returns are observed in a smaller sub sample that only considers deals by large public firms buying other large public firms. However, they observe that value gains to targets are much larger than that to acquirer firms, and also there is a decline in acquirer gains on an annual basis from 1992 to 2009.

**Short term performance of mergers and acquisitions by Indian Firms**

Studies on domestic Indian acquisitions have primarily used accounting measures for gauging acquisition performance; hence studies using event study in the context of domestic acquisitions are limited. Barai & Mohanty (2010) study the cumulative abnormal returns to acquirers in acquisitions that took place from April 1996 to March 2008. In line with research from the developed markets, the findings are that the cumulative abnormal returns are not significantly different than zero for the full sample; CARs are significantly positive for related acquisitions and for acquisitions where payment is in cash. However, in contrast to findings from developed market literature where private target yield positive CARS (Betton et al., 2008; Fuller, Netter, &
Stegemoller, 2002) they find that acquisitions of public targets yield significantly positive results. They state that this could be because of the fear of misappropriation of funds in the Indian context. In another study that compares CARS from domestic and cross border acquisitions; Kohli & Mann (2012) do not find any evidence of positive returns to shareholders of domestic acquirers. Supporting these results, Gubbi et al., (2009) do not find any evidence of positive abnormal returns in domestic acquisitions.

2.2.2 Short Term Performance of Cross Border Acquisitions

A theoretical foundation of research on cross border acquisitions is provided in a review of literature by Shimizu, Hitt, Vaidyanath, & Pisano (2004). They point out that, in a majority of studies; returns from cross border acquisitions are positive for both acquirers and targets. They summarize that cross border M&A provide benefits of diversification, internationalization, and bring about synergies which result in enhanced wealth for acquirers and targets. Chari et al., (2009) find that firms from developed markets earn significant positive abnormal returns when they acquire majority stakes in targets from emerging markets. This finding is not replicated if the same developed market firms acquire firms in developed markets. They have attributed the abnormal gains to developed market acquirers, to improvements in target firm value by sharing better institutional and corporate governance practices, and improvement in contract enforcement in target firms from emerging markets. Bhagat et al., 2011 contend that though earlier studies on cross border acquisitions reported positive wealth gains for acquirers; recent studies do not support these findings. More specifically they comment that acquisitions by emerging market studies need further research. The current state of research for emerging market cross border acquisitions is covered in the next section.

Short term performance of cross border acquisitions by Emerging Market Firms

In an event study based on 433 acquisitions by 58 emerging market firms that took place during the period 1991 to 2004; Ficici & Aybar (2009) find that majority of the transactions lead to a destruction of value. Analyzing the cross sectional results they find that returns are positive for larger relative size of the targets measured by transaction value to bidder market value; private targets and when the bidders are conglomerates.

Researchers have found that stock markets react positively to announcements of cross border acquisitions by Indian firms (Bhagat et al., 2011; Chakrabarti, 2008; Gubbi et al., 2009; Kohli & Mann, 2012; Nicholson & Salaber, 2013). Gubbi et al., (2009) study the
11 day announcement effect of 425 cross border acquisition by Indian firms during 2000 to 2007. They report positive CARs for the eleven day period for the entire sample. They also find that CARs are positively related to whether the target is in a developed nation, this is line with the suggestion by Bhagat et al., (2011) of firms bootstrapping to a higher corporate governance environment via acquisitions.

Bhagat et al., (2011) analyze 988 cross border acquisitions by firms from India, China, Brazil, Malaysia, Mexico, Russia, Philippines and South Africa during the period Jan 1991 to December 2008. Their sample includes 341 acquisitions by Indian firms. Bhagat et al., (2011) report a positive and significant three day CAR to cross border acquirers from India and find that CARs are linked positively with the relative size of the deal and support the theory that acquiring firms add value by bootstrapping to higher governance standards when they acquire targets with a better corporate governance environment. Dakessian & Feldmann (2013) apply the event study methodology to cross border acquisitions by Latin American multinationals from Argentina, Chile, Brazil, Columbia, Peru, Mexico and Venezuela during the period 1989 and 2011 and find no evidence of short term abnormal returns. They also find that relative deal size and cultural distance have a negative impact on announcement returns.

Nicholson & Salaber (2013) compare the short term market reaction to Indian and Chinese acquisition announcements. They explore market reaction to 203 acquisition announcement by Indian firms from 2000 to 2010; using a modified market model; and find that acquisitions announcements lead to a significant increase in shareholder wealth. They find that Indian bidders benefit from acquisitions in developed firms and from deals in firms with lesser cultural distance with India.

Singla, Saini, & Sharma (2012) in an event study based on 15 cross border acquisitions by Indian firms conclude that acquiring firms earn meagre positive CARs during a 29 day event window.

Kohli & Mann (2012) study a sample of 268 Indian acquisitions (cross border – 202, domestic -66) that were announced from 1st January 1997 till 31st March 2008. The results indicate highly significant positive returns to bidder shareholders for a period commencing from 40 days before announcement and continuing until 10 days after announcement. Maximum returns are reported for the three day event window. An
additional finding of this study is that acquisitions in technology intensive targets lead to positive returns and larger firms earn negative returns.

**Gaps** - While researchers have examined the determinants of performance in terms of deal and acquirer characteristics; as per the review the impact of factors that motivate firms to acquire on acquisition performance has not been examined. Apart from the primary question under analysis, the review also finds that there are a few variables that warrant further exploration in a cross sectional analysis of short term abnormal returns. A number of researchers have mentioned that competitive forces in the domestic markets influenced the decision to make cross border acquisition; however as per the review this factor has not been measured in cross sectional regression analysis to understand the impact of competition on abnormal returns. For example, Economic cycles have been found to have influenced the returns to share holders in developed markets; however as per the findings from the review, this has not been explored in the Indian context. Corporate governance characteristics in terms of group ownership, ownership concentration have been found to influence acquisition outcomes in the developed markets; corporate governance characteristics require further exploration in the Indian context.

To summarize there is scope for further research on short term announcement impact of cross border acquisitions and cross sectional analysis of determinants of performance in the Indian context.

### 2.3 Studies on Long Term Performance of Mergers and Acquisitions

#### 2.3.1 Long Term Stock Market Performance of Mergers and Acquisitions

Studies on long term stock market returns have either reported significant losses to share holders of acquiring firms or have reported insignificant underperformance. Firth (1980) in a study of acquisitions by UK acquirers during 1969 to 1975 report long term losses to bidders over a 36 month period. Agrawal et al., (1992) report a significant loss to bidders of merging firms for a period of 5 years post acquisition period on the basis of a 937 mergers from 1995 to 1987 between US domestic firms. Rau and Vermaelen, (1998) observe that acquirers in mergers underperform by 15% on an average when compared with a comparable portfolio of firms matched on size and value. While they report that bidders in tender offers earn significantly positive abnormal returns of 5%. Loughran and Vijn (1997) observe insignificant negative abnormal returns of -6.5% by acquiring firm
shareholders over a 5 year time period. Bouwman, Fuller, and Nain (2009) find that overall acquiring firms earn significantly negative buy and hold returns of -7.22% over a two year period post acquisition. They observe that these results are driven by managerial herding and acquisitions by firms that acquire late in a merger wave. Andrade, Mitchell, and Stafford, (2001) in their review of literature on long term post acquisition performance, conclude that most studies have reported long run underperformance of bidders, except in the case of tender offers, where they have received positive returns. However, they point out that these results are sensitive to methodology issues associated with computing long run abnormal returns. Dutta and Jog (2009) find that when methodological issues are taken care of in computing returns, the results do not point to negative long term returns to acquirers.

Bouwman et al., (2009) find that acquisitions during a period of high market valuation, have higher announcement returns but lower long term abnormal returns than those acquisitions that occur during periods of low market valuation. Ang & Cheng (2006) find that probability of being an acquirer, and payment being in the form of stock is higher for firms that are valued higher, and that shareholders of high valued firms do not lose in the long run. Loughran & Vijh (1997) find that long term abnormal returns are related to the mode of acquisition and the form of payment. They find that firms making tender bids and those that pay in cash earn higher long term abnormal returns while acquirers paying with stock earn significantly negative returns. Rau & Vermaelen (1998) find similar results as they report that bidders in tender offers outperform those that merge. They also find that higher valued glamour firms with low book to market ratios significantly underperform value firms in the long run. Chidambaran et al., (2009) measure one year buy and hold returns to acquirer stock holders in hot and cold merger waves and find that acquisitions that are financed with stock have lower returns, and same industry deals give higher returns to bidder shareholders. A. Agrawal, Jaffe, & Mandelker (1992) observe that acquiring firm stock holders suffer a wealth loss of 10% over a period of five years following acquisition completion.

2.3.2 Long Term Stock Market Performance of Cross Border Mergers and Acquisitions

There have been fewer studies that have examined long term stock market performance of cross border acquirers. In a study on Canadian cross border acquisitions, Francoeur (2006) finds that acquiring firms do not earn significant positive returns in a five year
period after announcement. Bhabra and Huang (2013) include a small sample of 10 cross border deals in their study on Chinese acquisitions and find that the results do not show any significant gains or losses to acquirers. Their contention is that this may be caused by the fact that cross border acquisition integration has been a challenge for Chinese acquirers, who are largely state owned enterprises.

A few researchers have examined long term stock market returns of Indian cross border acquisitions. Chakrabarti (2008) studies the long term stock market reaction for three years post acquisition for 24 acquisitions announced between 2000 and 2007. He finds that the long run performance is significantly positive, however when Industry adjustments are made the positive returns are not significant. Singh (2012) researched 91 deals between 2004 and 2009; and concludes that shareholders of cross border acquirers earn negative 12 month Buy and Hold returns.

**Gaps** - Considering the limited research on long term buy and hold returns to Indian cross border acquirers, there is scope for expanding the scope of deals studied and dealing with methodology issues through further research on long term returns to shareholders of acquiring firms. There is a need to perform a cross sectional analysis to determine how deal, target and the economic cycle impact long term performance of Indian cross border deals. This study also seeks to establish the impact of determinants of acquisition decisions on performance which has been explored to a limited extent in the Indian context.

### 2.3.3 Long term Operating Performance of Mergers and Acquisitions

Accounting measures of performance are popular means of gauging acquisition performance after event studies. Accounting returns are not based on market perception or subject to market efficiencies and are often used by managers to evaluate strategies and make decisions. A number of studies on acquisition performance have used these measures (Healy et al., 1992; H. A. Krishnan, Miller, & Judge, 1997; Melicher & Rush, 1974).

Healy et al., (1992)’s seminal work on acquisition performance has formed the basis for many future studies. They suggested the use of a measure of operating performance scaled by market value of equity plus book value of net debt to measure performance. This measure is not open to differences in results due to different methods of accounting – pooling or purchase or different ways of financing acquisitions. They compare the post
acquisition performance of acquirers with the combined pre acquisition data of bidding and target firms and with the industry adjusted performance. Other researchers have used other accounting metrics such as Return on Asset (H. A. Krishnan et al., 1997; Zollo & Singh, 2004) Return on Equity (Guest, Bild, & Runsten, 2010), combination of measures (Melicher & Rush, 1974).

Results on operating performance in the developed market have not been conclusive. Healy et al., (1992); Guest et al., (2010), find that operating performance has improved on the basis of the measures of performance that they have used in their analysis. Zollo & Singh (2004) observe that mean performance is not different from zero.

In the emerging market context, Bertrand & Betschinger (2012) explore the operating performance of cross border acquisitions by firms from Russia and find that mergers and acquisitions destroy value, however there is no negative impact in cases where the target is located in former soviet union countries, or same industry deals of deals in the high-tech industry. They attribute the poor performance of acquisition to lack experience and capability in cross border acquisitions.

**2.3.4 Long Term Operating Performance of Cross Border Mergers and Acquisitions**


In the emerging market context, Bertrand & Betschinger (2012) find that international acquisitions by Russian acquirers destroy value, however when a cross border acquisition is made in a former soviet union country, in a high tech industry, or within the same industry then there is no significant decline in performance.

Very few studies have examined cross border performance of Indian cross border acquisitions using accounting data. Saboo & Gopi (2009) examine a combined sample of 54 domestic and cross border deals that took place during 2001 to 2007 and find that there
is an insignificant decline in operating performance of cross border acquirers. Shukla & Gekara (2010) used a case based analysis to study the Tata Steel – Corus acquisition and found that there is an insignificant decline in accounting returns. Based on a sample of 15 cross border acquisitions by Indian firms between 2005 and 2008, Singla et al.,(2012) observe that firms do not experience any significant change in financial performance as compared with their pre acquisition performance.

**Gaps** – As per the knowledge of the researcher, studies on long term operating performance on Indian cross border acquisitions have either been case based or with limited sample sizes. Long term operating performance measures of cross border acquisition in the Indian context warrant further investigation and theory development.

### 2.4 Concluding Remarks

The first section of the literature review has discussed research on factors that motivate firms to pursue inorganic growth strategies. The review commences with an overview of these factors in the developed market context and then moves on to explore factors specific to Indian acquisitions. Next, factors that prompt firms to explore internationalization strategies including internationalization via cross border acquisitions have been reviewed. The section concludes with discussion on factors that prompt Indian firms to pursue outbound cross border acquisition strategies.

The next section reviews acquisition performance studies; both in the short term which are based on announcement period stock market reaction; and long term studies based on long term buy and hold returns to investors in acquiring firms, and operating performance studies based on accounting measures. The review commences with studies on acquisition performance studies in the developed market context and then moves on to emerging market studies and concludes with research on Indian acquisitions of cross border targets. The review of literature has provided a theoretical foundation and insight into the current state of research on cross border acquisitions by Indian firms. It has helped identify gaps in research on cross border acquisitions by Indian firms; based on the identified gaps, research objectives and hypotheses have been formulated. The next chapter describes the research objectives, hypothesis and the details of deal sample and methodology adopted to test the hypothesis.