CHAPTER 2
REVIEW OF LITERATURE

This chapter deals with literature reviewed for the study. It includes literature related to the use of event study methodology in various corporate events and then moves to event studies relating to mergers and acquisitions and then focusing on studies relating to post-merger performance.

A research study will be considered significant only if it could be related with existing empirical research done in the past. For this purpose literature review is essential. It not only helps us to have an extensive view of the subject of research but also shows us the way to define the parameters of our research. The purpose of literature review is to enable us to analyze the data in more informed way and thus refine our research question (Bryman and Bell, 2008). To have a thorough insight into the research topic relevant studies have been reviewed which are presented in this chapter. This chapter deals with literature reviewed for the study. Studies relating to the application of event study on various corporate events including mergers and acquisitions have been reviewed. The next section presents the review of event studies in various corporate events followed by studies relating to wealth impact of mergers and acquisitions.

2.1 CORPORATE NEWS AND MARKET REACTION

A lot of information is said to be released in the event of major corporate announcements like dividend announcements, mergers and takeovers by companies, share buyback, change in policies, new financing announcements etc. A number of studies have been done to examine the usefulness of information released in corporate announcements. A large strand of literature relating to corporate events used event study methodology (Brown and Warner, 1980, 1985). As one of the objectives of the study is to examine the market reaction around merger announcement using event
study, so review of studies relating to market reaction to various corporate announcements has been done.

2.1.1 Event Studies relating to Earnings Announcements

Joy et al. (1977) examined the adjustment of stock prices to announcements of presumed unanticipated changes in quarterly earnings and found that the market adjusts slowly to the information contained in quarterly earning reports. In India, Mallikarjunappa (2004) tested the semi strong form of efficiency of Indian capital market taking a sample of 30 BSE listed companies that made earnings announcement during Jan 2000 to May 2003. He used event study methodology to measure abnormal returns for 30 day window around the earnings announcement and reported that there was no statistical evidence to show that Indian capital market was efficient in its semi strong form.

2.1.2. Event Studies relating to Timing of Earnings Announcements

Givoly and Palmon (1982) examined the relationship between the timing of earning announcements and information content of stock prices. The objective was to assess the timeliness of annual reports and to identify its determinants. A total of 210 companies were studied for the time period of 15 years from 1960-1974. Cross sectional regression analysis is used to examine the change in reporting lag and the results showed that there was an improvement in timeliness of annual reports. The findings of market reaction of timeliness of announcements reported that early earning announcements convey more information than late announcements. Patell and Wolfson (1982) studied the systematic timing behavior of firms to reduce the effect of unfavorable news. They found that bad news corporate disclosures increase after the close of trading and good news is released when security markets are open. Chae (2005) investigated the trading volume before four types of announcements classified as scheduled (earnings announcements) and unscheduled (targets, acquisitions and Moody’s bond ratings) and found that cumulative trading volume decreased inversely to information asymmetry prior to scheduled announcements while trading volume before unscheduled announcements increased.
2.1.3 Event Studies relating to Dividend Announcements

Brickley (1983) examined the common stock returns around specially designated dividends labeled by management as 'extra', 'special' or 'year-end' and compared them to those around regular dividend announcements. The sample consists of 165 SDD's declared from 1969 through 1979 on stocks listed on NYSE and AMEX. Common stock returns over 121 day period around the announcement are examined. The results indicate that both regular dividend and SDD announcements convey positive information.

Kalay and Loewenstein (1986) investigated the information content in the timing of dividend announcements. The daily stock price data of 969 firms has been taken for the period 1978-1981. Mean adjusted method and market model are used. The results showed that there was negative market reaction around late announcements and positive reaction around the announcements, which were made early or on time.

Healy and Palepu (1988) studied information content of dividend policy changes for which they studied 131 firms that paid dividend for first time in ten years and 172 firms that omitted dividend payments after continuously paying for ten years. Abnormal returns for the dividend initiating and omitting firms are estimated for the period of 60 days before and 20 days after the announcement. The relation between stock price reaction and earning changes has also been examined. The results show that firms that initiate dividend payments have positive earning changes and those omitting dividend have negative earning changes around the announcement. The analysis of market reaction around dividend initiation and omission announcements shows similar results.

Mitra (1997) examined the information content hypothesis for specially designated dividends by analyzing stock price reactions to first time SDD announcements and consecutive announcements. He also tested whether first time reaction differs from reaction to final SDD and how the firm specific variables explain the magnitude of stock price reaction. The sample consisted of 583 SDD announcements during 1962 to 1989. Market model is used to
study the stock price reaction. The results showed that first SDD experienced highly significant announcement return and last SDD announcements experience low announcement returns. The results of regression model indicate that CAR has negative association with the market capitalization component variables, number of shares outstanding and the share price and significant positive association with the SDD yield.

Elfakhani (1998) examined the effect of expected favorableness of a dividend signal, signaling role and the direction of dividend change on share prices. The purpose of the study was to identify the major factor responsible for market reaction on dividend announcement. A total of 676 dividend announcements formed the sample. The time period of the study was Jan1, 1976 to December 31, 1985. Event study methodology has been used and abnormal returns were calculated through mean adjusted method. He found that the expected favorableness of dividend signal is the major factor used by the market than either the direction of dividend signals or the role of dividend signal.

Balachandran (2003) investigated the impact on prices of initial interim dividend reductions and initial final reductions for firms that did not reduce their dividends in the previous three years. The sample consisted of 521 companies that reduced dividend during 1989 to 2000. Market model has been used to estimate the abnormal returns for 20 day window period using 100 day share price data for estimation. The evidence showed that a price reaction to interim dividend reductions is stronger than the final dividend reductions suggesting that interim dividend reductions convey more information than final dividend reductions.

2.1.4. Event Studies relating to Equity Issue Announcements

Masulis and Korwar (1986) examined stock price adjustments to announcements of underwritten common stock price offerings during the period 1963-1980. The results of the event study showed that both combinations primary-secondary offerings and stock bond offerings show
negative announcement effects. The results of cross sectional analysis indicate that there is positive relationship between returns and firm’s leverage.

Burton et al. (1999) examined whether method of issue has an impact on stock market reaction to ordinary equity issues. They studied 108 equity issue announcements made in UK in 1989-1991 using event study methodology and found that there is significantly negative reaction to disclosures related to rights issue. The relationship between method of issue and abnormal returns around equity issue announcement has also been examined through multiple regression analysis and the results showed that there are significantly negative abnormal returns were experienced when there is disclosure relating to rights issue but there were no significant changes on announcement of other types of issues.

Burton et al. (2000) studied the stock market reaction to new equity issues in UK using a sample of 116 announcements made during 1989-1991. They used market model for estimating the predicted returns using 120 day estimation period and abnormal returns were measured for 30 day window period. They find that for majority of firms no significant relationship exists between pre-announcement income growth and market reaction to equity issues. They also attempted to find the relationship between growth opportunities and market reaction to announcements of equity issues and concluded that there is a positive relationship between preannouncement income growth and abnormal returns.

Burton et al. (2003) investigated the effect of insider trading on the market reaction to new financing announcements (NFAs). The results showed the evidence that insider trading prior to NFAs did not significantly effect either the abnormal returns around announcements or the relationship between growth opportunities and abnormal returns.

Bayless et al. (2005) examined the pattern of abnormal returns around 1752 seasoned equity issues made by industrial firms during 1974-1990. Half yearly abnormal returns are studied from five years prior to announcement and five years after the issue. Firms are classified on the basis of performance
measures and use of proceeds. The results show that negative abnormal returns tend to vanish after about 3.5 years after the issue.

2.1.5 Event Studies relating to Bonus issue

Kakati (2001) analysed the stock price performance of 115 bonus issues made during the period 1995-1999 by examining the abnormal returns around announcement date and ex-bonus date and reports that stock price rise before the announcement and fall after the bonus announcement.

P J and Rao (2005) investigated the signaling hypothesis by examining market reaction and operating performance around bonus issues by BSE listed firms during 1991-2000. The results revealed that bonus issuing firms show "superior operating performance" as compared to control firms matched on the basis of size and industry as well as on the basis of size and pre event performance. The evidence also showed statistically significant positive abnormal returns around announcement.

2.1.6 Event Studies relating to Share Buyback

Bradley and Wakeman (1983) examined the wealth impact of share buybacks that restricts the participation to a particular sub set of stockholders. The sample consisted of 15 repurchases from small shareholders and 86 repurchases from insiders, individuals unaffiliated with the firms and other corporations in the period 1974-1980. Market model was used to estimate cumulative abnormal returns. The results indicated that repurchase from insiders and small shareholders increase the wealth of non-participating stockholders and repurchases from shareholders unaffiliated with the firm reduce the wealth of non-participating stockholders.

Dann (1981) investigated effect of common stock repurchases on the value of company’s common stock, debts and preferred tock. The purpose was to identify the major factors causing changes in the value of stocks. The sample consisted of 122 US companies that repurchased their common stock during the period 1962-1976. He used raw returns of companies for 120 days (day -60 to day +60 ) awarded buy back announcement. The results showed
significant increase in the returns on day 1 and no class of securities showed decline around the event.

Dann and DeAngelo (1983) examined standstill agreements and privately negotiated stock repurchases during 1977-1980. Abnormal returns were estimated for the period 40 days window using market model. The analysis indicated statistically significant average negative effect on non-participating stockholders.

Gupta (2006) examined the impact of share buy-back announcement on equity share prices in India. The sample consisted of 46 buy-backs of shares made by listed companies in India during the period Jan 1999 to March 2004. The purpose was to examine the information signaling hypothesis. The abnormal returns were calculated for 30 days after the event date. The estimated returns are calculated through market model, estimation period bring 225 days before the announcement day. The evidence showed positive signaling effect of merger announcement. The results also showed that there has been inverse relation between size of the firm & the firm and abnormal return.

2.1.7 Event Studies relating to Stock splits

Jijo and Rao (2002) analysed 30 stock splits by BSE listed companies during 1992 to 2001. The purpose was to study the effect of stock splits on market valuation and trading pattern. Abnormal returns were calculated using event study methodology for 10 day window by taking estimation period of 120 days. They reported significant abnormal returns of 7.14% around stock split announcement. They also attempted to examine to liquidity changes and reported no increase in liquidity after stock splits.

Gupta and Gupta (2007) studied market reaction to stock splits in India. A total of 112 stock splits during Jan 1, 1999 to Sept 2004 formed the sample. The purpose was to study that announcement effect of stock splits in India and their impact on liquidity. Abnormal returns to share prices are measured through market model. The results showed negative average abnormal return of -0.05% during stock split announcement. The study also witnessed an increase in trading volume and liquidity of stocks in India.
Table 2.1

Studies Related to Market Reaction around Corporate Announcements

<table>
<thead>
<tr>
<th>Announcement</th>
<th>Study</th>
<th>Sample and period</th>
<th>Window period</th>
<th>Estimation period</th>
<th>Model</th>
<th>Value of CAAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Earning Announcement</td>
<td>Givoly and Palmon (1982)</td>
<td>210 companies, 1960-1964</td>
<td>-8 to +8 weeks</td>
<td>35 weeks before and 35 weeks after the announcement</td>
<td>Market Model</td>
<td>-</td>
</tr>
<tr>
<td>2. Dividend Announcement</td>
<td>Brickley (1982)</td>
<td>165 SDDS, 1969-1979</td>
<td>-60 to +60 days</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Kalay and Loewenstein (1986)</td>
<td>969 dividend announcements, 1978-1981</td>
<td>-15 to +15 days</td>
<td>-60 to +16 days</td>
<td>Mean adjusted and market model</td>
<td>+ve</td>
</tr>
<tr>
<td></td>
<td>Healy and Palepu (1988)</td>
<td>210 companies, 1969-1980</td>
<td>-60 to +20 days</td>
<td>-</td>
<td>Market adjusted return method</td>
<td>-</td>
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<table>
<thead>
<tr>
<th>Announcement</th>
<th>Study</th>
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<th>Value of CAAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity issues</td>
<td>Mitra (1997)</td>
<td>583 SDDs 1962-1989</td>
<td>-30 to +30 days</td>
<td>-90 to –31 days</td>
<td>Market model</td>
<td>+ve</td>
</tr>
<tr>
<td>Equity issues</td>
<td>Balachandran (2003)</td>
<td>521 dividend announcements 1989-2000</td>
<td>-20 to +20 days</td>
<td>-</td>
<td>-</td>
<td>+ve in post announcement</td>
</tr>
<tr>
<td>Equity issues</td>
<td>Masulis and Korwar (1986)</td>
<td>1085 equity issues 1963-1980</td>
<td>-20 to +221 days</td>
<td>60 days after announcement</td>
<td>Mean adjusted return method</td>
<td>-</td>
</tr>
<tr>
<td>Share Buyback</td>
<td>Dann (1981)</td>
<td>143 stock repurchase announcements, 1962-1976</td>
<td>0 day to +1 day</td>
<td>-60 to -11</td>
<td>-</td>
<td>+ve</td>
</tr>
</tbody>
</table>
| Share Buyback | Bradley and Wakeman (1983) | 101 share buybacks during 1974-1980 (15 repurchases from small shareholders and 86 from insiders and others) | Market model | +ve for buybacks from insiders and small shareholders and –ve from others | \( Contd... \)
<table>
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<tr>
<th>Announcement</th>
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<th>Value of CAAR</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dann and Deangelo (1983)</td>
<td>1977-1980</td>
<td>-40 day to +40 day</td>
<td>Market model</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Gupta (2006)</td>
<td>46 buy-backs by listed companies in India during 1999 to 2004</td>
<td>-30 day to +30 day</td>
<td>-255 to -31 days</td>
<td>Market model</td>
<td>+ve</td>
</tr>
<tr>
<td></td>
<td>Gupta and Gupta (2007)</td>
<td>60 stock splits during 1999 to 2004</td>
<td>-30 day to +30 day</td>
<td>-255 to -31 days</td>
<td>Market model</td>
<td>-ve</td>
</tr>
</tbody>
</table>
2.2 VALUE CREATION THROUGH MERGERS AND ACQUISITIONS

A large number of studies have been done to examine whether mergers and acquisitions create value to the shareholders or not. Studies related to wealth impact of mergers can be divided into two categories:
- Studies related to short run market reaction around merger announcement
- Studies relating to long-run impact after mergers
- Studies relating to characteristics of merging firms

2.2.1 Market Reaction around Merger Announcement

Firth (1978) analysed 150 UK mergers occurred daily the period 1972-1974. The purpose was to test synergism in mergers. The author replicated Haugen and Langtieg (1973) to test synergy effect of mergers. The return of sample firm portfolio and control firm portfolio were measured for 24 months prior to merger and 24 months after the merger. The William Sharpe’s market model was used measure the returns and test used test pre-merger the post-merger parameter there is not significant difference between merger group and control group.

Firth (1979) studied 224 bids by quoted companies in 1972, 73 and 74 with purpose of examining the profitability of takeovers in UK using efficient market framework. Residual analysis has been used to calculate the abnormal returns. Market capitalization is used to calculate total gains and total losses. The results show that there are “no gains associated with takeovers” however there are small losses. The effect of various financial characteristics on residuals has also been examined by multiple regression. The author concludes that stock markets are efficient in incorporating the news relating to takeovers.

Dodd (1980) examined daily market reaction to announcement and subsequent acceptance or rejection of merger proposals. A sample of 151 merger proposals made during 1970 to 1977 is taken. The sample was divided into two categories - completed and cancelled mergers proposals. Market model was used to estimate the abnormal returns for 40 day window period and the results show that there is positive market reaction to the first public announcement of merger proposal and subsequent positive reaction to
approval of completed proposals and negative reaction to cancelled proposals.

Firth (1980) analyzed 486 takeovers in UK during period 1969 to 1975. He studied the whether shareholders wealth maximization or management utility maximization is the driving force behind the takeovers. The results showed that takeovers had positive impact on acquired firms whereas acquirer companies suffered losses as market value reduced after takeovers. The results also showed increase in remuneration to directors thus indicating that the management utility maximization might have been a motivation for takeovers.

Elgers and Clark (1980) attempted to study effect of mergers on shareholders returns. A total of 337 mergers occurred during the period 1957-1975 formed the sample for the study. The study used Sharpe-Lintner capital asset pricing model (CAPM) and Sharpe market model to estimate the predicted returns. The results showed that buyer firms experienced moderate gains whereas there were substantial gains to seller firms during pre-merger period. They also examined pattern of abnormal returns in different merger types. Mergers were classified as conglomerate and non-conglomerate mergers and the results show that conglomerate mergers show superior wealth effects for both buyer and seller shareholders as compared to non-conglomerate mergers.

Wansley et al (1983) examined abnormal returns to shareholders of merged firms during pre-announcement period. The sample consisted of 101 firms that merged during 1973-1997. The cumulative average residual methodology has been employed where two-factor model derived by Black has been used to estimate the expected returns. The results show that there was substantial increase in cumulative average residuals during pre-merger period from month -7 to month -1. An attempt has also been made to identify merger profile which defines the financial characteristics of the acquired firms. To identify the acquired firms discriminant analysis has been used. The sample consists of 44 firms merged during 1975-1976 and 44 randomly selected non-merged firms. The characteristics that classify between merged and non-merged firms were price-earnings ratio, book-value of long-term debt to total assets, net sales, compound growth in net sales and market value of
equity to total assets. This classification function was further applied to a large sample of firms which consisted of 754 firms. The purpose was to discover whether abnormal returns result from the purchase of firms resembling the actual acquired merged or non-merged group depending on the degree of similarity to these groups using posterior probability. The results show that selection of acquired firms led to a CAR of 29.1% whereas selection of top 25 firms resembling acquired firms led to CAR 17.1% indicating that a large portion of gain to shareholders might have occurred due to mergers.

Dodds and Quek (1985) examined the impact of merger announcement on the share price of acquiring firm in UK over a long window period. The sample consists of 70 publicly quoted and actively traded companies in industrial sector on London Stock exchange for the period 1974-76. The share price movements was studied for 60 months after the merger announcement. The results of average residuals as well as cumulative average residuals show that the acquirer has gained for the first 25 months after the merger announcement. But after the 25th month the average residual as well as cumulative average residuals declined indicating that mergers were not viewed as profitable in the long-run. The firm size effect has also been studied and it was found that dispersion of average residuals reduced after taking firm size into account. The results also show that there were more number of negative average residuals in case of merger active mergers than non merger active firms and the cumulative average residuals of merger active firms were also smaller than those in non merger active firms. The comparison of cash financed and equity financed mergers show that acquiring firms experiencing negative average residuals were more than cash offering acquiring firms.

Dennis and McConnell (1988) studied the impact of corporate mergers on various classes of securities. The sample consisted of 132 mergers during the time period 1962-1980. He studied various classes of securities which have been studied are-common stock, convertible and non convertible preferred stock, convertible and nonconvertible bonds. Market adjusted returns were calculated as a difference between security return and market return. The results show that common stockholders of acquiring firms earned positive but not statistically significant returns.
Lubatkin (1987) analysed the relation between merger strategies and shareholder gains. A total of 439 acquiring companies for the time period 1948-1979 have been taken for the study. The mergers were classified into four relatedness categories – product concentric mergers, conglomerate mergers, horizontal and market concentric mergers and vertical mergers. Market model has been used to estimate the predicted returns and abnormal returns as excess of security return over the predicted returns. The returns were analysed for three time intervals – 1 month to 18 months following mergers, 19 months to 37 months after the merger and 38 to 64 month after merger representing short run, immediate and long-run post-merger periods respectively. The results show that related mergers create value for acquiring as well acquired firm shareholders.

Bradley et al (1988) studied 236 tender offer during 1963 to 1984 to estimate the synergistic gains from tender offers. Market model was used to estimate abnormal returns to target and acquiring firms. Dollar gains to acquirer and target firms have been measured as product of cumulative abnormal returns and market value of the firm before the window. The results reported that successful tender offers increase combined value of target and acquiring firms by 7.4%.

Franks and Harris (1989) examined the effect of takeovers on shareholders’ wealth. The sample consist of 1898 UK acquisitions during the period Jan 1955 to June 1985. To assess the effects of mergers on share prices, event study methodology was used where abnormal returns are calculated as difference between expected return is estimated through Capital Asset Pricing Model (CAPM). The results indicate that target firms on an average earn abnormal returns of 25.8% for value weighted sample and 29.7% for equally weighted sample whereas bidder firms experience 2.4% and 7.9% abnormal returns on value-weighted and equal weighted bases. The results of post-merger performance showed positive returns of 4% to bidder firms 4 years after the merger announcement. The authors observed that the results of UK takeovers are quite comparable to those in US.

Seth (1990)* examined the value creation hypothesis in acquisition by studying 104 tender offers in UK that took place during 1962 to 1979. The sample is divided into two categories related and unrelated acquisitions. The
two different classification schemes (one FTCC classification and the other based on Michael Porter's (1976) classification based on buyer seller relationship). Event study is used for estimating synergistic gains from acquisitions combined daily returns are estimated for target and acquirer firms. The daily return for combined firm calculated as value weighted average of firms’ daily return after adjusting for cross-holdings. The results showed positive and significant value creation for unrelated and related acquisitions.

Seth (1990) studied 102 tender offers that took place between 1962 and 1979. The purpose was to assess the relative importance of different sources of value creation in different types of acquisitions. The extent of value creation is analysed through event study methodology capital asset pricing model is used to estimate the predicted returns. The combined returns of acquirer and target firms have been measured to study the synergy effect of mergers. To examine the importance of sources of value creation the acquisitions have been categorized into two groups – related acquisitions and unrelated acquisitions. The results show that in related acquisitions sources of value creation were operating and financial decisions whereas in unrelated acquisitions financial diversification may be assumed to play an important role in value creation.

Chatterjee (1992) studied 577 tender offers between 1963-1986. Following Bradley, Desai and Kim (1988), he divided the sample into successful and unsuccessful takeovers which resulted in 436 successful and 144 unsuccessful takeovers. He advocated the returns through market model by taking 50 months estimation period and staring from 60 months before and ending month before the first announcement of bid. The result showed that target firms gained and most of the gain retained by target during post acquisition period thus rejecting the synergy hypothesis.

De Bondt and Thompson (1992) studied around 1178 mergers in US during the period 1926 to 1988. The purpose is to find out the motive behind mergers. The abnormal returns are calculated as excess returns of company over market, size and industry. The results show that merger activity is not linked with macroeconomic variables. The company by company analysis show that efficiency motive play less role than other motives.

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Berkovitz and Narayan (1993) investigated the relation between target gains and total gains and between target and acquirer gains around takeovers. The purpose was to suggest a way to distinguish between three major motives for takeovers—synergy motive, agency motive and hubris motive. The sample consists of 330 tender offers from 1963 to 1988. Market model was used to estimate the abnormal returns. The three hypotheses have been tested through correlation between target gains, acquirer gains and total gains which is presented in Table 2.2. The acquirer gains and target gains were defined as wealth created through abnormal returns around the announcement. The acquirer gain and target gain was calculated by multiplying cumulative abnormal returns with market value of the firm before the window. The total gains have been calculated as the sum of target gains and acquirer gains. The results showed that 75% takeovers experienced positive total gains and there was positive correlation between target gains and total gains thus supporting the synergy hypothesis.

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Target gain and Total gain</th>
<th>Acquirer gain and Total gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Synergy</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Hubris</td>
<td>Zero</td>
<td>Negative</td>
</tr>
<tr>
<td>Agency</td>
<td>Negative</td>
<td>Negative</td>
</tr>
</tbody>
</table>

Source: Berkovitch and Narayanan (1993)

Franks et al (1997) examined abnormal gains or losses to shareholders of acquirer and acquired firms in UK mergers. The purpose was to conduct an industry study regarding the profitability of mergers in Breweries & Distilleries sector. The sample consisted of mergers during the period 1955-72. Market model regression equation has been used to examine residuals and Fama, Fisher, Jensen and Roll (1969) methodology was used for cross sectional analysis of the residuals obtained through market model. The distribution of gains or losses between shareholders of acquirer and target firms has also
been examined. The results indicated positive abnormal returns to shareholders of acquiring firms and substantial gains (26%) to the shareholders of acquired firms.

Seth et al (2000) investigated 100 cross-border acquisitions of US companies during 1981-1990. The purpose was to identify the motives behind acquisitions. Three hypotheses were tested: synergy hypothesis, hubris hypothesis, and agency hypothesis following Berkovitch and Narayan (1993). Market model was used to measure expected returns and abnormal returns. The three hypotheses were tested through relationship between total gains and target and acquirer gains. The results showed that synergy motive is the main factor behind foreign acquisitions.

Leeth and Borg (2000) studied the impact of merger announcements on portfolios of acquiring firm and target firm common stock during the period 1919 to 1930. They employed market model and market adjusted method to assess the abnormal returns and the findings showed that target firms gained on average 15% abnormal returns in 1920s. The impact of mode of payment, industry relatedness has been studied through multiple regression analysis and the results showed that type of acquisition and mode of payment has no effect on acquiring firms and target firms returns. Also no significant difference has been found in target and acquirer firms gains on the basis of industrial relatedness.

Kang and Diltz (2000) investigated 175 divestitures and 21 acquisitions associated with divestitures occurring between 1990 and 1994 and found positive abnormal returns around the announcement. When the firms that have also made dividend announcement, are screened using dividend filter, the abnormal returns to acquiring firms disappear suggesting that wealth effects associated with divestitures are sensitive to ‘contemporaneous dividend announcement’ effects.

Kools et al (2004) investigated stock market performance of 205 U.S. companies involved in acquisitions for the period of 10 years from 1993-2002. The companies in the sample were divided into three categories – companies with highly acquisitive growth strategy, companies pursuing organic growth strategy and companies that pursued mixed growth strategy. The results showed that highly acquisitive companies reported large total shareholders
return (TSR) than companies with other growth strategies. The highly acquisitive companies were further divided into fast growth and slow growth companies and the results revealed that fast growth companies outperformed the slow growth companies.

Singh and Aggarwal (2004) attempted to study the price effect and trading volume pattern for the possible existence of informed trading prior to merger announcements by 42 companies which were divided into three categories - group companies, non-group companies and BIFR companies. The analysis shows the evidence of insider trading activity in case of group companies but not in case of non-group companies.

Kumar (2004) analysed the RIL merger with RPL and examines the effect of the merger on the wealth of shareholders and also on post-merger corporate performance. Market model has been used to estimate the expected and abnormal returns around the date of merger announcement. To examine the post-merger performance financial as well as operating performance indicators were used. For financial performance various ratios have been employed to compare pre and post-merger performance and for operating performance he used operating cash flow scale by market value of assets. The results showed that there were negative abnormal returns around the merger announcement and no improvement in operating performance of merged firm. But the results of the study cannot be generalized as it is based on single case only.

Anand and Singh (2008) examined the market reaction on merger announcements by private sector banks in India. They analysed five major mergers in Indian private sector banks using event study methodology. Single factor model as well two factor model were used to predict the returns on share prices. In single factor model, market model is used taking market index as benchmark and in two factor regression model industry specific benchmark – bankex has also been used as independent variable along with market index. The results for single factor model show that cumulative average abnormal returns of bidder banks are positive and statistically significant. The results for two factor model also show positive and statistically significant returns to bidder banks in one day, two day and three day run-up window.
Gupta (2008) studied impact of mergers on share prices of target companies. A total of 37 merger announcements during the period Jan 1, 2003 to Jan 31, 2007 form the sample. Event Study Methodology (Brown and Warner, 1985) was applied to measure abnormal returns. The results showed that there were significant positive abnormal returns on the date of announcement but the number of days with positive returns before the event were less than those after the event indicating that the gains during pre announcement seemed to vanish after the event.

2.2.2 Performance of Mergers and Acquisitions in the Long-run

A large body of M&A literature studied the impact of mergers through event study analysis in which most of the researchers examined the abnormal returns around the event announcement. Later the focus shifted to analyzing the post-merger or post-acquisitions performance in the long-run. Studies relating to post-merger performance included analysis of long-run abnormal returns on share prices as well as long-run operating performance after the event.

Haugen and Langetieg (1975) attempted to examine the synergistic effect of mergers. The sample consisted of 59 industrial mergers between companies listed on New York Stock Exchange. The purpose was to find whether there is significant difference in the two firms stock portfolio comprising acquirer and target firms and control firms portfolio during period and post-merger period. The returns were generated through market model for 36 months preceding the merger and 36 months after merger. The results showed no significant difference in the returns generated from sample firm portfolio and control from portfolio.

Asquith (1983) examined 196 successful mergers and 87 unsuccessful mergers during 1962-76. Abnormal returns were calculated for 11 months using beta control portfolio method. The results show statistically negative returns to acquiring firms after successful as well as failed mergers.

flow returns are measured as difference between values for the merged firm and its weighted average industry median estimates. The results showed that there has been a significant improvement in operating cash flow returns of merged firms. The relationship between post-merger operating cash flow return and merger announcement period returns has also been examined through regression analysis. The results show that there is a strong positive relation between post-merger operating cash flows and merger announcements returns.

Agrawal, Jaffe and Mandelkar (1992) examined post-merger performance of 937 mergers and 227 tender offers during 1955-1987. To examine the abnormal returns two models - Dimson and Marsh (1986) and Returns Across Time and Securities (RATS) methodology by Ibbotson (1975) were used which controlled for beta as well as size factor. The results showed wealth loss of 10% to acquirer firms’ shareholders over 5 years post-merger period. The relationship between the announcement period abnormal returns and post-merger abnormal returns has also been examined through regression analysis and negative relation between market reaction at the time of announcement and post-merger abnormal returns was reported.

Gregory (1997) analyzed 452 takeovers by UK listed companies with a bid value greater than £ 10 million for the period 1984-1992. The purpose was to examine the post-acquisition performance of UK companies undertaking large acquisitions, for examining the long-run post acquisitions performance six different models were used – Capital Asset Pricing Model (CAPM), Dimson and Marsh (1986) risk and size adjusted model (DM), Simple Size control portfolio (SS), multi-Index model using equally weighted smaller deciles minus large deciles returns (SML), value-weighted multi-index model, Fama-French (1996) value weighted three factor model. The results indicate significantly negative post-acquisition performance of acquirer firms using all the six models

calculated by control firm approach matched on the basis of size and book to market ratio. The sample was classified on the basis of mode of acquisition and method of payment. The results showed significantly negative abnormal returns in case of stock mergers while positive abnormal returns in case of cash tender offers.

Rau and Vermaelen (1998) examine long-term performance of bidding firms in mergers and tenders between Jan 1980 and December 1991. The sample consists of 3169 mergers and 348 tender offers. The abnormal returns of bidding firms adjusted on the basis of book-to-market ratio and size are computed for 36 months (3 years) after the merger completion. The procedure employed by Ikenberry et al. (1995), Barber and Lyon (1997) and Kothari and Warner (1997) are used to calculate the post-merger long term abnormal returns of the firm. The sample was divided into three categories – glamour, neutral and value firm based on book-to-market ratio and size. The results show that glamour bidders significantly earn negative abnormal returns of -17% in mergers and positive abnormal returns 4% in case of tender offers. Among the value acquirers, the bidder firms earn statistically significant positive abnormal returns of 15.5% while bidders in mergers earn abnormal returns of 7.64%.

Mitchell and Stafford (2000) examined long-term returns for three major corporate events – mergers, seasoned equity issues and share repurchases. The sample for mergers consists of 2193 events during 1958-93. Buy and hold (BHAR), Calendar time abnormal return (CTAR) and mean monthly return approaches have been used to calculate abnormal returns for 5 years after the events. They found that Calendar time abnormal return (CTAR) is the appropriate methodology for assessing long-term performance after any corporate event.

Pawaskar (2001) examined the post-merger operating performance of acquiring firms in India. The sample consisted of 36 firms engaged in merger over the period in merger over the period from 1992-1996. For comparing the performance of the firms involved in merger with that of non merger forms a
sample of non acquiring firms has been matched o the basis of size and industry. Multiple regression analysis has been done to identify the factors which have led to changes in profitability of the firms. The results show that mergers do not lead to improved performance and there is persistence profitability of firms indicating it is not affected by mergers.

Sharma and Ho (2002) examined 36 acquisitions in Australia during the period 1986 to 1991. The main objective of the study was to examine post-acquisition operating performance of acquirer firms. They used accrual as well cash flow measures to compare the pre and post acquisitions operating performance. The accrual measures used were ROA, ROCE, Profit margin and EPS and cash flow measures were cash flow return on assets, cash flow return on sales, cash flow return on shareholders’ equity and cash flow return minus preference dividend on number of shares. The adjusted operating performance measures using industry and size benchmark were compared for 3 years before and 3 years after acquisitions. The results showed that control adjusted performance measures in post acquisition were significantly lower than the pre-acquisition period. The relation of post-acquisition performance and pre-acquisition performance has been examined through regression analysis and the results show that there is significant continuance of pre-acquisition performance into post acquisition performance.

Dash (2004) tested the value creation hypothesis of mergers for which he studied mergers made during 1994-1996 using market model. The sample is divided into related and unrelated mergers. The results showed that there was positive impact of merger during first year after merger but it tends to disappear after 3 years. Further, evidence of value destruction in case of unrelated mergers was greater as compared to related mergers.

Martynova et al (2006) investigated the profitability of companies after acquisitions. They studied 155 European acquisitions that took place during 1997-2001. The purpose was to examine the post-acquisition performance of the companies involved in mergers and acquisitions and to investigate the determinants of changes in post-merger profitability of bidding and target firms. The measure used for post-merger performance was EBITDA scaled by
book-value of assets and sales and EBITDA after changes in working capital scaled by both book value of assets and sales. The

Pathak (2006) investigated the synergy effect of mergers by studying the post-merger operational synergy impact on target as well as acquiring firms. In India the sample consists of 4 companies in Indian cement industry which enters into MA transactions during the period 1993 to 2002. Pre-merger and post-merger operational synergy has been examined through intensity of operating expenditure with respect to sales for which multiple regression models has been used. The results partially supported synergy accruals for the target and acquiring firms.

Mantravadi and Reddy (2007) examined the impact of relative size of target firms to acquirer firms on operating performance of firms. The sample consisted of mergers of public listed companies at BSE or NSE during 1991-2003. Pre-merger and post-merger performance of acquiring firms has been compared using financial ratios — gross profit margin, net profit margin, operating profit margin, return on capital employed and debt-equity ratio. The pre-merger period consists of 3 years prior to the year of merger. The sample was divided into four categories based on relative size of target firms — mergers with relative size between 0.11 to 0.40, 0.41 to 0.70, 0.71 to 1.0 and above 1.0. The results show decline in net profit margin and return on capital employed in mergers with relative size between 0.11 to 0.40 whereas in mergers with relative size between 0.71 to 1.00 no difference in pre-merger and post-merger performance is reported. The authors concluded that relative size does not have impact on post-merger performance.

Bhaumik and Slarka (2008) made an attempt to examine the impact of firms in India. The purpose was to study the effect of ownership structure on the performance of companies. The sample consisted of 86 M&As during 1995-2002 Pre-end and post acquisition figures of profitability were compared through period to test regression analysis was used to study the impact of M&A on firm performance. The results showed that M&A involving unrelated business did not lead to improvement in the firm performance indicating that family oriented business may hamper the value maximization objections of companies.
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<td>Leeth and Borg (1989) (US)</td>
<td>To examine the impact of mergers on portfolio of target and acquiring firms' common stock</td>
<td>134 Mfg and mining mergers during 1919-1930</td>
<td>Market adjusted return method</td>
<td>No significant gains to acquiring and target firms</td>
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<td>Firth (1979) (UK)</td>
<td>To examine the profitability of takeovers</td>
<td>224 bids made in 1972, 73, and 74</td>
<td>Residual Analysis through market model</td>
<td>No gains associated with takeovers</td>
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<td>Berkovitch and Narayanan (1983) (US)</td>
<td>To develop tests to distinguish between three motives of takeovers - synergy, agency, and hubris.</td>
<td>330 tenders offers from 1963 through 1988.</td>
<td>Market model to calculate CAR and regression and correlation analysis for relationship between target, acquirer, total gains.</td>
<td>Synergy is the main reason for most of the takeovers.</td>
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<td>Bradley Desai, and Kim (1988) (US)</td>
<td>To estimate the synergistic gains from successful tender offers. To examine how these gains are divided into stock holders of target and acquiring firms</td>
<td>236 offers in 1963 to 1984 by firms tested on either NYSE or AMEX.</td>
<td>Event study methodology using market model</td>
<td>Successful tenders offer increase combined value of target and acquiring firms.</td>
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### Long-run abnormal return after merger

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<td>Asquith (1983) (UK)</td>
<td>To examine the effect of merger bids on stock returns.</td>
<td>196 successful mergers and 87 unsuccessful mergers during 1962-76</td>
<td>Abnormal returns are calculated by difference between sample firms and average returns on portfolio of firms having same beta.</td>
<td>Positive returns on all bonds of mergers on media announcement Reversal of excess of returns to unsuccessful target and bidding firms after announcement.</td>
</tr>
<tr>
<td>Agarwall, Jaffe and Mandelkar (1992) (US)</td>
<td>To examine post-merger returns over long period</td>
<td>937 mergers and 227 tender offer during 1955-87</td>
<td>Abnormal returns are calculated after adjusting for beta risk and market capitalization</td>
<td>Wealth loss of over 10% over 5 years after merger.</td>
</tr>
<tr>
<td>Loughran and Vlijh (1997) (US)</td>
<td>To find the relationship between post-acquisition return mode of acquisition form of payment</td>
<td>947 acquisition during 1970-1989</td>
<td>Buy and hold abnormal returns are calculated through matching firm approach.</td>
<td>Positive excess returns for cash tender offers and negative excess returns for stock mergers</td>
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<td>Franks and Harris (1989)</td>
<td>To examine the effect of takeovers on shareholders' wealth</td>
<td>1898 acquisitions during 1955-1985</td>
<td>Abnormal returns are calculated using event study methodology through Capital Asset Pricing Model (CAPM)</td>
<td>Positive return for target and bidder firms 4 years after the merger announcement.</td>
</tr>
<tr>
<td>Mitchell and Stafford (2000)</td>
<td>To examine long-term returns for three major corporate events – mergers, seasoned equity issues and share repurchases</td>
<td>2193 merger events during 1958-93</td>
<td>Abnormal returns are calculated using Buy and hold (BHAR), Calendar time abnormal return (CTAR) and mean monthly return approach.</td>
<td>They report that Calendar time abnormal return (CTAR) is the appropriate methodology for assessing long-term performance after any corporate event.</td>
</tr>
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<td>Healy et al (1990) (US)</td>
<td>To examine post-merger cash flow performance of target and acquirer firms and the relationship between post-merger operating cash flow return and merger announcement period returns.</td>
<td>50 targets mergers during 1979-1983</td>
<td>Industry adjusted cash flow returns are measured as difference between values for the merged firm and its weighted average industry median estimates. Regression is used for examining relationship between operating performance and announcement period returns</td>
<td>Significant improvement in operating cash flow returns of merged firms and a strong positive relation between post-merger operating cash flows and merger announcements returns.</td>
</tr>
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<tr>
<td>Pawaskar (2001) (India)</td>
<td>To examine the post-merger operating performance of acquiring firms.</td>
<td>36 firms engaged in merger during 1992-1996</td>
<td>Non acquiring firms matched on the basis of size and industry are used for comparing performance of firms involved in merger and multiple regression is employed to identify the factors which have led to changes in profitability of the firms.</td>
<td>No improvement in performance.</td>
</tr>
<tr>
<td>Sharma and Ho (2002) (India)</td>
<td>To examine post-acquisition operating performance of acquirer firms.</td>
<td>36 acquisitions during 1986-1991</td>
<td>Industry and size benchmarks are used to compare the operating performance measures and regression to examine the relation of post and pre-acquisition performance.</td>
<td>Lower post acquisition performance measures and significant continuance of pre-acquisition performance into post acquisition performance.</td>
</tr>
<tr>
<td>Parrino and Harris (1999) (US)</td>
<td>To examine post-acquisition operating performance of mergers.</td>
<td>197 mergers during 1982-1987</td>
<td>Industry adjusted cash flow returns are computed</td>
<td>Improvement in post acquisition operating performance</td>
</tr>
<tr>
<td>Mantravadi and Reddy (2007) (India)</td>
<td>To examine the impact of relative size of target firms to acquirer firms on operating performance of firms</td>
<td>Mergers of public listed companies at BSE or NSE during 1991-2003</td>
<td>Comparison of pre and post-merger performance of sample divided on the basis of size</td>
<td>Size does not have impact on post-merger performance</td>
</tr>
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2.2.3 Relationship between Post-merger Performance and Other Factors

Huang and Walking (1987) examined the relation between target firm abnormal returns at the time of initial announcements of acquisitions and types of merger, payment method and managerial relation. The sample consists of acquisition announcements over the period Sept.1987-April 1997. Abnormal returns around the merger announcement are measured through market model. Multiple regression analysis was used to find the relation between abnormal returns and transaction specific variables. The results indicate that tender offers show higher significant returns than mergers and cash offers show higher and significance abnormal returns than those of stock offers.

Agrawal, Jaffe and Mandelkar (1992) examined the speed of adjustment of information released at the time of merger announcement through relationship between pre-announcement and post-merger abnormal returns. They found no relationship between pre-merger returns and post-merger returns.

Parrino and Harris (1999) examined post-acquisition operating performance of 197 mergers of U S public companies during the period 1982 – 1987. To measure the operating performance operating cash flow scaled by market value of assets is calculated for 10 years, five years prior to acquisition (years -5 to year -1 ) the acquisition ( year +1 to + 5). The industry adjusted cash flow returns are computed following Healy, Palepu and Ruback (1992). The results show that merged companies depict improvement in post acquisition operating performance as average industry adjusted cash flow returns (IACFR) is 2.15 and significantly different from zero. The sample (merger transactions) was further classified into three groups – management replacement, industry consolidation and growth resource imbalance and their links with operating performance has been explored through cross section regression. The results of regression analysis signaled significant positive association between management replacement and post acquisition cash flow returns.
Heron and Lie (2002) studied 657 firms that conducted 859 acquisitions between 1985 and 1997. They examine the relation between method of payment in acquisition, earnings management and operating performance of firms that enter into acquisitions. To examine the earnings management, accruals have been estimated, multivariate regression is used to study the relationship between independent variables like mode of acquisition, market to book ratio of the acquirer and target firms and current and long term accruals. Operating performance is measured as operating income called by sales. To examine the operating performance of firms with control firm approach has been used. Two benchmarks are used as a proxy for control firm – industry adjusted and pre-event performance adjusted. The results of operating performance analysis show superior performance by sample firms than control firms in the same industry as well as control firms with similar pre-event performance.

Dash (2004) examined the relationship between pre-merger announcement abnormal returns and post-merger abnormal returns. He studied 10 top mergers in India during the time period 1994-1996. Event study methodology has been employed to assess the pre-merger and post-merger abnormal returns and the results showed that mergers lead to value destruction. The results relationship between pre-merger abnormal returns and post-merger returns assessed through multiple regression reported that there was no relationship between announcement period returns and post-merger returns.

Hazelkorn and Zenner (2004) studied 1547 merger transactions announced between Jan 1, 1990 and Jan 1, 2002 by U.S. acquirers. The purpose of the study was to analyse whether acquiring firms create value for their shareholders as result of M&A transaction. To measure the impact of M&A announcement, excess return of firms stock over the market returns has been calculated. both short run and long-run excess returns are examined, the results show that on an average acquired shareholders suffered losses around 0.5% - 0.7% on market adjusted basis around the merger announcement. The impact of
other factors (transaction specific as well as firm specific factors) on acquirer returns has also been examined. The results showed that factors that ownership of target firm, industry, method of payment seemed to have an impact on acquirer performance.

Gregory (2005) examined 217 UK takeovers of listed domestic companies between Jan 1984 and December 1992. The purpose was to test free cash flow (FCF) hypothesis in takeovers. The abnormal returns around the announcement and 60 months after the announcement are calculated. The benchmark portfolio is matched on the basis of size and book-to-market ratio. The matched portfolio return is calculated through 'buy-and-hold' method following Lyon et al (1999). The sample is divided into 'high q' and 'low q' firm based on NPV or FCF and difference in abnormal return between two groups is tested. The results show that low q firms perform better than high q firms. To test the FCF hypothesis it has been observed that low FCF firms earn higher returns than high FCF firms thus rejecting FCF hypothesis that firms having high FCF should have lower returns as they indulge in wasteful investment activities. The regression analysis has also been done to test the relation between FCF variable and other control variables. The results show positive association between post acquisition performance with average pre-acquisition FCF, investment in fixed assets and free cash flow.

Eckbo and Thornburn (2000) examined the performance of domestic and foreign (US) bidder firms acquiring Canadian targets. the sample consisted of 345 target firms and 1261 bidder firs listed on Toronto stock exchange (T- TSE) and 390 bidder firms listed on New York stock exchange that make merger bids between Jan 1964 and December 1982. Excess returns were computed using market model. The estimation period of 60 months and 13 months (-12 to zero month of announcement) window period has been taken. The abnormal returns to domestic (Canadian) bidders are reported as significantly positive whereas US bidders in Canada are earn statistically insignificant abnormal returns. Further
relationship between superior performance of domestic bidders and other factors is examined and the results showed that foreign direct investment control and horizontal product market relationship did not explain superior performance of bidders whereas positive relation between method of payment and announcement period returns has been reported.

Servaes (1991) examined the relation between takeover gains and Tobin’s q ratios of target and bidders. The sample consist of 704 mergers and tender offers in USA over the period 1972-1987. Market model is used to estimate the expected returns taking 200 days clean period share price data before the takeover announcement. Individual as well as weighted cumulative abnormal returns have been estimated for both target and bidder firms, taking market value of equity 11 days before the announcement as weights. The results showed that target returns were positive and significant and bidder returns are negative. The relation of target and bidder returns with Tobin’s q ratio has been examined through multiple regression. The results of regression showed that there was positive relation between CAR and bidders’ q ratio and negative relation with target’s q ratio which indicates that total returns are higher if targets perform poorly and bidders perform well.

Martin (1996) studied the relation between payment methods in corporate acquisitions and investment opportunities. A sample of 846 US acquisitions during the period 1978-1986 has been studied which was divided into three groups – equity financed, stock financed and mixed. Multinomial regression analysis was used to study the relation between investment opportunities and three methods of payment. The results of regression show that if the acquiring firms have higher investment opportunities, it is more likely to use stock financing in corporate acquisitions as the firm with Tobin’s q of 2.0 is 2.7 times more likely to use stock financing than with q ratio 1.0. The relation between ownership and payment method is negative as the firm with higher ownership in the range of 5% to 25% indicates less chances of use of stock financing and likelihood of
Alexandridis et al (2007) examined the relation between divergence of opinion about the value of the firm and post acquisition stock returns of acquiring firms. They studied 4641 acquisitions in UK announced in the period Jan 1, 1986 to Dec 31, 2002. Long-run post-acquisition stock returns have been measured by through calendar time portfolio regression (CTPR) using Fama and French (1993) three-factor model. Calendar-time abnormal returns have been measured as difference between expected through CTPR and actual monthly returns on securities. Divergence of opinion above the value of acquiring firm has been measured as standard deviation of returns during pre-announcement period of 100 days (day -5 to day -105). The results show that here is negative relation between divergence of opinion about the value of acquiring firm during pre announcement period and post-acquisition stock return.

Several studies have been done to examine the adjustments of share prices to publicly available information such as dividend announcements, equity issues, bonus issues etc. These events have lot of impact on shareholders wealth, which is well documented in event study literature. Mergers and acquisitions are major corporate decisions taken in order to create value to shareholders. A large strand of national as well as international literature focused on various aspects of mergers and acquisitions. The foregoing review of mergers and acquisitions literature has suggested various meaningful insights into this field though they showed mixed conclusions relating to wealth impact of mergers. Most of the studies suggested that target companies gained substantially on merger announcement and acquirer companies experienced little or no gains (Dennis and McConnell, 1986; Frank and Harris, 1989). Studies relating to long-run performance of M&As include Asquith (1983), Agrawal Jaffe and Mandelkar (1992) and Loughran and Vijh (1997) which suggested that acquirer companies experienced negative abnormal returns on share prices in the long-run. However,
studies that focused on long-run operating performance of mergers and acquisitions suggest that mergers have a positive impact on the post-merger performance of companies and there is positive relationship between pre-merger announcement returns and post-merger operating performance (Healy, Palepu and Ruback, 1992). A sizeable number of studies investigated into other aspects of mergers and acquisitions as well. The mergers and acquisitions literature in India does not provide a thorough insight into this issue which indicates that lot more research is needed in this field to have an in depth insight into the subject so as to provide useful contribution to the existing literature as well as meaningful implications to the corporate world.


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