Domestic and cross-border acquisitions: The impact of stock market and exchange rate conditions on bidders' returns

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Abstract

The paper examines whether a simultaneous analysis of various indicators of aggregate economic conditions help managers in timing the announcement of takeover bids. The estimates show that bidders yield higher announcement period returns from bids announced when high stock market valuation coincides with relatively strong trade-weighted effective exchange rate of the Pound Sterling, irrespective of the target firm’s country of residence. Although the implications of stock market valuation conditions may continue for up-to five years following the announcement of the deal, the strength of the domestic currency interacts with it in shaping acquirers’ long-term performance.

Keywords: Acquirers announcement period gains; Long-run performance; Market valuation conditions; Effective exchange rate.

JEL classification: G11, G14, G34

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1. Introduction

Reflecting the importance of mergers and acquisitions (hereafter M&As) in shaping the corporate sector, a considerable literature has emerged over several decades investigating whether M&As create or destroy value for merging firms’ shareholders. While some of the earlier studies focus on the wealth implications of several factors pertinent to deal- and merging-firms specific factors, others analyse the implications of stock market valuation conditions on the distribution of bidding firm’s announcement and post-merger returns (Shleifer and Vishny, 2003; Rosen, 2006; Bouwman, Fuller and Nain, 2009).\(^1\) Despite the validity of previous evidence, there are still considerable gaps in our understanding of the impact of aggregate economic conditions on the returns of bidders that engaged in M&As of both domestic and foreign target firms. As a consequence, this paper aims to fill this void by examining whether it is possible for managers to time the announcement of takeover bids of both domestic and foreign targets by analysing various indicators of aggregate economic conditions simultaneously.

Previous literature shows that M&As of domestic targets clusters over time and several theories attempt to explain this phenomenon, such as the neoclassical theory, the strategic theory, and the behavioural approach. The neoclassical theory of merger waves (Gort, 1969) posits that M&As activity spikes with technological, economic, and regulatory industry shocks. Similarly, in an earlier work, Nelson (1959) shows that M&As activity is highly correlated with the stage of the business cycle. The behavioural explanation, articulated by Shleifer and Vishny (2003), argues that the observed clustering in M&As activity is largely driven by stock market misvaluations.

Furthermore, the strategic theory of merger waves focuses on the appraisal of acquisition performance, motives, and strategies (Kusewitt, 1985; and Toxvaerd, 2008). The diversification strategy of firms, by analysing the comparative performance of related and unrelated acquisitions, remains the core of this theory. Toxvaerd (2008) theorises that competitive pressure interacts with the irreversibility of mergers in an uncertain environment, and argues that acquirers either postpone the bid in order to gain from more favourable future market conditions, or enter the bidding contest. The same author also shows that in a

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1 Earlier studies focus on the sensitivity of bidders’ announcement period returns on several deal- and firm-specific factors, such as the relative size of the deal (Asquith, Bruner, and Mullins, 1983), the method of payment (Myers and Majuf, 1984; Travlos, 1987), the listing status of the target firm (Chang, 1998), and the size and growth opportunities of the bidding firm (Moeller, Schlingemann and Stulz, 2004 and Rau and Vermaelen, 1998, respectively).
complete information model all acquirers rush to bid creating merger waves. However, in an incomplete information environment, various factors representing economic fundamentals, including the benefits from mergers and target scarcity, affect the timing of the merger waves.

In light of the above theoretical arguments, existing literature based on the experience of US acquirers suggests that the announcement period and long-term performance of acquirers is dependent on several factors representing aggregate stock market and economic conditions at the time of M&As announcement. For example, Rosen (2006) shows that bidder announcement returns are likely to be higher if recent M&As deals made by other firms have been received well (a 'hot' merger market), or if the overall stock market is doing better compared to other periods. However, the same author also shows that such returns are eliminated in the long-run. The same author argues that the superior announcement period returns of bidders at high market valuation periods are driven by investors’ sentiment.\(^2\) Bouwman et al, (2009) present similar findings. More recently, Goel and Thakor (2010) investigate the impact of different stages of merger wave on bidders’ returns. The authors show that the earlier bids in the merger wave generate higher gains to bidders’ shareholders, involve smaller targets, and also result in higher compensation gains for the bidding firm’s top management team, compared the later bids in the merger wave.

Along these lines, the globalisation of financial markets and the relaxation of restrictions in capital mobility have increased significantly the volume of cross-border mergers and acquisitions (hereafter CBA).\(^3,4\) While several studies analyse the wealth effects of CBAs on bidders returns (Doukas and Travlos, 1988; Gregory and McCorriston, 2005), numerous others investigate the effects of domestic versus foreign acquisitions on the returns of merging firms’ shareholders (Moeller and Schlingemann, 2005; Barbopoulos, Paudyal, and Percetto, 2011). These studies highlight that on average domestic M&As outperform foreign ones and that the factors affecting bidders’ returns are similar between the two groups of transactions (see footnote 1). However, unlike domestic deals, foreign ones

\(^2\) Baker and Wurgler (2007) state: “Investor sentiment, defined broadly, is a belief about future cash flows and investment risks that is not justified by the facts at hand.” page 129.

\(^3\) The World Investment Report 2009 (Annex B), for example, shows that in 2007 the total value of global CBA deals reached over 1.03 trillion US dollars, which represents a record increase of more than 62% over the value of 2006. In the same year, British firms’ net purchases reached 21.5% of the global market.

\(^4\) The terms cross-border acquisitions, foreign acquisitions, and international acquisitions, are used interchangeably in the paper.
present additional complexities and risks for acquirers, such as political, economic and foreign exchange risk, which is therefore reflected on acquirers’ returns at the time of the M&As announcement. To some extent, the investors’ perception towards such risks should vary significantly with aggregate economic conditions at home market (Rosen, 2006 Baker and Wurgler, 2007). Evidence also suggests that the CBAs activity is affected by aggregate economic conditions. Di Giovanni (2005) shows that financial and other institutional factors play significant roles in explaining CBAs activity, with the size of financial markets to stand as one of the most important factors. Other studies also show that the gains of merger partners in CBAs are affected by the strength of the currency of the bidding firm’s country of residence (Froot and Stein, 1990; Kiymaz, 2004).

Evidence presented in the aforementioned discussion suggests that both domestic and foreign M&As activities are affected by financial and economic conditions in the bidding firm’s home market. However, to our knowledge, very little is known on the simultaneous effect of stock market valuation conditions, and the strength of domestic currency, on domestic and foreign acquirers’ returns. This paper aims to address this issue and shed more light on this very issues by providing a comprehensive analysis on the gains from takeovers of domestic versus foreign acquisitions within the framework of various economic conditions. To some extent, this paper attempts to identify whether a simultaneous analysis of various indicators of aggregate economic conditions help managers in timing the announcement of takeover bids.

The paper employs two measures of aggregate economic conditions in the home market of acquirer, namely (a) the stock market valuation conditions, representing the domestic financial sector, and (b) the relative strength of the domestic currency, representing the state of the national economy relative to the international economy. Considering all possible differences in the implications of the indicators of aggregate economic conditions on the gains to acquirers of both domestic and foreign targets, the paper makes such distinction where appropriate. In addition, conditional upon several deal (e.g. relative size, method of payment), market/economic (e.g. stock market condition and relative strength of the domestic currency), and merging firm (e.g. bidder size and MTBV, listing status of target) specific features that should influence the decision of UK firms to acquire domestic and/or foreign targets, and based on a logistic regression approach, the identification of
the ‘correct’ investment decision into both investment arenas is estimated. Accordingly, the impact of the ‘correct’ investment decision is tested on whether it shapes the distribution of the announcement and post-merger returns of bidders across both domestic and foreign M&As. This approach provides a methodological contribution of the paper.

The results show that UK bidding firms yield higher announcement period returns from bids announced at high stock market valuation periods in the UK and relatively strong trade-weighted effective exchange rate of the UK currency. The estimates also reveal that the aggregate economic condition in the UK affects the choice between domestic and foreign targets deals. In fact, both the univariate and multivariate approaches suggest that in the short-run bidders’ shareholders enjoy higher gains from acquisitions of domestic targets than foreign ones. Among the CBA, deals announced at the time of high stock market valuation and strong UK currency, generate the highest gains. In contrast, bidders of domestic targets yield superior abnormal returns from the bids that are announced during low stock market valuation but strong economic growth. In the long-run, however, bidders either break-even, or suffer a small loss, irrespective of the domicile of the target firm, further confirming earlier studies.
References


