

The Role of Corporate Governance for Acquisitions by the Emerging Market Multinationals: Evidence from India

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1. Research Question

Acquisitions by emerging market (EM) firms of targets located in developed markets have increased drastically over the recent years, creating a class of emerging market multinational enterprises (EMNEs). Typically, such transactions are motivated by access to newer markets and improved operational synergies. In particular, improvements in the supply chain by sharing sales and procurement channels, manufacturing facilities as well as brand names to increase sales and reduce costs. But Coffee (1999) suggests that cross-border acquisitions, similar to cross-listings, also provide a medium for firms to bond to better institutions. Using country-level corporate governance measures, cross-border M&A studies (e.g. Martynova and Renneboog, 2008) find that when differences in investor protection exist between the countries where the firms are located, acquisitions resulting in improvements in corporate governance generate positive returns. But do such transactions result in corporate governance changes for the acquiring EM firms?

Legal and institutional factors play a major role in deciding contractual terms and hence the corporate governance of individual firms. Doidge, Karolyi and Stulz (2007) find that country characteristics such as legal protections for minority investors and financial development explain most of the variation in firm-level measures of governance and transparency, especially in less-developed markets. Cross-border M&As provide access to foreign capital and therefore, acquiring EM firms have greater incentives to adopt good governance. Are cross-border M&As of EM firms when the target is located in a developed market (DM) associated with changes in firm-level

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corporate governance? Are higher valuations of EMNEs caused by stronger country-level investor protection of the target?

We contribute to the literature that explores the relation between firm-level and country-level governance, as well as the literature regarding convergence in corporate governance practices following cross-border deals.

2. Data

We use a novel database that provides firm-level governance characteristics in a major emerging market, India, to explore a cross-border M&A setting. The mergers and acquisitions data is obtained from SDC Thompson's International M&A database. We collect firm-level fundamental data from the financial statements, market data from stock prices, as well as governance data on board and ownership characteristics of all completed acquisitions by Indian companies with target firms in developed market (DM) nations from Prowess. Our sample period is January 2001-December 2010.

We examine the percentage of equity ownership by three different types of investors: institutional investors, foreign institutional investors (FII), and insiders (referred to as promoters in India). We also examine three different types of board characteristics: independence, busyness, and diligence. Independence is the ratio of independent directors to the total number of directors on the company's board. Busyness is the number of directors who serve on other corporate boards, while diligence is the ratio of meetings attended by the board of directors to the total meetings held in a year.

The decision to engage in a cross-border M&A is not random and it is possible that firms that engage in such transactions are inherently different from others. In order to alleviate any concerns about self-selection, we use the propensity score matching (PSM) procedure on the Prowess population to identify a control sample of Indian firms with similar attributes that have not engaged in a cross-border M&A. Our final sample includes 147 unique treatment firms and their matched counterparts.

3. Tests

First, we examine whether there is a difference in change in corporate governance characteristics between one year after the acquisition and one year prior to the acquisition with that of its matched counterpart. In a multivariate setting, we test

whether the mean of difference-in-differences (DID) across all firms (those that did and did not engage in a cross-border acquisition) in our sample is associated with an indicator variable that equals one for developed market acquisitions (DM) and zero otherwise.

Next, we examine whether the institutional environment of the country where the target is located plays a role in explaining changes in corporate governance. Following Durnev and Kim (2005), we multiply judicial efficiency of the target country by the country-level investor protection index, measured as the principal component of disclosure, liability standards, and anti-director rights, (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998) to determine the quality of institutional environment. The regression coefficient on the indicator variable, which equals one when the target's country has a better institutional environment than that of the acquirer's country, measures the sensitivity of change in corporate governance of the acquiring firm to the institutional environment of the target nation.

Our final test examines the direct effect of DM as well as the joint effect of DM and change in corporate governance on valuation, measured using Tobin's Q. Adopting a methodology similar to Cole and Mehran (1998) and using the full sample of treatment and control firms, the valuation implications of corporate governance changes after DM acquisitions are tested by examining the coefficient on the interaction term.

4. Results

We find that after EM firms acquire targets in DM nations, they change two distinct firm-level attributes of corporate governance significantly; ownership structure and board characteristics. We also find that among the sample with targets located exclusively in DM nations, changes in corporate governance attributes are more pronounced for acquirers in countries with higher investor protection. Furthermore, acquirers that exhibit these changes are also associated with higher valuation after the acquisition. Overall, our results support the argument that cross-border acquisitions involving targets in DM can be motivated to self-impose better firm-level corporate governance with the ultimate goal to reduce the cost of capital and increase firm value.

It is possible that EM firms that plan to become global players develop an "outward looking" strategy and improve their corporate governance to signal to firms and

markets in developed nations that they can be trusted. To test this signaling story, we analyze changes in corporate governance attributes over the years prior to the acquisition. We do not find any evidence that firms implement better governance in years leading up to the acquisition.

Finally, we explore the effects of the corporate governance reforms recently implemented in India, particularly Clause 49 introduced by the Securities Exchange Board of India (SEBI). We compare the changes in corporate governance following cross-border M&As for the pre and post-reform period. Our results support the argument that the monitoring benefits introduced through cross-border M&As with DMs are larger when the home country regulations are weaker.

5. Conclusions

Our findings add to the body of literature that suggests that firms located in countries with weak investor protection grow by holding themselves up to higher standards via the acquisition route. By voluntarily subjecting themselves to higher levels of corporate governance, as applicable in the target firm's nation, these acquirers are able to access global capital markets and increase their valuation. While there can be many other reasons for such acquisitions, the evidence provided in this paper establishes the importance of good governance in executing a firm's strategy.