CHAPTER 2
REVIEW OF LITERATURE

The previous chapter presents a discussion on the rationale of mergers and acquisitions and also highlights the role of various deal specific and company specific factors in influencing shareholder wealth gains. Further, various contemporary issues upcoming in the area of mergers and acquisitions have been discussed. This chapter presents the detailed review of the studies that have been conducted in the above context. Accordingly, the review of the literature has been segregated into four sections namely, the studies examining the rationale of mergers and acquisitions and their resultant impact on shareholder wealth gains, the studies analyzing the role of bid related and company specific factors on the announcement returns, the studies analyzing the impact of the contemporary strategic issues on the shareholders announcement returns and the studies related to Indian mergers and acquisitions.

STUDIES EXAMINING THE RATIONALE OF MERGERS AND ACQUISITIONS AND THEIR RESULTANT IMPACT ON SHAREHOLDER WEALTH GAINS

The studies discussed in this section have been conducted by the traditional researchers with the objective of finding the drivers that motivates the acquiring companies to pursue mergers and acquisitions. Besides, the studies also assess the impact of mergers and acquisitions on the wealth of the acquiring and the target company shareholders.

*Studies supporting synergy hypothesis as the rationale of mergers and acquisitions*

Manne (1965) through his conceptual study brought the importance of the market for corporate control into limelight by highlighting the motivations for takeovers and their resultant impact on shareholders wealth. He proposes that the major objective of an acquiring company pursuing mergers and acquisitions is to improve the inefficient management of the target company and to gain various operating and financial synergies by efficient utilization of the physical and financial resources of both the companies. He
further opines that takeover gains are divisible between the acquiring and the target company depending upon the objective of the acquisition. He states that if the objective of the takeover is to remove inefficiency of a relatively underperforming target company, such acquisition would result in substantial gains to the target company shareholders but may result in losses for the acquiring company. However, he states that if the acquisitions are aimed at driving synergies or market power such acquisitions would result in abnormal gains to the shareholders of both the acquiring and the target company.

Mandelkar (1974) is the first researcher to employ event study methodology to assess the impact of mergers on the announcement returns of the acquiring and the target company shareholders. He proposes various hypotheses as the motivators of mergers and acquisition activity viz. size/growth maximization hypothesis, perfectly competitive market hypothesis, and synergy hypothesis. He finds that the stockholders of acquiring firms earn normal returns during the pre and post merger period whereas the stockholders of the acquired firms earn abnormal gains of approximately 14% in the seven months preceding the completion of mergers. On the basis of positive gains to both the companies, he concludes that mergers are value creating activities and attributes the gains to synergy hypothesis. Further, linking the findings to perfectly competitive acquisition market hypothesis, he suggests that the reason for the acquiring company earning only normal returns is the competition in the acquisition market that transfers entire acquisition gains from the acquirer to the target company in the form of higher acquisition premiums.

Bradley et al. (1983) investigate the rationale behind the inter-firm tender offer by examining the announcement returns of the acquiring and the target companies engaged in successful and unsuccessful tender offers. For this they propose two hypotheses namely synergy hypothesis and information hypothesis. They state that if an acquisition is motivated by synergy objective, only successful acquisitions will result in abnormal gains to the target and the acquiring company because synergies are realized only when the resources of the two companies are combined. Regarding information hypothesis, they state that even if the acquisitions are not aimed at attaining synergies, the target shareholders would earn significant abnormal returns irrespective of the outcome of the bid. The reason being the announcement of an acquisition reveals positive information
about the underperformance of the target and induces its managers to implement value creating strategies. They find that the target company shareholders earn significant abnormal returns on announcement of both successful and unsuccessful tender offers. However, the share prices of those target companies whose bids are rejected by the acquirer and are also not subsequently acquired by another bidder within five years of the actual acquisition announcement fall back to their pre announcement level. On the other hand, the share prices of the successful target companies experience additional significant abnormal returns. Similarly, the acquiring companies that make an unsuccessful offer to a target and which is eventually taken over by other rival bidder realize a significant wealth loss as the rival bidder, seize a specialized resource which in turn put the unsuccessful bidder at the competitive disadvantage in the product or/and the factor market. Thus, they find the results in consonance with the synergy hypothesis and conclude that gains from the acquisition can be realized after the combination of both the firm’s resources and not only from the availability of resources with either firm.

Schipper and Thompson (1983) examine the impact of complete acquisition program on the acquiring company shareholder wealth. Examining the announcement returns of 30 companies engaged in acquisition program during 1960-1967 they find significant positive returns for the acquiring company shareholders. They state that the only factor that reduces the returns to the acquiring company is the regulatory changes that increase the cost of the acquisition for the acquirer. They conclude that the results are consistent with the synergy hypothesis while inconsistent with the size maximization hypothesis.

Thus, these studies highlight that synergies are a prominent source of value creation in mergers and acquisitions.

Studies favoring management inefficiency hypothesis as the rationale of mergers and acquisitions

Ellert (1976) examine the objective underlying mergers and acquisition strategy. He states that the mergers and acquisitions are a useful tool for re-allocating the resources from an inefficient management to more efficient management and are not aimed at building monopolies by the acquiring company. For this he compares the announcement returns of the bidding firms whose mergers are challenged by the antitrust law with those
bidding firms whose mergers are not challenged by antitrust law for creating monopolies. He finds that both groups of firms earn significant positive abnormal returns on the announcement of the acquisitions and there is no difference in the announcement returns of these pairs. He also finds that bidding firms acquire those target companies that are suffering from the mismanagement of the assets as reflected in the negative pre merger abnormal returns. Thus, he concludes that mergers do not lead to monopoly gains rather these are attempts to remove inefficiency of the merging firm.

Dodd and Ruback (1977) for the first time use the date of public announcement of tender offers as event date to examine the impact of both successful and unsuccessful tender offers on shareholder wealth gains. Employing event study methodology on a sample of 344 tender offers (260 successful and 84 unsuccessful firms) they find that the target firm shareholders earn large and significant abnormal returns of 20.58% for successful offers and 18.96% for unsuccessful offers whereas successful bidders earned gains of 2.83%, while the shareholders of unsuccessful firms neither gain nor lose. They identify the removal of inefficiency of target management and synergies as a source of value creation in mergers and acquisitions. However, they conclude that results are more consistent with internal inefficiency hypothesis.

Kummer and Hoffmeister (1978) analyze the valuation effect of cash tender offers for the acquiring and the target shareholders. For this they take a sample of 88 companies engaged in cash tender offers during the period 1958-1974. For target shareholders they find negative abnormal returns during the pre acquisition period but significant positive returns on and after the announcement. They opine that negative returns during the pre acquisition period highlight the below par performance of the target company due to the sub optimal strategies being followed by the target managers. While, the positive returns on the announcement highlights that the acquisition is an attempt to improve the performance of the target by replacing the inefficient target managers. They also find positive returns for the acquiring company shareholders and attribute such gains to the fact that the acquiring managers act favorably for the shareholders.
Langeteig (1978) examines the announcement returns of both the acquiring and the acquired companies. He finds that the target company suffers significant negative returns during the pre-acquisition period (from -72 to -19 months). However, from the 6th day before the actual announcement of the event, the target company earns highly significant returns that continue in the post-announcement period also. He suggests that losses in the pre-acquisition period highlight that internal inefficiency of the management is the motivating factor for a merger. On the other hand, the gains around the immediate announcement period highlight the probability of improved performance in the post-acquisition period. For the acquiring company shareholders, he finds normal returns and concludes that along with shareholder welfare the managerial welfare is also instrumental in causing the merger for the acquiring company.

Asquith et al. (1983) study the announcement gains of bidding and target companies in successful and unsuccessful offers. They find that successful target companies earn significant abnormal returns on the announcement while unsuccessful targets suffer significant losses in the post-announcement period. Similarly, the acquiring shareholders gain positive returns in successful offers while insignificant negative returns in unsuccessful offers. They attribute the findings to both synergy and internal efficiency hypothesis. However, they state that as per the target’s results, the internal inefficiency hypothesis is a better explanation. It is so because on the announcement of a successful acquisition, market bids up the target shareholders’ shares in the expectation that now its resources will be better utilized by the acquiring company. However, when such acquisition turns out to be unsuccessful, market reacts in an opposite way and that leads to significant losses to the target.

Malatesta (1983) examine the wealth effect of merger activity for the acquiring and the target company shareholders by measuring the cumulative abnormal dollar return around the announcement period. He finds that the target companies’ shareholders earn positive wealth gains USD 19.67 millions during the event window -5 to 0 while USD -9.42 millions during the period -61 to 0. He ascribes this result to the internal inefficiency hypothesis that predicts that underperformance of the target company motivates the acquirer for its acquisition. Regarding the acquiring company shareholder wealth, he
finds significant negative abnormal dollar returns for both sub periods and concludes that findings are consistent with the size maximization hypothesis.

Agrawal and Jaffrey (2003) re-examine the inefficient management hypothesis by analyzing stock return performance of the target firms. They find that the target firm as a group does not under perform over a decade long period before announcement. However, they find a sparse evidence of below par performance in case of few sub samples such as hostile offers, tender offers and offers involving multiple bidders. On the basis of sparse underperformance they reject the conventional view that targets under perform before acquisition and the acquisitions are a mode of removing their inefficiency.

From the review of above studies it is evident that mergers and acquisitions can either be value maximizing activities or non-value maximizing activities. The value maximizing mergers and acquisitions are aimed at improving the fundamentals of the combined company and hence optimizing the wealth of the acquiring and the target company shareholders. While non-value maximizing mergers and acquisitions are aimed at satisfying the personal objectives of the acquiring company managers through size maximization and lead to value destruction for the acquiring company shareholders though the target shareholders may earn abnormal returns due to price premium being paid by the acquirer.

STUDIES EXAMINING THE IMPACT OF DIFFERENT STRATEGIC FACTORS ON THE ANNOUNCEMENT RETURNS

These studies are motivated to resolve the ambiguity regarding the wealth gains to the acquiring company shareholders. Researchers conducting these studies emphasize that in order to know the value creating potential of a particular deal and its impact on the shareholders wealth it is imperative to unearth the managerial intentions for an acquisition that they suggest are highlighted by various bid related and the company related factors. Hence, these studies examine the role of various bid related and company related strategic factors on the shareholders wealth (more specifically on the wealth of the acquiring company shareholders). The strategic bid related factors are mode of payment, industry relatedness, hostility, competition in takeover market, nationality of the target
Review of Literature

company while the strategic company specific factors are the relative size of the target company and the size of the acquiring company. The studies in this section have further been segregated on the basis of a particular strategic factor being covered by the researchers and are discussed as follows:

Studies measuring the impact of mode of payment on the announcement returns
The studies analyzing the impact of the mode of financing on the acquiring and target shareholder wealth are discussed as follows:
Carleton et al. (1983) examine the target company related factors that affects the acquirer’s choice for a particular mode of payment. For this they divide entire sample into three categories viz. the target companies acquired in cash offers (30 companies), the target companies acquired in stock offers (31 companies) and the target companies that are not acquired (1352 companies). They find that out of various target specific factors viz. size, leverage, dividend payout, the only factor that played a vital role in affecting the acquirer’s choice for a mode of payment is market to book ratio. They suggest that the acquiring company employs stock for those targets that have high market to book ratio and thus find their results in consonance with the signaling hypothesis.

Wansley et al. (1983) study the impact of mode of payment on the target company announcement returns. Analyzing the announcement returns of 203 US target companies during 1970-1982 they find that the target companies engaged in cash mergers enjoy significant abnormal returns of 33.54% starting from 40th day prior to the announcement compared to the stock mergers where the announcement gains are 17.47%. They ascribe the findings to the taxation hypothesis.

Jensen (1986) in his conceptual paper propounds the free cash flow theory of takeovers. He states that takeovers are a means to resolve the agency problem associated with free cash flows at the disposal of the acquiring company managers. He opines that generally cash takeovers can successfully mitigate the adverse use of free cash flows as these would reduce the financial slack in the hands of managers that they would have otherwise invested in any other unprofitable or negative NPV activity. On the other hand, the stock offers do nothing to take the financial slack and hence are unlikely to motivate managers
to use resources more efficiently. Due to this fact cash acquisitions create higher value for the acquiring company shareholders while stock offers are coupled with negative reaction of the market.

Hansen (1987) through his conceptual model defines the conditions where the likelihood of stock financing on the part of the acquirer is higher. He states that an acquirer generally uses stock financing to cover the risk of adverse selection that arises as a result of information asymmetry on his part regarding the exact value of the target or where the risk of performance is higher due to the target’s size being larger relative to that of the acquirer. Moreover, he states the tendency of the acquirer using stock financing also depends upon the control considerations. He opines that the likelihood of stock financing increases with increase in the debt position of the target. The reason being in this case the level of equity shareholding with the target is lesser which in turn reduces the extent of dilution of control for the acquirer in the post acquisition period.

Huang and Walkling (1987) measure the impact of managerial reaction (favorable, unfavorable and neutral), payment method (cash, stock, mixed or undisclosed) and the type of acquisitions (merger, tender offer or undisclosed) on the announcement period abnormal returns of 204 target firms that have announced mergers during the period 1977-1982. They find that all three factors individually affect the announcement period returns. Tender offers, cash offers and resisted offers generate more returns than mergers, stock offers and un-resisted offers but when all the factors are collectively considered the returns are same or not significantly different.

Travlos (1987) explores the role of method of payment in explaining the announcement returns of bidding companies. Taking a sample of 126 mergers and 41 tender offers announced during the period 1972-1981 and using event study methodology and regression analysis he finds that in pure stock offers bidders experience significant loss at the announcement whereas in cash offers the acquiring firms earn normal returns. Moreover, he finds such valuation difference irrespective of the bid related factors viz. type of the bid (merger or tender offer), success of the bid or the size of the target company. He attributes significant difference in the abnormal returns between stock and
cash offers to the signaling hypotheses. He concludes that financing a takeover through exchange of common stock conveys negative information about the shares of the bidding firms being overvalued that in turn convey negative signal about the risk in realizing expected synergies in the post acquisition period.

Morck et al. (1990) study the impact of managerial objectives for takeovers on announcement returns for the acquiring company. Analyzing the announcement returns of US acquirers in 326 acquisitions during 1975-1987, they find that the acquisitions backed by managerial objectives are generally aimed at buying growth targets, or are initiated by the managers who perform badly as compared to their industry peers. If the acquisitions possess any of the above two features these would generate significant negative announcement returns to the shareholders of the acquiring company as compared to the acquisitions that are not driven by such objectives.

Amihud et al. (1990) study the impact of the acquirer’s managerial ownership on choice of mode of payment and its resultant impact on the announcement returns for the acquiring company shareholders. Taking a sample of 209 US acquisitions for the period 1981-83 they find that the likelihood of an acquisition being financed with cash is the increasing function of ownership with acquiring managers. As the level of managerial ownership with the acquiring company increases, the probability of cash financing also increases due to the fear of dilution of control. Also, at higher ownership level managerial interests get aligned with those of the company and hence the tendency of such managers pursuing value creating acquisitions increases. Accordingly, they find that at very lower ownership levels, the cash acquisitions generate normal returns to the acquiring shareholders while stock offers yield highly significant negative returns. But, as the level of ownership increases not only cash but stock offers start yielding positive abnormal returns to the acquiring company shareholders. They conclude that it is the level of ownership with the acquiring company managers that determines their choice for a particular mode of payment and also in turn determines the announcement gains for the acquiring company shareholders.
Brown and Ryngaert (1991) develop a model to prove that in addition to the information asymmetry, taxes benefits are also very important determinant of the mode of payment in an acquisition. They find that acquiring company shareholders observe negative returns at the announcement of stock offers as these not only signal overvaluation of the bidder’s shares but also the absence of tax benefits therein. The returns in cash offers are high as these not only resolve the valuation problem but also provide tax benefits in terms of depreciation tax shield and interest tax shield.

Sullivan et al. (1994) examine the relation between medium of exchange and the valuation effects associated with the terminated merger proposals. They find that the target company shareholders gain positive abnormal returns even 90 days after the termination of the merger proposal in cash offers than in the stock offers. On the other hand, the bidding firm shares are not revalued permanently in cancelled offers irrespective of the mode of payment employed. They suggest that the permanent revaluation of the target firm in cash offers is due to the revelation of the private information pertaining to its unique synergy potential as signaled by the medium of exchange.

Hubbard and Palia (1995) examine the relationship between the managerial ownership structure and the acquiring company shareholder returns. Analyzing the announcement returns of 354 companies undertaking mergers during 1985-1991 they find that the acquiring companies suffer significant negative returns (-0.45, Z = -2.82) during 9 day period around merger announcement. They attribute the negative announcement returns to the acquiring company’s managerial ownership. They find that at very low levels of ownership the managers pursue value destroying mergers to maximize their personal benefits (salaries and other perks) and thus generate negative abnormal returns for the shareholders. At very higher level of ownership the managers pursue acquisitions just to diversify their portfolio and pay higher bid premium to the target company shareholders even if the target lack valuable resources at its disposal. This again generates negative returns to the acquiring company shareholders. Thus, they conclude that acquisitions are motivated by personal benefits of the managers either in the form of higher compensation.
Martin (1996) examines the influence of various strategic factors on the acquirer’s choice for a particular method of payment, using a sample of 846 corporate acquisitions announced during 1978-1988. He opines that investment opportunity set (measured in terms of Tobin’s Q) faced by the acquiring companies is the most important characteristic that influences the choice for a mode of payment. He states that the acquirer uses stock financing to mitigate the possible risk of overpayment when the target’s stock is overvalued in the market due to overestimation of the growth opportunities with the target. Further, he finds insignificant relationship between the acquiring firm’s managerial ownership and the probability of stock financing and suggests that the managers do not pursue acquisitions for their personal benefits but for the benefits of the shareholders of the company. However, he cannot find any relationship between the relative size of the target firm and the likelihood of stock financing and concludes that size of the target is a poor indicator of an acquirer’s tendency of sharing risk.

Davidson and Cheng (1997) examine the relationship between the target’s abnormal returns and the mode of payment. They find that cash offers generate higher wealth for the target shareholders only because they receive larger premiums in such offers to offset their tax liabilities. They conclude that bidders offer higher price to the target companies in cash offers not to resolve the problem of information asymmetry but to satisfy the tax considerations of the target company. Thus, they produce result in consistence with the taxation hypothesis.

Loughran and Vijh (1997) examine the impact of mode of acquisition (tender offer or merger) and form of payment on the shareholders’ wealth by taking a sample of 947 acquisitions consummated during 1970-1989. For the target companies they find that in stock mergers the target shareholders earn 14.9% more than the matching firm while in cash tender offer the target shareholders earn 138.3% higher returns than the matching pairs. As regard the acquiring companies they find 15.9% lesser returns for the acquirer than the matching firms in stock mergers while in cash tender offers their returns are 43% more than those of the matching pairs. Further, they suggest a negative relation between the relative size of target and the acquiring company returns. Thus, they conclude that stock financed mergers of large sized targets are value destroying mergers.
while cash financed tender offers of small and medium sized targets are value enhancing investment activities for both the acquiring and the target company.

Blackburn et al. (1997) study the relationship between mode of payment and ownership structure on the announcement returns of the acquiring company. For this they take a sample of 440 US acquisitions for the period 1981-90. They find significant negative returns for the shareholders of the acquiring company in both owners controlled and managers controlled firms. They ascribe the negative returns in managers controlled companies to the negative signal about the overvaluation of the acquiring companies. However, they cannot detail the reasons for negative bidders’ returns in owner controlled companies.

Ghosh and Ruland (1998) examine the influence of managerial ownership with the target and the acquiring company on the acquirer’s choice of payment to be employed in an acquisition. They propose that when managerial ownership is higher at the target company’s end, its managers would prefer stock financing for covering the unemployment risk in the merged company. Similarly, the acquiring managers who value control would favor cash financing in order not to dilute their shareholding in the combined company. However, in such situations generally the target company managers have more influence in determining mode of payment than those of the acquiring company managers. It is due to this phenomenon that the target managers are able to retain their jobs in the combined company.

Emery and Switzer (1999) analyze the wealth gains of the acquiring companies in cash and stock offers and find that the acquiring companies experience substantial loses in stock offers while positive market reaction in cash offers. They suggest that the performance difference in cash and stock offers is attributed to the phenomenon of information asymmetry.

Zhang (2003) studies the influence of the acquiring and the target company specific factors on the choice of mode of payment. He finds that the probability of stock financing increases with the lower dividend payout and lower return on equity with the acquirer and
also when the acquirer’s shares are overvalued in the market. However, in contrast to the previous findings he does not find influence of the acquirer’s and target’s ownership levels on mode of payment. Moreover, he also cannot find any influence of relative size of the target on the acquiring choice for a mode of payment.

Faccio and Masulis (2004) study the relationship between various bid related and company related factors and the acquirer’s choice for a particular mode of payment. They propose that acquirer’s financial conditions and control concerns have a clear influence on M&A financing choice. They find that bidders issue stock in conditions where either their shares are overvalued in the market or the stock return variance (risk) is high and also when the size of the target company is relatively larger than the size of the acquiring company. The reason being in all these situations the bidders face performance risk and try to share it with the target company in the post acquisition period. They also opine the bidder’s preference for cash financing increases with increase in its ownership level as the use of stock poses problem of dilution of control in the combined company.

Martynova and Renneboog (2006) examine the impact of mode of payment on the announcement returns of the acquiring company shareholders. For this they study European acquisitions announced during the period 1993-2001. They find that the acquiring company shareholders earn significant positive abnormal returns in all cash offers as compared to the significant negative returns in the all stock offers. They conclude that negative price reaction to all stock offers are in consonance with the belief that equity payments transmit a signal of the overvaluation of the bidding firm to the market.

Bugeja and Rosa (2007) analyze the impact of changing tax regulations on the takeover premium and the resultant announcement returns of the target shareholders in cash and stock offers. They find prior to the year 1999 when the target shareholders were taxed on capital gains irrespective of the mode of payment, target shareholders earn significant higher announcement returns in cash offers. However, afterwards with change in takeover rules (when target shareholders are taxed for only cash offers) no association between the target shareholder capital gains and the takeover premiums is evidenced.
Thus, they propose that target shareholder gains are higher in cash offers for non-taxable reasons and find results inconsistent with taxation hypothesis.

From the review of above studies it is clear that the mode of financing used in an acquisition is an important indicator of the value creating potential of an acquisition as it highlights various risks and managerial intentions underlying a particular acquisition. Besides, it also highlights that tax benefits are an important determinant of the mode of payment that in turn affects the wealth gains in acquisitions.

Studies measuring the impact of industry relatedness on the announcement returns
These studies measure the impact of industry relatedness on the announcement returns of the acquiring and target company shareholders. The details of the studies have been discussed as follows:

Lewellen (1971) through his conceptual model try to compare the value creating potential of non-conglomerate (related) and conglomerate (unrelated) acquisitions. He suggests that if conglomerate acquisitions are pursued at modest degree these can provide many value creating opportunities for the acquiring company viz. coinsurance benefit and enlarged debt capacity. He opines that the acquiring companies pursuing conglomerate mergers are able to diversify their operations in newer areas that in turn reduce the variability of the future cash flows and thus provide the coinsurance benefit to the lenders of the acquiring company. Moreover, he states that as a result of this acquisition the debt capacity of the acquiring company increases due to its expanded size.

Haugen and Udell (1972) examine the excess market rate of return for the target companies engaged in related and unrelated mergers. They state that the target company earned significant gains in both kinds of acquisitions and these are not attributed to the kind of acquisition strategy but to the substantial premium paid by acquirer to the target company.

Elgers and Clark (1980) study the impact of related and unrelated mergers on the wealth of the acquiring and the target company shareholders. They find that, in general, acquisition yield moderate returns to the acquiring company shareholders while substantial wealth gains are enjoyed by the target company shareholders. However,
unrelated acquisitions confer superior returns to the shareholders of both the acquiring and the target companies compared to that of related ones. They are not able to highlight the source of superior wealth gains in unrelated acquisitions and state that both acquisitions offer similar level of risk reduction and diversification benefits.

Chatterjee (1986) compare three broad classes of resources that contribute to value creation from acquisitions. The resources are classified as resources related to the cost of capital (resulting in financial synergy), cost of production related resources (resulting in operational synergy) and price related resources (resulting in collusive synergy). By analyzing the returns of 157 mergers he ranks the value creation through different synergies as: Collusive synergies, Financial Synergies, Operational Synergies.

He opines that the value creation in an acquisition does not depend primarily upon the type of merger (related or unrelated) rather upon the amount of scarce or distinctive resources at the disposal of the acquiring and the target company and the strategic fit between these resources.

Lubatkin (1987) examines the relationship between the merger strategy (relatedness of merging firms) and the stockholders gains of merging firms. He classifies mergers into four categories: Product Concentric Mergers; Horizontal Mergers and Market Concentric Mergers; Conglomerate Mergers and Vertical Mergers.

Using both traditional and modified market model on the pre and post merger period returns of 439 acquiring firms and 340 large acquired firms in 1034 large mergers (above $10 billion) he finds that mergers in general are a means of permanent gains for both the acquiring and the target company stockholders. However, these gains accrue to the acquiring and the target company only when the mergers are consistent with the overall mission of the merging companies and are realized irrespective of the merger strategy (relatedness). So the study supports that mergers are value-creating activities, but does not support the popular prescription, “all things being equal, some product and market relatedness is better than none” or the relatedness hypothesis.

Singh and Montgomery (1988) re-examine the relatedness hypothesis by analyzing the announcement returns of the acquiring and the target company in related and unrelated
acquisitions. They find the target companies earn significant positive abnormal returns in both related and unrelated acquisitions. However, the value creation in related acquisitions is substantially higher than in unrelated acquisitions. Similar results are found for the acquiring company shareholders with the difference that value creation in both acquisitions being not significantly different. Thus, they conclude that combination of resources of two related companies have higher value implications than those of two unrelated companies.

Barney (1988) in his conceptual paper tries to explore the conditions in which relatedness in mergers and acquisitions can be a source of abnormal returns for the acquiring company shareholders. He states that relatedness per se does not guarantee abnormal returns for the acquiring company shareholders because competition among the bidders distribute entire gains to the target shareholders. He opines that relatedness would yield abnormal gains to the acquiring company shareholders under two conditions. Firstly, when private and uniquely valuable synergies exist between the acquirer and the target companies and the competitors can’t replace it. Secondly, when some unexpected gains occur between acquiring and the target company about which even the acquiring company is ignorant.

Shelton (1988) takes a sample of 218 mergers to examine the acquisition strategy that create highest value for the acquiring company shareholders. For this he divides acquisitions into three categories, namely, related supplementary (that permit bidders access to new markets), related complementary (that permit bidders access to new products) and identical (that permit bidders access to the same business). By measuring the abnormal dollar value gains and considering other factors like size of target, regulatory effects and competition in bidders market via multiple regression analysis he ranks the acquisitions that provide most value and better business fits as identical, related supplementary and related complementary. As regard the other bid related factors he finds that the value creation in acquisition increases with increase in the size of the target relative to the bidder. The reason being the larger target offers exceptionally valuable assets like national brand names and national distribution network and also valuable opportunities to the acquiring company. Besides, the mergers in which rival bidders are
present yield more to target and bidder combined. The reason being the presence of the rival bidders indicates that the target being purchased possesses high quality assets that would generate superior gains to the combined company.

Mann and Sichermann (1991) extend the free cash flow theory of Jensen (1986) and states that acquisitions are used by the managers to reduce their employment risk. In order to protect their jobs, increase the compensation level and to get promotions to higher positions, the managers use the excess cash flows with the acquiring company to pursue acquisitions that expand the size of the company and as a result their personal benefits linked to such increased size. In the process they even acquire those businesses that are completely unrelated to the firm’s primary line of business. Thus, unrelated acquisition can be value destroying for the reason that these are motivated by the managers for their personal benefits and not for the welfare of the general shareholders.

Chatterjee (1992) tries to explore the source of value creation in acquisitions by proposing two hypotheses namely, synergy hypothesis and restructuring hypothesis. He intends that if synergy is the source of value creation in acquisitions then only successful acquisitions will benefit the shareholders of the target and the acquiring company because it requires the combination of the resources of two companies. On the contrary if restructuring, in the form of disciplining the target’s managers and removal of target’s inefficiencies, is the objective of the acquisition then even unsuccessful acquisitions will create value for the target company shareholders. Analyzing the announcement returns of the target companies in 577 tender offers (436 successful and 141 unsuccessful tender offers) he finds that the target companies that restructure their operations created 5% higher value than the original offer price and 31% more than the pre announcement level. But the value of those target companies that do not take any action fall sharply from the offer price back to zero. Thus he finds support for restructuring hypothesis and concludes that if as a result of the announcement of an acquisition, the operations of the target company are restructured then any type of acquisition can perform well irrespective of the fact whether it is related or unrelated.
Capron and Pistre (2002) examine the sources of acquirer gains in acquisitions by combining the event study with the post acquisition survey on the resource transfer by the target company to the acquiring company. They suggest that acquisitions are value creating activities but value creation does not guarantee value capture for the acquiring company. Even, despite of the strategic relatedness and good resource fit between the acquirer and the target’s assets, competition among the acquirers cause the entire value gains to be shifted to the target company shareholders. They conclude that value is captured by the acquiring company only when it possesses unique managerial and innovative resources and transfer these to the target company and also when such resource fit is not available with competing acquiring companies. Thus, they suggest that value captured by the acquiring company depends upon respective distribution of resources among the competing bidders. As the bidder’s capabilities become similar, the value captured by bidder shrinks while that of the target company increases.

From the review of above studies it is evident that researchers possess differing views regarding the influence of relatedness on shareholder wealth. Some researchers state that related acquisitions outperform the unrelated ones while the others give the contrary opinion and argue that unrelated acquisitions outperform the related ones. Besides, there is another class of researchers who opine that relatedness per se does not affect the announcement returns. However, despite the conflict regarding the impact of relatedness on the acquirer gains, the extent of relatedness in an acquisition indicates the sources of gains in a particular acquisition.

Studies assessing the impact of hostility on the announcement returns

The findings of the studies examining hostility as a value influencing factor are explained as follows:

Healy et al. (1997) study the impact of hostile acquisitions on cash flows of the combined company. They find that the friendly acquisitions generate significant positive cash flows (2.6%) for the combined firm while the hostile acquisitions fail to yield any cash flows in the post acquisition period. They suggest that the reason for the friendly acquisitions performing better than the hostile ones is the lesser price premium paid by the acquiring managers in such acquisitions.
Dodd (1980) study the impact of target management resistance in takeovers on the shareholder wealth. For this he segregates his sample into completed and cancelled offers. He finds that the target shareholders earn significant abnormal returns on the announcement of a merger proposal irrespective of the outcome of the proposal. He finds that for completed proposals target shareholders earn 33.16% returns. For rejected offers he finds that if the bid is rejected by the target managers then the target shareholders earn 10.99% abnormal returns but when rejection is on the part of bidding company the abnormal gains are to the extent of 0.18%. For bidders they find negative return of -7.22% for completed mergers and -5.50% for cancelled ones. He concludes that the target shareholders reject a proposal only to maximize the premiums. This is the reason for target shareholders gaining substantial returns in completed offers while the acquiring shareholders losing substantially in such offers.

Georgen and Reneboog (2004) suggest that the target shareholders gain significantly higher returns in domestic acquisitions compared to that of foreign ones only because these include larger proportion of the hostile deals that enable the target shareholders command higher premium from the acquirer. Dewenter (1995) also states that foreign acquisitions create higher wealth for the target shareholders than the domestic ones only in case of hostile deals. Similarly, Huang and Walkling (1987) find that target shareholders are able to earn higher returns in resisted offers than those offers that are un-resisted by the target managers.

From the review of above studies it is clear that the extent hostility in an acquisition yield superior returns to the target shareholders as they are able to command a higher price from the acquirer. However, it works unfavorably for the acquiring shareholders if the acquiring managers, driven by their personal benefits or hubris, end up overpaying the target than the expected synergies from such acquisition.

Studies measuring the impact of competition in the takeover market on the announcement returns
These studies examine the impact of the competition among bidders on the shareholders’ returns and also its role in shifting the gains from the acquirer to the target shareholders. The studies have been detailed as follows:
James and Wier (1987) examine the effect of competition in the acquisition market on the announcement returns of the acquiring company shareholders. For this they analyze the announcement returns of 60 acquiring banks engaged in acquisitions during the period 1972-81. The initial results of the study reveal that the acquiring bank can earn highly significant positive announcement returns during the event window -1 to 0 (1.07, 3.09) and during the event period -4 to 0 (1.77, 3.30). However, with the help of regression analysis they find that these gains are related to the extent of competition among bidders in the takeover market. If there are number of target companies possessing the resource desired by the bidders, bargaining power of the bidders will increase and will pay lesser price that in turn will increase the announcement returns of the acquirers. However, if more than one acquirer competes for the resources of the target, then it will leave the acquiring company pay a higher price for the target. Hence, they conclude that the acquirer’s returns are negatively related to the number of alternative bidders in the market and positively to the number of the targets available in the market.

Berkovitch and Narayanan (1990) try to find the role of mode of payment in distributing the returns to the acquirer and target in the presence of competition among bidders with the help of statistical model. They suggest that the probability of cash financing increase with the increase in competition in the takeover market. This in turn increases the amount of synergies to be shared by the target. Thus, they suggest that higher the level of competition, higher the probability of the acquisition being financed with cash and higher the probability of the announcement gains being shifted to the target company from the acquiring company.

Cebenoyan et al. (1992) study the wealth gains of the US target companies in foreign and domestic acquisitions during the period 1978-1987. They find that in the overall sample the foreign acquisitions create lesser value than the domestic ones. However, those foreign acquisitions where the intensity of competition among the bidders is high, yield superior returns to the target companies compared to the domestic acquisitions. So, they conclude that target firms are able to earn significantly higher abnormal return in the foreign acquisitions compared to the domestic acquisitions only when the competition
forces the foreign bidders to share the incremental acquisition gains with the target companies.

A review of the above studies makes it clear that the extent of competition in the takeover market indicates the direction in which the gains from the acquisitions would be distributed. Greater the intensity of competition among bidders, weaker the bargaining power of the acquirer and hence higher the probability of the acquisition gains being shifted to the target company shareholders.

Studies measuring the impact of foreign acquisitions on the announcement returns
The studies in this section measure the impact of geographic expansion through mergers and acquisition on the shareholders’ wealth. Besides, the studies in this section aim at comparing the wealth gains in domestic and cross border acquisitions.

Agmon and Lessard (1977) examine the international diversification hypothesis by analyzing the share prices of 217 US firms. They find that companies that have diversified their operations in various countries have lower betas (lower risk) compared to the firms where international involvement is lesser. Besides, share price of the internationally diversified companies fluctuate lesser in response to the domestic conditions as their portfolio contains securities of different nations. They conclude that the market recognizes and rewards the geographic diversification of the companies because MNCs can diversify at lower costs as compared to the individual diversification and also help MNCs gain benefit of imperfections in goods and factor market.

Cushman (1985) studies the impact of exchange rate fluctuations on the FDI in the US with the help of his theoretical model. He finds that fluctuations in the exchange rate signal a variety of risks associated with the foreign investment that in turn lead to significant reductions in FDI in the US. Thus, he suggests an inverse relation between the two factors.

Doukas and Travlos (1988) examine the impact of international acquisitions on the acquiring company’s shareholder wealth. They find that the US firms that expand in the countries where they already have operations experience insignificant abnormal returns while insignificant positive abnormal returns are experienced by the acquirers who made
first foreign acquisitions. The only significant returns are enjoyed by those acquirers who acquire a firm in a country other than the existing country. Thus, they support the positive multinational network hypothesis and suggest that those MNCs that are able to diversify their operations in different countries and are thereby able to exploit unique international distortions in the capital, product and factor markets are able to create superior wealth for the shareholders. On the contrary, those acquirers that follow the international acquisitions as survival strategy are not able to gain the above stated advantages and experience negative abnormal returns.

Froot and Stien (1991) study the relationship between exchange rates and FDI in case of imperfect foreign exchange markets through their conceptual model. They find that a depreciated currency gives foreigners an edge in buying the control of a corporate asset and enables them to buy the assets at relatively cheaper price. Thus, they suggest an inverse relation between exchange rates and the FDI meaning thereby that the FDI increases when the currency of the foreign investor appreciates with respect to the US dollar.

Hariss and Ravenscraft (1991) study shareholder wealth gains for the US target firms acquired by domestic as well as foreign buyers and also examine the factors that are responsible for difference in the announcement returns of both the kinds of acquisitions. They find that the target company shareholders gain significantly higher returns in cross border takeovers than in domestic ones. They further state that the cross border effect persists even after controlling for the industry effect, mode of payment employed, competition among the bidders etc. They attribute superior gains in foreign acquisitions to imperfections in the factor market that enables the acquiring company to judiciously utilize its intangible assets via internal market and imperfections in exchange rate market that enables the acquirer acquire the assets of the target company at a cheaper price.

Morck and Yeung (1991) propose internalization theory as a justification for the international involvement of the firms. They state that multinationality is favored by the market when it offers the opportunity to the MNC to judiciously utilize its intangible assets by sharing it across the group companies though the internal market. The reason
being these assets are based on proprietary information and can’t be exchanged at the arm’s length. Thus, they favor internalization theory as a justification for foreign direct investment (FDI) and reject the diversification theory.

Marr et al. (1993) analyze the announcement returns of 96 US companies being acquired by the foreign and the domestic acquirers during the period 1975-1987. They find that foreign acquisitions create higher wealth for the target shareholders than the domestic ones and attribute superior returns in foreign acquisitions to imperfections in the product market. They suggest that foreign bidders acquire the US targets to improve their performance by transferring their intangible assets. Further, the foreign acquirers acquire only related US targets and the targets that have low market to book ratio thus indicating their quest for expanded markets and synergistic gains.

Pettway et al. (1993) analyze the wealth effect for the Japanese acquirers who acquire the US targets by taking a sample of 53 acquisitions announced during 1981-1991. They find that both the Japanese acquirers and the US targets earn significant wealth gains on the announcement of such cross border acquisitions. They attribute the gains to the imperfections in the product, factor and capital markets.

Markides and Ittner (1994) examine the wealth gains to the acquirers in domestic and foreign acquisitions and also study the factors that affect such wealth gains. Investigating the announcement returns in 276 US acquisitions for the period 1975-1988 they find that international acquisitions create highly significant wealth than the domestic acquisitions. They opine that the highest wealth gains accrue in cross border acquisitions when the acquiring and the target companies are able to share their intangible resources. Moreover, they suggest that the wealth gains to acquirers are also positively related to the relative size of the target, relatedness in the acquisition and in those cases where acquisitions are financed with equity of the acquirers.

Dewenter (1995) compares the target shareholders announcement wealth gains in domestic and foreign takeovers restricting the sample to only chemical and retail sector. He finds that there is no significant difference in the announcement wealth gains in
domestic and cross border acquisitions. However, he states that foreign acquisitions create higher wealth for the target shareholders in hostile transactions while lesser value is created in case of acquisitions where rival firms are present and also in transactions financed via equity of the acquirer. So he concludes that wealth gains to the target shareholders are sensitive to the standard transaction variables and not to the nationality of the acquirer per se.

Zaheer (1995) tries to explain the ways by which an MNC operating in various countries overcomes the liability of foreignness. By liability of foreignness he means various costs that an MNC has to bear either due to the unfamiliarity with the local industry specific environment or the costs arising from the unfamiliarity with the host country’s legal and political environment and lastly the cost arising out of the spatial distance between the host country and the country to which the MNC belongs to. He states that MNCs can handle this cost either by mimicking the features of successful local firms or by importing the firm specific advantages from their parent company. Conducting the survey on the operations of 28 banks engaged in foreign exchange trading he concludes that a firm can overcome the liability of foreignness when it imports firm specific advantages like technologies, brand names, cost advantages and managerial skills from its parent rather than mimicking the strengths of the successful local companies. Accordingly, these firms produce better results than the local firms.

McCorriston and Sheldon (1998) study the impact of the exchange rate fluctuations on the wealth gains to US acquirers for the acquisitions only in food industry. They find no evidence that wealth gains are a function of exchange rate fluctuations and conclude that announcement gains may be more influenced by the bid specific factors (though they do not study the impact of bid related factors in the study).

Reeb et al. (1998) study the impact of international diversification on the risk of the MNCs. Contrary to the results of existing literature they find that the MNCs engaged in international operations evince an increase in the systematic risk. They attribute the results to the presence of multiple risks viz. political risks, foreign exchange risks, agency
problems, problems of information asymmetry that causes the cost of international operations surpass the expected benefits.

Kiymaz and Mukherjee (2000) examine the wealth effects of the US firms engaged either as bidders (112 companies) or as targets (141 companies) in cross border mergers in nine developed countries during 1982-1991. They find that both the acquiring and the target company shareholders earn significant abnormal returns in their foreign acquisitions. The target earns abnormal returns in cross border acquisitions because competition among bidders motivates the acquiring company to pay a higher premium to the target. The acquirer earns abnormal returns because it gets better opportunities to be realized from the frictions in capital markets. Thus, they find their results in support with the diversification hypothesis and suggest that benefits to the acquiring companies in cross border acquisitions are inversely related to the extent of co-movement in the economies of the bidder and the target countries.

Seth et al. (2002) study the sources of value creation in cross border acquisitions. They find that only those cross border acquisitions that are aimed at creating synergies by way of asset sharing, reverse internalization of valuable intangible assets create value for the acquiring company shareholders. Besides, they suggest that relative size of the target company positively affect value creation in cross border acquisitions as it leads to the transfer of valuable intangible assets in larger quantity.

Chari et al. (2004) study the wealth gains for the acquiring and the target companies when acquisitions are initiated by the US acquirer for a target in the emerging markets. The results indicate that cross border acquisitions in the emerging markets create significant positive wealth for both the acquiring and the target company for two reasons. They opine that if these acquisitions are initiated during the period of relative calm, these increase wealth gains by transferring the intangible assets like technology and skill between two companies. However, if these acquisitions are pursued during the period of financial distress, these generate significant wealth gains for the acquiring company as a result of its increased bargaining power that enable it to purchase the target at comparatively lower price. The target company shareholders also gain in such
Review of Literature

acquisitions as these transfer the control of the target company from the poorly performing management to the superior management. Thus, foreign acquisitions directed towards emerging markets are beneficial for both the acquiring and the target company shareholders.

Danbolt (2004) analyzes abnormal returns to the shareholders of the target companies engaged in domestic and cross border acquisitions by studying three hypotheses viz. international diversification hypothesis, market access hypothesis and exchange rate hypothesis. He also analyses the impact of various bid related features viz. mode of payment, resistance, relatedness, bid revision, hostility, industry and outcome on the announcement wealth gains. His results indicate that target companies gain positive abnormal returns in both domestic and cross border acquisitions and that there is no significant difference in the announcement returns of sets of acquisitions. Besides, he does not find any support to the market access hypothesis, international diversification hypothesis and contrary results to the exchange rate hypothesis. However, he finds that cash acquisitions generate higher wealth gains for the target irrespective of the nationality of the acquirer. Thus, he concludes that the target returns are unrelated to any of the above hypotheses but are linked with the bid related features more specifically the mode of payment.

Georgen and Renneboog (2004) analyze the impact of 187 inter European M&A deals on the acquiring and the target company shareholder wealth. For the target companies they find domestic acquisitions create significant higher wealth gains than the foreign acquisitions. While for the acquiring companies they find that foreign acquisitions create insignificant higher wealth than the cross border acquisitions. They attribute the differences in the wealth gains in the two sets of acquisitions to the characteristics of the bid. They state that the target shareholders gain more in domestic acquisitions as it includes higher proportion of hostile deals that increase the probability of upward revision of the bid price by the acquirer. Accordingly, the acquirer earns lesser returns in domestic acquisitions as it end up paying higher price to the target company. They further state that in addition to hostility, mode of payment is the another factor that has a very influential role in defining the announcement returns. They find that both the acquiring
and the target company earn higher wealth gains in cash offers than in stock offers. Thus, they conclude that announcement gains to both the acquirer and the target companies are affected by the bid related features and are irrespective of the nationality of the target or the bidder per se.

Lowinski et al. (2004) analyze the impact of domestic and foreign acquisitions on the acquiring company shareholder wealth. For this they take a sample of 114 domestic and foreign acquisitions conducted by Swiss acquirers. They find that the cross border acquisitions create slightly higher wealth for the shareholders than the domestic acquisitions but there is no statistical difference in the wealth gains of the two sets of acquisitions. They also study the effect of various bid related variables like relatedness, size of the target on the wealth gains in domestic and cross border acquisitions but they do not find any effect of these variables on announcement gains. Thus, they conclude that the reason for such findings is the fact that Swiss markets are highly integrated with international markets thus yielding no benefit of imperfections and hence no superior gains in cross border acquisitions.

Conn et al. (2005) examine the announcement returns of the UK acquirers in domestic and cross border acquisitions. For this they take a sample of 3204 domestic and 1140 foreign acquisitions during the period 1984-1998. They find that for overall sample cross border acquisitions create lesser value than the domestic acquisitions. However, the cross border acquisitions by the companies in hi-tech sector create higher returns than the domestic acquisitions.

Moeller and Schlingemann (2005) compare the stock returns of the bidders across domestic and cross border transactions using a sample of 4430 acquisitions announced during the period 1985-1995. They find that cross border transactions create significantly lesser wealth than the domestic acquisitions. They ascribe the results to the institutional factors like restrictive takeover environment, restrictive legal environment and concentrated ownership level that increase the cost of the acquisition and reduce the net wealth gains to the acquiring company.
Donohoe (2006) compare the wealth gains of UK acquirers in foreign and domestic acquisitions. He finds that cross border acquisitions create slightly lesser wealth gains for the acquiring company shareholders than the domestic acquisitions. He attributes the results to various companies specific and bid related variables. He suggests that the bids involving multiple bidders, more profitable target companies, research and development intensive targets positively affect the acquirer’s returns irrespective of the nationality of the target.

From the review of the above studies it is evident that there are two schools of thoughts with regard to the cross border acquisitions. On the one hand, the followers of the industrial organization theory state that cross border acquisitions create superior returns than the domestic ones as these confer the benefit of international diversification, internalization and exchange rate variation. On the other hand, the advocates of the bid specific theory argue that the wealth gains are influenced by the bid related and company related factors, and the nationality of the acquirer or the target does not have any impact on the announcement returns of the target or the bidder as the case may be.

Studies measuring the size effect on the announcement returns
These studies measuring the impact of the absolute size of the acquiring company and the relative size of the target company on the announcement returns are detailed as follows:

Studies measuring the impact of the acquiring company size on announcement returns
Eckbo and Thorburn (2000) compare the announcement returns of Canadian bidders in domestic (Canadian) and foreign (US) acquisitions. They find that bidders earn significant higher returns in domestic acquisitions compared to the foreign ones. They relate superior gains in domestic acquisitions to the relative size of the acquirer. They suggest that the basic reason for lower returns of bidders in foreign acquisitions is due to the attenuation bias that arises due to the larger size of the acquirer compared to that of the target that overcast the synergistic gains in acquisitions.

Similarly, Moeller and Schlingemann (2005) who compare the announcement returns of the acquirer in domestic and foreign acquisitions find that announcement returns to smaller bidding firms are 2% points higher than for the large bidders. They suggest that
in case of larger bidders there is larger tendency of the bidding firm managers being prone to the agency or hubris problems.

Roman and Michael (2006) examine the relationship between the size of the acquiring company and the announcement returns to its shareholders. Analyzing the announcement returns of 269 acquisitions by Dutch acquirers during 1980-2003 they find that smaller acquiring companies earn significant higher announcement returns (2.65%) than those of larger companies (0.20%). They further state that size effect prevails even when other firm and deal specific features viz. form of payment, extent of relatedness, geographic location of the target and the listing status of the target company are controlled. They attribute their findings to the presence of managerial hubris on the part of the acquiring company managers that leave them paying higher premium to the target companies.

Studies measuring the impact of relative size of the target on the announcement returns

Asquith et al. (1983) examine the impact of the relative size of the target on the stockholders returns of 214 bidding firms. They find that on an average, a bid for a target firm half the bidding firm size produces a cumulative excess return of 1.8% greater than a bid for a target 1/10th the bidder size. Thus, they suggest a positive relationship between the bidders return and relative size of the target company.

Kusewitt (1985) examine the impact of different acquisition factors viz. relative size of the target company, acquisition rate, industry commonality, type of consideration and price paid on the market return of the acquiring company. He finds that stock offers and related offers create significantly higher wealth for the shareholders compared to cash acquisitions and unrelated offers. Besides, he finds a significant positive relation between the target’s pre acquisition profitability and the acquiring company’s market return and suggests that the most successful acquisition strategy involves the acquisition of highly profitable companies. However, he finds a significant negative relationship between the relative size of the target company and the acquisition rate on the market returns of the acquiring company. He suggests that for a successful acquisition there should be an optimal relationship between target’s size and acquisition rate. If target size is large the acquisition rate should be lesser and if the target size is small then the acquisition rate
should be increased to fill the resource gap otherwise the acquisition program would create problems from financial as well as managerial standpoints.

Seth (1990) re-examine the issues regarding synergistic benefits of acquisitions and the gains associated with different acquisition strategies. She applies a new measure of value creation and new classification scheme on a sample of 104 tender offers. She finds positive value in both related and unrelated acquisitions for the combined firm and concludes that value creation depends upon the combination of the characteristics of the two merging firms rather than those of each of the firms considered alone and different sources of value creation operate in different types of acquisitions. Thus, she does not find unequivocal evidence that related acquisitions outperform the unrelated acquisitions. Rather, she states that the acquisitions create higher wealth gains only when the target company is relatively larger than that of acquirer.

Similar conflict is found with respect to the role of target’s size in literature relating to cross border acquisitions. Seth et al. (2002) finds that the relative size of the target positively affect value creation for acquirers as it leads to transfer of valuable intangible assets in larger quantity. Pettway et al. (1993) and Chari et al. (2004) also find insignificant positive impact of target’s size on acquirer’s announcement returns. However, Donohoe (2006) finds that the smaller targets create more wealth then larger ones.

Review of the above studies indicate that size of the acquiring company is also an important determinant of the wealth gains as it indicates negative managerial intentions to the market/investors at large. However, researchers possess a conflicting view regarding the impact of the relative size of the target on the shareholders wealth gains.

STUDIES MEASURING THE IMPACT OF CONTEMPORARY STRATEGIC ISSUES ON THE ANNOUNCEMENT RETURNS

This section presents the review of studies conducted in respect of two emerging issues in mergers and acquisition literature namely, earnout offers and brand acquisitions. The detail is given as follows:
Studies measuring the impact of earnouts on the announcement return

These studies aim at measuring the announcement returns of the acquirer in earnout offers and compare these with the announcement gains of cash and stock offers. Besides, the studies aim at analyzing the conditions in which earnouts are prominently employed. The details are given as follows:

Kohers and Ang (2000) study the feasibility of earnout contract and also compare the wealth gains in earnouts with those of cash and stock offers. They find that earnouts are used to perform two basic functions viz. hedging the risk of adverse selection and also acting as a retention bonus for the valuable human capital of the target company. Accordingly, they find that earnouts are more pronounced in case the target companies are in the hi-tech industry and in service industry and in case of private target companies that are difficult to value and also possess valuable human resources. Besides, probability of earnouts is higher in case the size of the target is larger relative to that of the acquirer as in such a case risk in realizing the synergies is more. As regards wealth gains they find that earnouts create superior wealth gains to the acquiring company shareholders as compared to stock and the cash offers and these gains are not reversed over subsequent 3 years. Moreover, the frequency of earnout payouts and the probability of the target managers staying beyond the earnout period highlight that these are a mechanism to retain valuable target human resource.

Datar et al. (2001) identify the situations where earnouts are more likely to be used and also compare the use of earnouts with the use of stock offers. Combining the results of the survey with those of the statistical analysis (through probit regression) they find that earnouts are more likely to be used in the cases where the target is a private company, is in high tech sector or is a service company and also when the target is in an unrelated industry. The reason being in all these situations the acquirer faces the problem of adverse selection due to its incapacity to value the target. On the contrary, earnouts are lesser likely in those acquisitions where management is a part of the acquiring company, when larger number of mergers and acquisitions take place in an industry thus lowering the transaction costs and also are lesser used in international acquisitions due to enforcement problem. The probability of stock financing is more in case of larger target,
in case of public companies and in case of related companies. Thus, they conclude that earnout are used to hedge the adverse selection problem while stock is used to hedge the agency problem and also to handle financing constraints of the acquirer.

Reuer et al. (2004) examine the likelihood of earnout payouts in international acquisitions by analyzing a sample of 1325 acquisitions by the US companies during the period 1995-98. They suggest that the acquiring company employs earnouts in high technology and service industries where due to the high proportion of intangible assets it becomes difficult for an acquirer to assess the exact value of the target company. Further, the acquiring company resorts to this strategy when it lacks international and domestic acquisition experience. However, it is avoided in host countries with lesser investor protection and legal enforceability as it creates problems in the implementation of the earnout contract. They conclude that earnouts are a means to transfer the risk of adverse selection from an uninformed bidder to an informed target.

Fabregat (2005) study the market reaction to earnout offers and compare it with the non-earnout offers. He finds that both types of offers generate statistically significant wealth for the acquiring company shareholders and there is no significant difference between the two sets of acquisitions regarding wealth creation. He concludes that the reason for the capital market not rewarding superior returns to earnout offers is the lack of market awareness regarding the advantages that an earnout can provide while setting a merger and acquisition deal.

Cain et al. (2006) also analyze the conditions where earnouts are employed. They find the results consistent with the conjecture that earnouts are a means to hedge the problem of adverse selection arising as a result of information asymmetry regarding the value of a target company. They state that this problem is highly pronounced in case of those target companies that have huge growth opportunities in terms of high Q ratios that makes it difficult to assess precise value of the target. Besides, earnouts are used in those acquisitions where the acquirer projects the problems in integrating the operations of the two companies and also in case of unrelated acquisitions. Thus, they conclude that
earnouts are designed with the objective of minimizing the costs and maximizing the payoffs from the acquisitions.

A review of above the studies shows that earnouts are a prominently used mechanism to hedge the risk of adverse selection and also as a tool to retain the target company’s managers. This is the reason for shareholders earning superior returns in these acquisitions compared to those of the stock and cash offers.

**Studies measuring the impact of brand acquisitions on the announcement returns**

This section reviews the studies conducted on the issue of brand acquisitions and their contribution towards the wealth gains. The studies are detailed as follows:

Aaker and Jacobson (1994) assess the impact of brand equity on shareholder wealth at both macro (industry level) and micro (firm level) level. At macro level they measure the impact of brand equity on the market value of the firms with the help of Q ratios while at micro level they analyze the impact of major marketing decisions such as new product announcements, new advertisement campaign on the stock prices of two companies namely, Coke and Pepsi. They find that at macro level the industries and the companies possessing strong brand names have higher brand equity reflected in terms of higher Q ratios. Besides, at individual level, they find that the stock market does not ignore the marketing efforts of a particular company as its impact is reflected in the stock prices of a company. For instance, the introduction of diet coke by Coca Cola led to increase in its stock prices while the stock prices of the rival company Pepsi declined. They conclude that brand equity comprise a large proportion of the total value of the company that in turn affect the shareholder value.

Mahajan et al. (1994) try to explain the perceived importance of brand equity in selecting a potential acquisition candidate by applying their conceptual model to a hypothetical merger situation. They find that brand equity measured in terms of brand loyalty and brand recognition plays an important role in selecting a particular candidate. They state that every acquirer want that brand loyalty of the target’s products should either be equal to or more than brand loyalty of its own product so that it leads to increase in the brand loyalty of the combined firm. But how much importance is given to the brand
considerations, it vary across firms as well as in direction with in a firm that is, it depends upon the person who is evaluating the brand for acquisition.

Lane and Jacobson (1995) assess the influence of two key components of brand equity that is, brand familiarity (defined as share of mind) and brand attitude (defined as brand esteem) on the stock market reaction towards brand extension announcements. They find that the market react most favorably to the brand extension announcements of those products that either have higher esteem and high familiarity or in those cases where the products has low esteem and low familiarity. When product has high esteem and high familiarity, brand extension announcement signal the investors that the company is embarking on a brand building strategy that would help it in saving brand establishment cost in extension market and such extension has lesser probability of brand image dilution and product mishaps (reducing the probability of successful introduction of new product). When brands have low esteem and low familiarity, brand extension performs a vital function of making people aware about the product itself. However, when brands rank lesser on esteem and high on familiarity the brand extension would get most negative response as people already have negative perception about the brand. Finally, brands that are high on esteem and low on familiarity, brand extension announcement receives negative response from the market because in this case those brands are being extended that satisfy the needs of a selective group of customers and can succeed only by focusing on the idiosyncratic needs of the small target market and need not expand it into a broader arena.

Kerin and Sethuraman (1998) study the relationship between brand value and shareholder value taking market to book ratio (M/B ratio) as a measure of the shareholder value. Analyzing the M/B ratio and brand value of 58 companies for the year 1995 and 55 companies for the year 1996 they identify a positive but concave relationship between brand value and shareholder value. They opine that though brands create positive value for the shareholders but the incremental benefit of brand value has a threshold limit beyond which further accumulation to brand growth may not yield a corresponding increase in the shareholder value. Hence, they suggest that managers should keep into
consideration the brand’s existing contribution to the shareholder value before embarking upon a brand’s growth initiatives.

Doyle (2001) discusses the situations/conditions in which brands create shareholder value. He states that brands create value under three conditions. Firstly, when it has differential advantages in terms of lower cost or superior perceived quality that leads to increase in future cash flows and thus increase in the profits of the company. Secondly, a brand creates value when the market in which it operates is attractive in terms of lesser competition and lesser price sensitivity of the customers. Finally, brand value creation also depends upon the extent to which the branding strategy is aligned with the objective of shareholder value maximization. He suggests that there is a need to measure the success of the brand in terms of its contribution to the shareholder value creation and not in terms of the criterion like market share.

Yeung and Ramasamy (2008) examine the relationship between brand value and firm’s financial performance and stock market performance. They find that the companies with strong brands in their portfolio are more profitable irrespective of the measure of profitability being used. Besides, they suggest that companies having big brands display better performance in stock market as compared to their peers thus generating higher wealth for their shareholders. Thus, they conclude that there is a significant positive relationship between the brand equity and the financial and the stock market performance of a company.

Thus, the above studies indicate a positive relationship between the brand value and shareholder value. However, there is a dearth of the studies that have directly measured the impact of the brand acquisitions on the shareholder wealth.

STUDIES RELATED TO INDIAN MERGERS AND ACQUISITIONS
This section analyzes the studies that have been conducted in context of mergers and acquisitions in India and are explained as follows:

Beena (2000) examines the impact of mergers and acquisitions on the share prices of the acquiring companies. She finds that share prices of the majority of the acquiring companies rise prior to merger and the trend continues for 2-3 years after merger. She
concludes that the results are consistent with earlier evidence that majority of mergers are characterized by pre merger buoyancy in the share prices of the acquiring companies in anticipation of the synergistic gains form such mergers.

Pandey (2001) studies the target shareholder returns in 14 large open offers undertaken during the period 1997-2001. He finds that open offers create positive returns to the target company shareholders from run up to the actual announcement day (that is from the event window -10 to 0). However, these positive gains get wiped out on the day immediately after the announcement. Hence, he suggests that in India takeovers are driven by private benefit of control by the managers rather than for maximizing the shareholders’ wealth. Hence, he concludes that takeovers are not an effective means of corporate governance.

Pradhan and Abraham (2003) study the patterns and motivations of overseas M&As. They find that major motivations of the Indian firms for acquiring overseas firms are to have access to international markets, operational synergies, access to firm specific assets like skilled manpower, brand names, R&D and survival in the competitive environment. They opine that most of the acquisitions originate in service sector and are directed towards the developed countries of the world.

Mishra and Goel (2005) analyze the announcement returns around the merger of Reliance Petrochemicals Limited (RPL) with Reliance India Limited (RIL) to highlight the underlying motivation for the merger. They find that the target company earns substantial positive returns during the entire event window of -20 to +20 while the shareholders of the acquiring company experience significant negative returns for the corresponding period. They conclude that the merger is not motivated by the synergy objective rather it is aimed at empire building and sharing the risks between the shareholders of both companies.

Basanna and Basavaraj (2006) analyze the impact of means of payment in mergers and acquisitions on the capital structure of the acquiring companies by analyzing a sample of 10 mergers during the period 2000-05. They find that 7 out of 10 are financed by equity
shares while remaining are financed with preference shares. The reason being the acquiring companies want to use the internal cash resources for future growth. As regard the impact of merger financing on capital structure they find that the pre merger reserves and surpluses of the merged entity increase substantially immediately after the merger in case of a profitable company merging with another profitable company. Whereas, in case of the merger of a sick company with the profitable company, the leverage of the acquiring company is affected negatively that is, it increases in the post acquisition period.

Mathew and Jain (2006) analyze the trends and motivations of overseas acquisitions by Indian companies. For this they analyze the outbound acquisitions undertaken by the Indian companies during the period 2000-06. They find that various drivers for the Indian companies pursuing outbound acquisitions are growth in newer markets, availability of target companies in the US and the European markets at cheaper prices (these foreign companies wanted to rationalize their costs structure by plugging into the low cost country advantage by getting acquired by Indian acquirers), and the availability of capital. Most of the acquisitions are initiated in IT&ITES sector followed by the pharma sector. The rationale for the IT companies going overseas is to acquire customers and to enter into niche and new markets. For pharma companies the objective is to leverage low cost Indian model; to expand the market for generics and to expand the product range by acquiring brands from overseas companies. Besides, cash is the commonest form of payment due to the prevalence of dominant promoter shareholding. Regarding the success of these acquisitions they opine that half of the acquisitions turn out to be successful.

Anand and Singh (2008) study the wealth effect of five bank mergers in Indian banking sector during the period 1999-2005. They find that both the acquiring and the target banks earn significant positive announcement returns during various event windows. Further, the case by case analysis reveals that except for the Oriental Bank of Commerce and Global Trust Bank combine, other mergers created positive wealth for the combined firm also. They conclude that bank mergers are value creating activities for both the acquirer and the target banks.
Zhu and Malhotra (2008) study the impact of cross border acquisitions on the announcement returns of the acquiring companies in India restricting their sample only to the acquisitions of the US targets only. They find that the acquiring company shareholders earn significant positive returns on the announcement of these acquisitions. However, the positive impact lasts for only 2 days after the announcement beyond which the returns turn negative. They conclude that positive announcement returns are the result of over reaction to the announcement due to the positive psychological bias on part of the market. Hence, they suggest that such positive announcement returns are cosmetic and are attained without carefully examining the real underlying value consequence.

Thus, the review of all the above studies indicates that the value creation in mergers and acquisitions is driven by the bid related and company related factors as these are the indicators of the probable risks in acquisitions, managerial intentions underlying acquisitions, sources of gains in acquisitions and also the direction in which the gains would be distributed. The review of literature also highlights that earnouts and brand acquisitions are relatively unexplored issues in the field of mergers and acquisitions. Though, voluminous research has been carried out in this area internationally, but in India, very limited research has been conducted. Though, studies have found the impact of mergers and acquisitions on the announcement returns of the acquiring companies (Beena, 2000; Pandey, 2001; Mishra and Goel, 2005; Anand and Singh, 2008; Zhu and Malhotra, 2008), yet none of these studies have comprehensively analyzed the impact of mergers and acquisitions on the shareholder wealth of both the acquiring and the target companies. Moreover, none of the study has so far studied the impact of bid related and company related factors on the shareholders wealth gains for both the acquiring and the target companies though Basanna and Basavaraj (2006) have analyzed the impact of means of payment on the capital structure of the acquiring companies. Thus, keeping in view the gap in the Indian mergers and acquisitions literature the present study seeks to examine the determinants of wealth creation in mergers and acquisitions in India.