SHAREHOLDER WEALTH EFFECTS OF EUROPEAN TAKEOVERS: 1997-2004

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RYAN WALES

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Abstract

This study provides an empirical analysis of the returns to acquirers and targets in European mergers and acquisitions. An event study has been carried out to test the announcement effect of a merger on the bidding and target company stock prices over the period, January 1, 1997 to December 31, 2004, for twenty-three markets in Europe. This is the first comprehensive study, the author is aware of, to complete such that includes transactions throughout all of Europe, including Eastern Europe and countries from the former Soviet Union. This thesis tests the hypothesis that the incentive mechanisms created by investor protection rights, along with the strength of legal enforcement across countries, affects the value created and destroyed by managers in domestic and cross-border acquisitions within Europe. Thus, the relative difference in corporate governance rules between nations is a source of value for merged firms in and of itself. Prior studies have found significant variation in the gains to acquiring and bidding firms as a function of the nationality of the bidder, but the ultimate source of this international variation in returns has not been satisfactorily addressed. It is argued that a firm's legal and corporate governance environment provides a partial explanation for the observed variation in returns for domestic and cross-border acquisitions and it is tested across all European countries, something that has not been done before. The results suggest that countries with stronger investor protection rules generate larger returns to target shareholders. The better accounting standards increase disclosure, helping acquirers identify potential targets. This reduces the cost of capital and thus increases the competition among bidders and the premium paid by the winning bid. Similarly, target shareholders in strong investor protection and disclosure regimes also experience a price drift in 30 days leading up to a takeover announcement. The sophistication of legal rules requires substantial legal and financial consultation resulting in leakages in the market. The analysis also looks at the difference between domestic and cross-border transactions, and confirms that targets in cross-border deals generate higher returns, implying that targets benefit from expanding into foreign marketplaces. However, acquirers receive lower benefits in cross-border deals than in national transactions, signalling that acquiring firms are to some extent penalized for engaging in a cross-border merger.

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Introduction

Throughout the past 150 years the actions of mergers and acquisitions have had a dramatic impact on the way businesses operate. The first European merger wave occurred during the second industrial revolution (1880-1904). Over these years, the railroads insatiable demand for steel and new technologies such as petroleum refining, and the ever expanding electricity industry fuelled dramatic economic growth in the U.S. and Europe. In search for monopoly profits, consolidation resulted in many of these industries, creating the world's first giant corporations such as U.S. Steel, General Electric, and Bayer AG.

To curb these companies' monopoly power, the United States government implemented the Sherman Act as the world's first antitrust legislation. It prohibited the combination of entities, with regard to trade and commerce that would have the effect of restraining trade. However, this legislation led to vertical integration within industries erupting in a second merger wave from 1919-1929. This caused lawmakers to impose extremely strict rules and regulations over competition and mergers. From 1930 until the 1950's the U.S. legal system deemed all mergers as illegal acts of collusion by corporations to gain monopoly profits. Consequently, merger activity remained stagnant for decades.

However, in the 1950's economists revisited the merger debate. Harry Markowitz's (1952) portfolio theory firmly established the benefits of diversification. While the antitrust legislation virtually banned horizontal mergers, it allowed the joining of unrelated companies. As a result, from 1955-1965, a third merger wave erupted where companies attempted to take advantage of the benefits of diversification. Corporations believed that the creation of large conglomerates was needed to remain competitive in the new, global marketplace.

At the same time, contrary to popular beliefs about mergers, economists also showed that traditional horizontal mergers could be a useful economic tool. Specifically, economists hypothesized that most horizontal mergers have nothing to do with either the creation of market power or the realization of scale economies. The are merely an

alternative to bankruptcy or voluntary liquidation that transfers assets from falling to rising firms (Manne, 1961). Manne (1961) points out that if perfect capital markets exist, and a merger conferred no monopoly power, a rising firm would be indifferent towards expansion through traditional means and by merging. Furthermore, he shows that the conventional approach to the merger problem identifies corporations merely as decision making unit. This view ignores all other benefits from merging and consequently, dictates a ban on horizontal mergers almost by definition. However, while changes to legislation had not yet taken place, Manne (1961) set the groundwork for change by showing that mergers are instrumental to all economies, ever present, market for corporate control.

While economists had established the benefits of merger activity, antitrust legislation was strictly enforced until the 1980's when legislative authorities adopted a looser interpretation of the Sherman Act. Consequently, this increased legal freedom, combined with the inefficiencies of the 1960's conglomerates, resulted in a fourth merger wave running from 1983-1989. This combined with the vastly expanding areas of biochemistry and the technology, and the development of new financial instruments and markets resulted in an unprecedented number of hostile bids. Many of those mergers involved in the acquisition of unrelated businesses that were targeted for their break-up value or designed to generate cash for corporate raiders.

However, by the end of the 1980's, conditions affecting mergers had changed. Debt financing became more expensive as interest rates rose. Furthermore, higher stock prices made potential targets more expensive. The scandal of high-profile financiers such has Drexel Burnham soured the junk bond market and the collapse of several large leveraged buyouts (LBO) made banks more cautious about participating in such deals. Furthermore, U.S. federal regulators restricted the participation of savings and loans, as well as insurance companies, in such buyouts. In addition to this, U.S. state legislatures and courts came down firmly on the side of targets, enhancing their negotiating position. Thus, by 1989, the culmination of these things resulted in the death of the 1980's takeover binge.

Nevertheless, in 1993 the most recent wave erupted with the total dollar value paid for target firms in the United States and Europe doubled after four consecutive years of

decline in merger activity (Goergen & Renneboog, 2004). This sharp turnaround coincided with the development of new European stock exchanges (such as the European New Markets and EASDAQ) and a substantial boom in the internet and telecommunications industries, resulting in sustained merger activity. A steady increase in merger business remained until 1996 when the total value of U.S. and European acquisitions rose substantially to $1,117 million, with Europe accounting for 37% of the worldwide value of merger deals. From 1996 to 2000 this value tripled to $3,451 million, with 43% of this occurring in Europe. 1999 was remarkable for the European merger marketplace. In this year Europe accounted for 47% of merger activity and 12% of the deals were in excess of $100 million U.S.D making the European market was now nearly large as the United States. To add to this, during the same year in Europe the number of hostile bids jumped to 369 compared to only 14 in 1996 (Goergen & Renneboog, 2004). However, this boom was not to last. In 2001, the collapse of consumer confidence in the "tech industries" as well as the overcapacity in the traditional sectors caused for a revaluation of the stock market, resulting in an abrupt reduction in merger activity.

While the European merger market was as large as the U.S., factors emerged in Europe that impacts the returns to target and acquiring shareholders. Considering a whole continent, containing over 20 countries, as a single market meant that a countries legal history, shareholder protection legislations and executive disclosure laws, and cross-border transactions impacted the resulting merging returns. La Porta et al (1998) find that English Common Law countries had dramatically stricter legal rules over those with the traditional French, German, and Scandinavian Civil Code countries. In further studies they showed that legal background would have an impact on the strength of a countries capital markets, the ownership structure of a company, and the quality of a countries government[1]. These issues have an impact on corporations financing, and strategic, operations. Thus, legal background has predictive value in and of itself. Furthermore, Rossi and Volpin (2004) also showed that the premium paid to target shareholders in a merger transaction was impacted by legal history.

[1] See La Porta et al (1997-2005) for further investigation

While the predictive value of legal history is now embedded in current research, no broad based European study has been done to investigate the wealth effects of mergers in Europe, and the differences in returns among different legal regimes. As such, this thesis investigates the wealth effects of the 1990's European merger wave, and how a country's legal history contributes to differences in merger returns throughout Europe. Given that most M&A research concentrates on the U.S. and UK markets and, most studies concentrate on merger activity within a single country, a European wide study including Eastern Europe adds dramatically to the research in this area. The sample consists of all available intra-European mergers and acquisitions, in 24 countries reported in Zephyr database over the period 1997-2004.

The rest of the study is separated into four parts. An extensive review of the literature relating to mergers and acquisition is in Part One. Chapter One is an overview of mergers and acquisitions. It looks deeply at the theoretical justifications for M&A with and without perfect capital markets. Chapter Two then discusses mergers as a means for corporate control and the impact that legal tradition has on company shareholders. Finally Part One is concluded in Chapter 3 with a discussion of the M&A wealth effects in the U.S., Europe, and the corresponding differences between domestic and cross-borders transactions.

Part Two presents the data, methodologies used in this study, and the results. Event study methodology is described in Chapter Four, while Chapter Five describes in detail the summary data and its impact on the study. Chapter Six include and analyze the merger returns within Europe, and how legal tradition and cross-border transactions can impact these returns. The conclusions from the empirical analysis carried out in Chapter Six are presented in Chapter Seven, which summarises the study's major findings and give directions for further research.