M&A Activity in Europe

Cash Reserves, Acquisitions and Shareholder Wealth in Europe

Master Thesis

in

Business Administration

at the

Department of Banking and Finance

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Filling Date: 23.02.2012

Abstract

In the presence of large cash reserves, previous US literature indicates that M&A deals are value-destroying for the acquirers' shareholders. Analyzing European data, this paper finds that this result is not generalizable in its absolute totality. Only firms from countries with high ownership concentration destroy value in the European setting. Furthermore, cross-country differences in legal shareholder protection do not have explanatory power for value destruction. Finally, findings for UK firms do not support the presence of the free cash flow agency conflict in Europe. In summary, this paper supports Bruner's (2004) hypothesis that M&A is a local business.

„The best foundation for pursuing success and avoiding failure in M&A lies in seeing the important ways in which individual deals differ from one another. ***In other words, all M&A is local.****"*

Bruner, Robert F., 2004, Where M&A Pays and Where It Strays: A Survey of Research, *Journal of Applied Corporate Finance* 16, p. 63.

Executive Summary

Theory and Hypothesis

Some firms hold much more cash than required for operational issues and precautionary motives (Opler et al. (1999)). Even then, holding more cash than effectively needed by the operational background and characteristics of a firm is not bad news for investors per se (e.g. Opler et al. (1999) and Harford (1999)). Opler et al. (1999) argue that these firms might have an extraordinary precautionary motive to hold cash. Another explanation is proposed by the pecking order theory of financing, which states that managers and firms accumulate cash due to imperfect capital markets, which make it too costly for these firms to finance their future value generating investments externally (Myers and Majluf (1984) and Harford (1999)). Agency theory also provides critical voices and hypotheses, predicting that there are reasons to be concerned if firms hold excess cash. In his influential paper, Jensen (1986) presents the theory of free cash flow hypothesis. This theory builds up on primary arguments by Jensen and Meckling (1976), and predicts that managers prefer to optimize their own wealth, rather than the wealth of the shareholders of the firm for which they work. Jensen (1986) argues that this general principal-agent problem is emphasized if firms have high free cash flows, which they do not need for operational reasons or to finance projects with positive NPV. Harford (1999) extrapolates this argument to excessive cash reserves in general. What in fact is nothing else than stockpiled free cash flow, is called excess cash.

The discussion about the free cash flow theory argument in the context of value destruction for shareholders is predominant in the US, because overseas firms are normally more widely held as compared to firms in continental Europe (La Porta et al. (1997)). Therefore, the main agency problem is between managers and shareholders. Looking at the sample of the present paper, which consists of companies located in continental Europe and the UK, these characteristics typical to US firms can be applied to UK firms in particular. This paper, however, has to deal with two kinds of agency problems: The conflict between managers and shareholders, and the conflict between different kinds of shareholders. Regarding agency problems between managers and shareholders, the fact that publicly traded firms in continental Europe are not widely held, but often have a dominant shareholder, leads to the conclusion that this kind of agency problem is less likely to occur in continental Europe (Faccio and Lang (2002) and Dahya, Dimitrov and McConnell (2008) among others). Claessens et al. (2002) argue that such investors are able to monitor and control the management. However, these shareholders can also be criticized, because they conduct informal interventions to actively influence the firm, instead of monitoring the company. The dominant shareholder thereby has the interest, and in general the ability, to expropriate other shareholders and divert corporate resources to himself (Dahya, Dimitrov and McConnell (2008)). This agency problem is commonly assumed to be predominant in the continental European market (Dahya, Dimitrov and McConnell (2008)). The link between this general agency problem to cash holdings is provided by Servaes and Tufano (2006). They argue that dominant shareholders may use firms to store wealth and thus accumulate cash. This cash is subsequently transferred to other firms of their interest (Servaes and Tufano (2006)). This practice suggests that minority shareholders suffer from the intentions of dominant shareholders in terms of excessive cash holdings, and is related to the tunneling argument reported by Johnson et al. (2000). Therefore, high cash reserves can be expected to be value-decreasing in both fundamentally different institutional environments and corporate governance structures, as long as there is a conflict that causes agency costs, and the agents have the ability to extract value (La Porta et al. (2000)). Jensen (1986) explicitly states that takeovers are important opportunities with which to spend excess cash, in order to follow personal interests, instead of maximizing minority shareholders' value. In summary, this means that the presence of free cash flow leads managers with discretion to make value-decreasing, or at least lower-return, takeovers. At the same time, Johnson et al. (2000), as well as Ben-Amar and Andre (2006) and Dahya, Dimitrov and McConnell (2008), argue that mergers are one way among many to transfer profits to other entities dominated by large shareholders. Therefore, in order to investigate both settings, the present paper uses M&A deal data to measure the effect of high cash holdings on acquirers' shareholders wealth. Since both agency problems assume that the managers as well as the dominant shareholders have the possibility to expropriate wealth from their principals, it is assumed that M&A activity in the presence of excess cash is value-decreasing for the acquirers' shareholders.

Even though it is expected that agency problems are present across all companies, they might differ in different situations. Since the present paper deals with an international sample, cross-country aspects are used to analyze different levels of agency problems. First of all, ownership concentration within firms is varying over different countries. Country-level ownership concentration is used as a proxy for firm-level ownership of control. Ownership concentration is a valid measure, because the majority of firms in Europe have only one dominant shareholder and that one is assumed to drive the concentration measure (Faccio and Lang (2002)). In general, the higher the ownership of control, the more control the dominant shareholder has over the firm, resulting in more agency problems (Shleifer and Vishny (1997)). Furthermore, La Porta et al. (2000) argue that outsider legal shareholder rights protection is one way to reduce agency problems. As such, firms from countries with better shareholder protection should suffer from fewer agency problems than firms from countries with lower shareholder protection. It is expected that the potential for value destruction is higher in countries with higher agency problems, as indicated by higher cash holdings.

Methodology

To analyze these theoretical and empirical hypotheses, Harford (1999) delivers a three-step procedure. His work is likely the most comprehensive and most cited in relation to excess cash and shareholder value destruction due to agency problems combined with M&A activity. Therefore, the structure of this paper mainly follows Harford's (1999) idea. Nonetheless, the methods and theories behind the models applied are always critically examined and updated. As a result, all three sections providing empirical results use models that are developed based on a wide range of previous literature. To analyze cash holdings, regressions based on Fama and MacBeth (1973) are used. Furthermore, a binary probit model is used to analyze the effect of cash on bidder activity. Finally, an event study combined with multiple regression analyses, with a wide range of control variables for firm and deal as well as cross-country characteristics, is used to analyze the relationship between cumulative abnormal returns around the announcement day, and cash holdings. This paper uses a sample of 14 continental European countries as well as the UK for its analyses. In Sections 5 and 6, 354 completed M&A deals between publicly traded firms from 1995 to 2010 are used to analyze the influence of excessive cash holdings on M&A activity.

Results

The present paper does not find any significant evidence for free cash flow agency problems in UK firms. Regarding the whole sample, it can be stated that firms from countries which are expected to suffer more from agency conflicts do hold more cash, indicating more potential for value-destroying activities. Furthermore, for acquirers from countries with high ownership concentration, and therefore from firms which are expected to have more dominant shareholders with more control, a statistically significant and negative relationship between excess cash and CARs is found. In fact, these M&A deals are value-destroying for acquirers' shareholders, which indicates the presence of agency costs. This is not true, however, for firms from countries with lower ownership concentration. Legal shareholder rights protection, as related to excessive cash holdings does not have an influence on value destruction in M&A. It is found that the relationship between of excess cash and CARs varies over different levels of protection. However, even in an environment with weak legal shareholder rights protection, excess cash does not destroy value, but instead reduces value creation. In terms of bidder activity, there is no statistically significant influence of cash holdings on the probability of being a bidder in a particular year.

Conclusion

Summarizing, firms from countries with low shareholder protection do not destroy value when holding excess cash. Therefore, it appears that low shareholder protection alone is not a sufficient explanation for why minority shareholders of acquiring firms suffer from these M&A deals. This indicates that there must be at least a minimum level of agency problem, as shown by the findings related to firms from a country with high ownership concentration. Based on these analyses, however, it cannot be stated whether the missing value-destroying character of M&A, in the presence of excess cash in certain countries, is due to better shareholder protection, or due to the fact that the dominant shareholders do not have enough power to control the management and therefore expropriate wealth. Theory suggests that a high ownership concentration is probably more important than merely a low level of shareholder protection in agency theories. Additionally, findings of bidder activity analyses, although not statistically significantly, indicate the same. Finally findings on cash holdings in general are in line with both kinds of argumentations.