CHAPTER 2: LITERATURE REVIEW

2.1 Definition and concept of cross-border Merger and Acquisitions

According to UNCTAD, (2000) Mergers and Acquisitions are important FDI tools available for multinational companies (MNCs). The report defines cross-border merger and acquisition in the context of internationalization, international economics and diversification, as the process whereby control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter. Shimizu et al., (2004) exposed that cross-border M&A's impact a company's internationalization efforts and its FDI strategy, which is in contrast to domestic M&A's, which involve one company taking over the shares of another company, or two companies merging into one within the same country.

Most of the studies have related to mergers and acquisitions with firm growth and diversification choices by relating to five merger waves which the United States experienced over the past 100 years. The study by Lipton (2001; 2006) and Park (2005) revealed that there have been five significant waves of M&A activities starting from the late 19th century, and continuing into the 20th century. According to their study the first of the five major waves was the 1890-1905 Monopolistic waves. Second was the Oligopolistic wave in 1924-1928, followed by the 1961-1969 Conglomerate waves, Then the Disciplinary wave in 1981-1989, and lastly was the Strategic -De-regulatory wave in 1993-2000. (DePamphilis, 2008) identified the current sixth wave as cross-border transactions, horizontal mega-mergers, and private equity investments.

In order to understand clearly the concept of cross-border merger and acquisition, we need to understand the two major terms used, ‘merger and acquisition’. A merger transaction takes place when two or more firms join to form a single enterprise, overseen by single management. The classification of merger depends on management’s attitudes towards the merger, how the merger takes place and the relationship between the merging companies. A firms’ merger can be either the sales of assets or the sale or exchange of stock.

Another term which is commonly used in merger and acquisition is takeover. A takeover happens only when the control of the company of the seller passes to the buyer. In most studies, the word acquisition and takeover are taken interchangeable. For the purpose of this study, the words acquisition and takeover carry the same meaning. The only criterion to consider in the acquisition of companies is that, the company should have acquired at least 51 per cent of the outstanding shares of the target companies. Buy the voting stock is another way to acquire a firm. This is done by management agreement or by tender offer. In a tender offer, the acquiring firm bypass the management by making the offer to buy stock directly to the shareholders.

Child et al., (2001), defined cross-border merger and acquisitions as those involving an acquirer firm and a target firm whose headquarters are located in different home countries. It is important to note, however, that Merger and acquisition of companies with their headquarters in the same country, although normally classified as domestic, often have cross-border issues of

concern when they integrate operations located in different countries.'' Cross-border merger and acquisition is an implementation instrument for the firm's international diversification strategy. Cross-border merger and acquisitions have been motivated by the necessary search for new opportunities across different geographic locations and markets in a turbulent and continuously changing environment.

There is evidence suggesting that the rate of cross-border mergers and acquisitions is growing rapidly. In 1999, cross-border mergers and acquisitions were valued at approximately USD1.4 trillion (nearly 40% of the overall acquisitions for that year); doubling the value of the preceding year several factors are responsible for fuelling the growth of cross-border M&A's. Among these factors are the worldwide phenomenon of industry consolidation and privatization, and the liberalization of economies' (Hitt et al., 2001).

2.2 Motive for cross-border Mergers and Acquisitions

According to the study done by Schmidt, (2002), more than 45% of the acquisitions in recent years have been made across country borders; this means a firm headquartered in one country acquiring a firm headquartered in another country. Previous trend in cross-border activities shows that, American firms have been the most active acquirers of companies outside their domestic market. In current years the trend has changed and cross-border merger and acquisition has become the strategy for all firms throughout the world. Experiences show that the motive behind cross-border

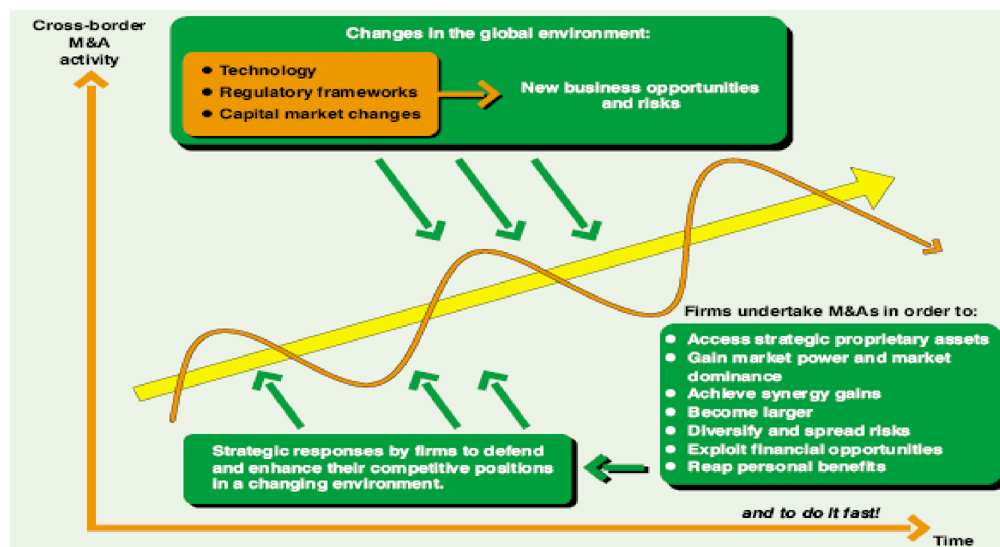
mergers and acquisitions is to build shareholder value and thus maximize the firms' share price.

Emerging markets acquirers have played an increasingly large role in recent cross-border mergers and acquisitions deals. According to the Kearney (2009) estimations, for the year 2002-2007, the cross border M&A by emerging market firms raised at an average annual rate of 26%, while global rate was only a 6%. The report further maintains that in 2008, while the number of deals of cross border M&A decreased by 38 percent (-38%) in the global market, the number of cross border M& A by emerging market firms increased by 29% and reached 38% of the deal volume in 2007 (Accenture, 2009).

Hitt and Pisano, (2003) discuss three significant advantages of cross-border merger and acquisitions. Firstly, they are a quick solution to entry barriers. In fact, acquisitions may provide the fastest, and often the largest, initial international expansion of any of the alternatives. Secondly, cross-border mergers and acquisitions may be a cost effective way of gaining competitive advantages such as technology, brand names valued in the target market and logistical and distribution advantages, while simultaneously eliminating a local competitor. Thirdly, international economic, political and foreign exchange conditions may result in market imperfections, allowing target firms to be undervalued.

The important role for cross-border mergers and acquisitions is to encouraging longer term reforms, such as operational restructuring and reallocation of assets. Foreign participation through M&A could also be more effective in improving efficiency, competitiveness, and corporate governance (UNCTAD, 2000). Under the circumstances, foreign direct investment, in the form of cross-border mergers and acquisitions, play an important role in the restructuring and continued developing of East Asian economies. The United Nations Conference on trade and development, Centre for transnational corporation, revealed that, firms are encouraged to undertake CBMA by several factors as illustrated in the figure 2.1

Figure 2.1: Driving Forces of Cross-border M&A Activity



Source: UNCTAD, World Development Report 2000: Cross-border Mergers

According to Ingham et al, (1992), cross-border merger and acquisition is classified as one of the following two types:

1. Horizontal merger and acquisition; one that encompasses both related product lines and geographic expansions. Bower (2001) highlighted

that horizontal M&A's (where target and acquirer operate in the same industry), are pursued for motives involving economies of scale, economies of scope, and or revenue increases from market expansion (Church, 2008).

2. Non-horizontal merger and acquisition; one where the products of target and acquirers are in separate unrelated markets (Bishop et al 2005; Church, 2008). The primary difference between horizontal and non-horizontal M&A is the fact that horizontal mergers remove direct competition in industry as a result of merging manufacturers of substitute products. Non-horizontal mergers combine suppliers of complementary products under one firm so they are not eliminating competition. Non-horizontal cross-border M&A can be further distinguished between vertical and conglomerate mergers.

A vertical M&A entails acquiring a firm that is either a backward or forward link in the production process. A diversifying (conglomerate) M&A is one that involves acquiring a firm in an unrelated area of business. Church, (2008) explained that prior to a vertical merger; two firms could be in a customer post-acquisition performance or cross-border merger and acquisition.

In developing countries, also, deregulation and liberalization of trade and services have opened up greater opportunities for foreign investors. However, this first stage of M&A is being driven either by the privatizations of state

owned enterprises, which need significant upgrading, or by M&A's of troubled private firms.

Trautwein, (1990) described merger and acquisition as macroeconomic phenomenon by developing the disturbance theory which explains that merger and acquisition waves are caused by economic disturbance. Economic disturbances cause charges in individual expectation and increase the general level of uncertainty, thereby changing the ordering of individual expectations.

According to Barba, et al (2004) despite that cross-border merger and acquisition activities are quantitatively important and are main vehicles for foreign direct investment its determinants of cross-border merger and acquisitions are still not well understood. Neary, (2007) and Salant et al, (1983) revealed two basic motives which are; an efficiency motive and strategic motive. Efficiency gain arises because merger and acquisition increases synergy between firms through increased use of economies of scale or scope. A strategic motive is when a merger and acquisitions might change the market structure and as such have an impact on the firm's profits

2.2.1 Growth

According to Bruner, (2004), business systems are undergoing a dramatic transformation in response to the continual changes that have become the only constant in the business environment and companies constantly have to adapt to these changes. Merger and acquisition is one of the most important means by which companies respond to changing conditions. Gaughan, (2001)

revealed that, internal growth can be slow and ineffective if a firm is seeking a short term advantages over its competitors. On the other hand, a firm that is seeking to grow aggressively will often view merger and acquisition and internal growth as complementary strategies (Hay and Liu, 1998). Merger and acquisition as a source of growth in order to reach strategic and financial advantages is becoming increasingly an instrument of macroeconomics renewal (Bruner, 2004).

2.2.2 Synergy

Most of the studies in the theory of mergers and acquisitions (M&A's) have positioned some support for suggestion that the value of the merging firms may possibly increase after merger and acquisition transaction has taken place. Andrade et al. (2001) attributed the sources of increased value to the possibility of synergy. Trautwein, (1990) and Yook, (2003) identified three main types of synergies as financial synergy, operational synergy and managerial synergy.

The primary motivation of most mergers is to increase the value of combined enterprises. If firm A and B merge to form firm C and if the value of firm C exceeds from that of firm A and B separately then synergy is said to exist. Synergy can rise as a result of different factors or sources such as operating economies, financial economies, tax effects, differential efficiency and market power. According to Seth (1990) and Gaughan (2002), synergy arises when the value of a merger and acquisition exceeds the combined value of the two participating firms.

2.2.3 Diversification of risk

In practice, no one firm is exempted from business risk exposure, either systematic or unsystematic risks, regardless of the industry in which it operates. One of the ways for a firm to lower its systematic exposures is through diversification. Diversification helps to stabilize the earnings stream and reduce risk (Bergh 1997). The *Strategic Management Journal* asserts that using Merger and Acquisition to diversify a firm is the quickest and typically the easiest way to change of its business portfolio; it also states that diversification can also lessen a firm's dependency on a particular division or specific market.

2.3 Definition of emerging markets

Emerging markets have become in vogue subsequent to a wave of mass financial liberalization that occurred toward the end of the 1980s (Bekaert and Harvey, 2003). Today, international investors progressively include emerging markets as part of their holdings in order to reap the benefits these markets offer in a portfolio context. This section aims to provide the reader with a basic understanding of emerging markets fundamentals.

The term "emerging market" was brought into fashion in the 1980s to describe a fairly narrow list of middle to higher income economies among the developing countries. These countries were often undergoing rapid growth and industrialization, and had stock markets that were increasing in size, activity and quality (Dimson et al., 2010). Beim and Calomiris (2001) understand "emergence" to mean the separation of financial systems from

state domination through a process of liberalization, which supports the term "emerging markets" to describe these economies.

Although, there is no waterproof definition of emerging markets, major index providers, such as the Financial Times and London Stock Exchange (FTSE) and Standard and Poor's (S&P), identify countries as "emerging" in accordance to different criteria such as GDP per capita, market size and regulatory environment. This thesis focuses on the four countries, namely Indonesia, Malaysia, Philippines and Thailand, which are viewed as emerging markets of Southeast Asia and were hit hard with the 1997 financial crisis consequences.

2.4 Emerging markets characteristics

Emerging markets have some distinctive features that stand out, Bekaert and Harvey, (2002). First, they are regional economic powerhouses with large populations, resource bases and markets, and their economic success typically spurs development in the countries around them. Second, they are restructuring their economies along market-oriented lines and offer a variety of opportunities in trade, technology transfers and foreign direct investment. Third, they are the world's fastest growing economies, contributing to a great deal of the world's explosive growth in trade.

After the collapse of the Japanese market in the early 1990s, global investors turned their attention toward emerging markets. Shortly after foreign investors entered, however, many of these markets were struck by a serious downturn.

The Hong Kong crisis of 1997 marked the worst collapse in the history of emerging Asian economies as the equity markets plunged. The crisis spread to markets in Latin America, Eastern Europe and Russia. Almost all emerging market investments were deemed unsafe. According to Siegel (2005), measured in USD returns, the markets in the Philippines and South Korea fell by more than 80%, and Indonesian, Thai and Russian markets fell by more than 90%. Even stocks in the strongest and most advanced emerging markets, Singapore and Hong Kong, fell by 70%.

Emerging financial markets behave differently than developed financial markets because of their level of integration with world markets. This means that liberalization of closed and restricted markets has to take place if emerging market is to become more integrated in the world economy. According to Beim and Calomiris (2001), emerging financial market liberalization experiments are complex. They involve, among other things, privatization of state owned enterprises, legal system reforms, development of accounting and corporate governance systems, restructuring of government finances and exchange rate policy, and regulation of the banking system.

2.5 The role of emerging markets in the world economy

The globalization of financial markets implies that emerging markets play an increasingly important role in the world economy. At the end of World War II, US stocks comprised nearly 90% of the world's equity capitalization and in 1970 they still constituted two thirds. Nowadays, the US market comprises

less than half of the world's stock value, and the fraction is shrinking (Siegel, 2005).

Despite the formidable real economy growth in emerging markets, equity markets are still dominated by the world's developed countries. Emerging markets account for more than 70% of the world's population, which is five times more than developed markets. However, they represent only 29% of the world's GDP, which is half of the developed markets' fraction. As a group, emerging markets have experienced more rapid growth in real GDP than developed markets, and the consensus is that key emerging markets will continue to grow rapidly (Dimson et al., 2010). Although emerging markets account for a significant fraction in terms of both world population and GDP, the weighting of emerging markets in the all world indices compiled by MSCI and FTSE constitutes only 12%.

This imbalance of world equity markets is attributable to the fact that emerging markets indices reflect a free float investable universe, i.e. shares available in the market as a fraction of the total number of outstanding shares. Solnik and Meleavey (2004) point to factors that may restrict foreign investments. For instance, only authorized investors are allowed to invest in India and Thailand, whereas China still imposes restrictions on which stocks foreign investors are allowed to hold (Dimson et al., 2010). Many investors are thus prevented from entering these markets. Moreover, foreign investors may not be able to channel capital gains back to their home country.

According to UNCTAD (2010) foreign direct investment has a major role to play, if the global financial and economic recovery remains fragile, threatened by emerging risks, constraints in public investment and other factors. In order for the recovery to remain on track, private investment is crucial for stimulating growth and employment.

However, several emerging markets are undergoing liberalization processes, which subsequently imply that these markets will open up further to foreign capital. If growth projections are realized, today's emerging markets will become major constituents of the all-world portfolio by 2050 and can by then easily account for 40-50% of the total world capitalization (Dimson et al., 2010.) Siegel (2005) predicted that in 2050 the developing world (all non-developed countries, including emerging markets) will constitute 64.4% of the world's equity capital. What seems inevitable is that the importance of emerging markets and their weightings in world indices will continue to rise as they become more influential participants in global affairs.

2.6 Foreign direct investments

Foreign direct investment (FDI) has long been seen to be an important means of transferring capital, improving efficiency, and stimulating growth. Potential benefits can accrue to both host and home countries. In this context and with the recent economic difficulties in developed markets, the growth of outward FDI (OFDI) from developing countries has been a welcome contribution to the world economy. Developing Asia has been at the forefront of OFDI from developing countries. To the extent the relatively developed financial markets

in Asia have facilitated this trend, there may be important lessons for Asian (and other) policymakers.

Most OFDI outflows from developing Asia have been intraregional, taking place especially among the economies of East and Southeast Asia, but also increasingly venturing further abroad. Developing Asia continues to be a major destination for inflows from developing countries in other regions. In developing Asia, investment flows from developing countries together accounted for some two fifths of total inflows (UNCTAD 2005).

The World Investment Report 2010 showed that, in the half of 2009 global foreign direct investment flows began to bottom out. The report noted that, the flows were followed by a modest recovery in the first half of 2010, sparking some cautious optimism for FDI prospects in the short term. Furthermore, the report detailed that global inflows are expected to pick up to over USD1.2 trillion in 2010, rising further to USD1.3 to 1.5 trillion in 2011, and heading towards USD1.6 to 2 trillion in 2012. However, these FDI prospects are fraught with risks and uncertainties, including the fragility of the global economic recovery.

Foreign direct investment played an important role in the economic development of many Asia countries. Urata, (1999) revealed that FDI contributed significantly to the rapid economic growth of East Asia from the mid 1980s. Fan and Dickie, (2000) argued that FDI has made an important contribution to the economic development of the five ASEAN countries

(Indonesia, Malaysia, Philippines, Singapore and Thailand) economies. Therefore, many developing economies, such as the Asian economies, have liberalized FDI policies to reap the benefits from FDI.

The acceleration in FDI in Asian countries is explained by many writers. For example, the 2010 World Investment Report revealed that, FDI in China rose to second place after the United States in 2009. The report noted that, 50% of the six top destinations for FDI flows are now developing or transition economies. It explained that, over two thirds of cross-border M&A transactions still involve developed countries, but the share of developing and transition economies as hosts to those transactions has risen from 26 per cent in 2007 to 31 per cent in 2009.

Table 2.1: Global Foreign Investments Inflows (billion of dollar)

Descriptions	2007	2008	2009
Developed countries	1,335	914.7	441.3
Change in %		-32.5	-51.8
Emerging markets	737.4	816.3	533.9
Change in %		10.7	-34.6
Developed countries share in %	64.8	52.8	45.3
Emerging markets share in %	35.2	47.2	54.7
World FDI Total	2,092.4	1,730.9	975.2
Change in %		-17.3	-43.7

Source: IMF. National statistics; UNCTAD; Economist intelligence Unit forecast for 2009

FDI in South-East Asia has already started rebounding and is likely to pick up speed as the region plays a leading role in the global economic recovery. In particular, inflows to China and India started picking up as early as mid 2009, and their sustained FDI outflows are expected to drive the region's outward investment back to growth in 2010 (UNCTAD, 2010). The report further explained that, foreign direct investment has a major role to play, if the global financial and economic recovery remains fragile, threatened by emerging risks, constraints in public investment and other factors. In order for the recovery to remain on track, private investment is crucial for stimulating growth and employment.

Table 2:2 Emerging Markets Foreign Investments Inflows (billion of dollar)

Descriptions	**2007**	**2008**	**2009**
Sub Saharan Africa	38.0	49.7	30.3
Change in %		30.7	-39.1
Middle East & North Africa	81.9	98.1	73.4
Change in %		19.8	-25.2
Developing Asia	298.1	323.2	235.5
Change in %		8.4	-27.1
Latin America & Caribbean	128.1	140.5	93.8
Change in %		9.7	-33.3
Eastern Europe	165.7	183.3	90.4
Change in %		10.7	-50.7

Source: IMF. National statistics; UNCTAD; Economist intelligence Unit forecast for 2009

The financial crisis had a discouraging impact on FDI because of increasing uncertainty in macro-economic performance that resulted from the crisis and its aftermath (Urata 1999). In fact, real world data indicate that the negative effect of the financial crisis on the FDI inflows is strong despite the fact that global FDI inflows rose by 30% to USD1, 833 billion in 2007, FDI decreased during the crisis because of the climate of increased uncertainty. In other words, the global financial crisis had a limited impact on FDI flows in 2007 but began to bite in the year 2008 (UNCTAD 2008). Based on available FDI data, UNCTAD estimated that the global FDI flows for the whole of year 2008 were expected to be about USD1,600 billion, representing a 10% decline from 2007 (UNCTAD 2008).

Table 2.3: Percentage of Global FDI Inflows

	UNCTAD Definitions		**Economist Intelligence Unit definitions**	
Years	**Developed countries**	**Emerging markets**	**Developed countries**	**Emerging markets**
1992	69.4	36.0	67.3	32.7
1993	66.7	33.3	64.3	35.7
1994	59.7	40.3	57.7	42.3
1995	65.5	34.5	61.8	38.2
1996	61.0	39.0	58.3	41.7
1997	59.9	40.1	57.1	42.9
1998	72.0	28.0	69.4	30.6
1999	78.7	21.3	76.9	23.1
2000	81.5	18.5	79.9	20.1

Table 2.3: Percentage of Global FDI Inflows (continued)

2001	69.7	30.3	67.3	32.7
2002	71.9	28.1	68.0	32.0
2003	66.3	33.7	63.4	36.6
2004	57.8	42.2	52.5	47.5
2005	66.2	33.8	61.6	38.4
2006	65.9	34.1	61.6	38.4
2007	68.3	31.7	64.8	35.2
2008	56.7	43.3	52.8	47.2
2009	48.4	51.6	45.3	54.7

Source: IMF. National statistics; UNCTAD; Economist intelligence Unit forecast for 2009

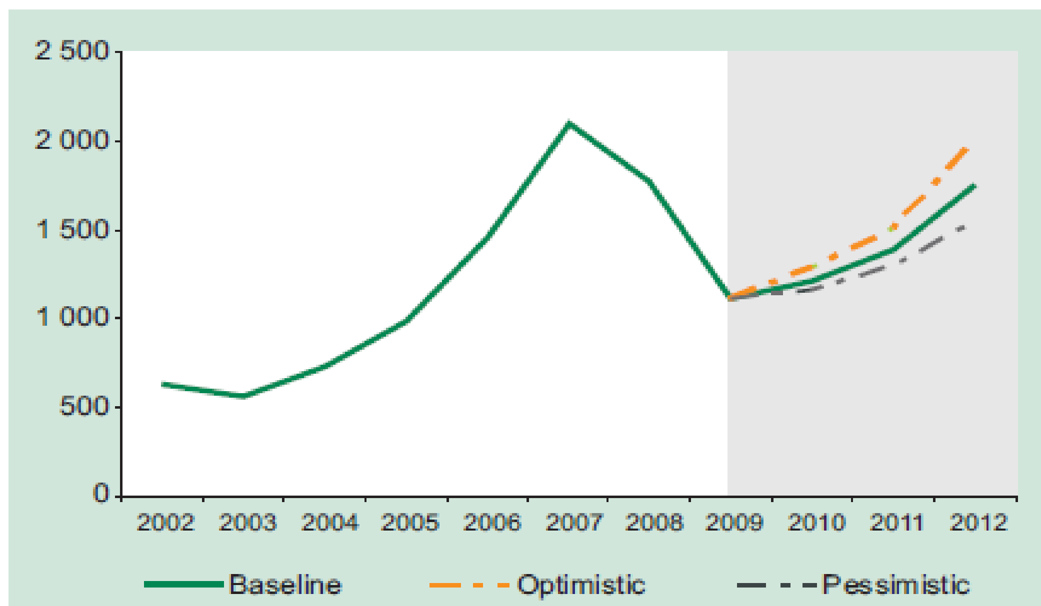
The UN survey (UNCTAD, 2008) on global Investment prospects showed that the current financial crisis and economic downturn are making corporations more cautious about future foreign investment. The further noted that as mergers and acquisitions (M&A) activity began to slow down, corporate profits and bank loans were also declining. Moreover, both inflows to and outflows from developed and emerging economies may have declined because of the financial crisis (UNCTAD, 2008).

Several studies have been conducted on the effects of financial crisis on FDI; most of these studies have been related to FDI inflows into Asian countries during the Asian financial crisis in 1997/98. For example, Athukorala (2003) examined FDI in the Asian crisis, and Edgington and Hayter, (2000) examined the extent to which the Asian financial crisis impacted the behaviour of Japanese FDI in the manufacturing sector. Furthermore, Urata, (1999) analysed the impact of the crisis on Japanese FDI. Athukorala, (2003) also

examined FDI during the financial crisis in East Asia. He analyzed FDÍ policy and the overall investment climate in the five crisis-hit countries namely, Thailand, Malaysia, Indonesia, Korea, and the Philippines.

The findings suggested that, FDI was a relatively stable source of foreign capital in the crisis. Additionally, Athukorala examined the behaviour of FDI compared to other forms of capital flows after the onset of the crisis. Athukorala, (2003) stated that, despite some negative predictions the Asian financial crisis has not resulted in a major discontinuity in FDI inflows to the region, other than a modest decline as an immediate consequences of the crisis.

Figure 2.2 Global FDI flow, 2002 to 2009 and projections for 2010 to 2012(billion of dollars)



Source: UNCTAD

2.7 Cross-Border Mergers and Acquisitions in Emerging Markets

The *International Journal of Economics and Management* (2010) exposed that, growth in FDI the 1990s was ascribed to the increase in cross-border mergers and acquisitions activities rather than the increase in green field investment. Table 2.4 shows performance sectors distributions of cross-border mergers and acquisitions in five East Asian countries for period from 1998 to 2007 as it was revealed by the *International Journal of Economics and Management*.

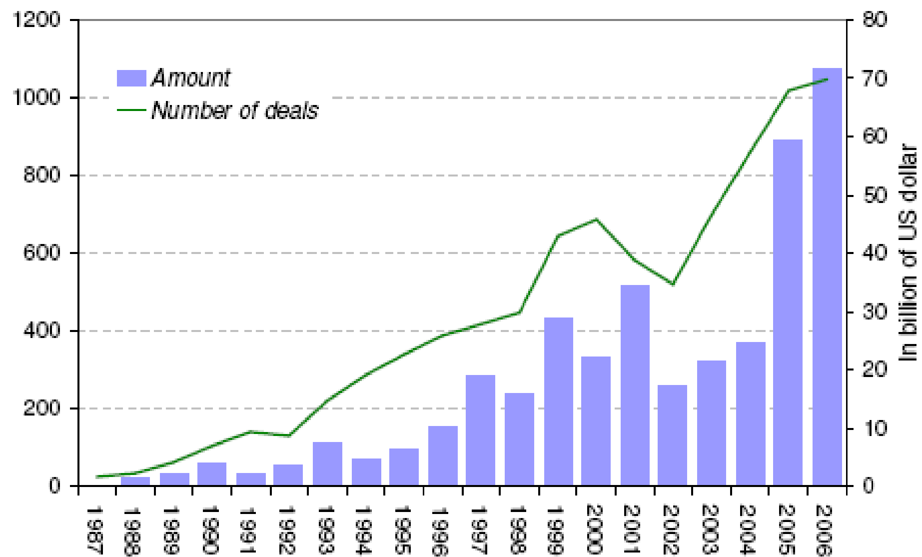
Table 2.4: Performance of CBMA in five East Asian countries (sectors distributions)

Descriptions/ years	**'98**	**99**	**00**	**01**	**02**	**03**	**04**	**05**	**06**	**07**	**Total**
Consumer Products and services	9	14	18	5	4	8	11	11	13	20	113
Consumer Staples	25	31	16	23	12	16	15	24	16	23	201
Energy and Power	25	30	27	22	13	23	21	19	17	21	218
Financials	71	63	43	47	36	57	75	75	39	45	551
Healthcare	5	8	3	5	5	3	6	2	7	6	50
High Technology	9	29	45	33	21	25	34	37	41	24	298
Industrials	52	51	35	26	45	45	44	44	44	46	432
Materials	62	57	39	42	19	22	41	36	34	41	393
Media and Entertainment	9	16	13	11	15	12	16	15	13	13	133
Real Estate	3	17	11	2	3	10	9	26	12	18	111
Retail	9	14	11	6	2	6	7	11	8	5	79
Telecommunications	11	19	13	16	9	10	13	13	11	8	123

Source: *International Journal of Economics and Management* 4(1): 61-80 (2010)

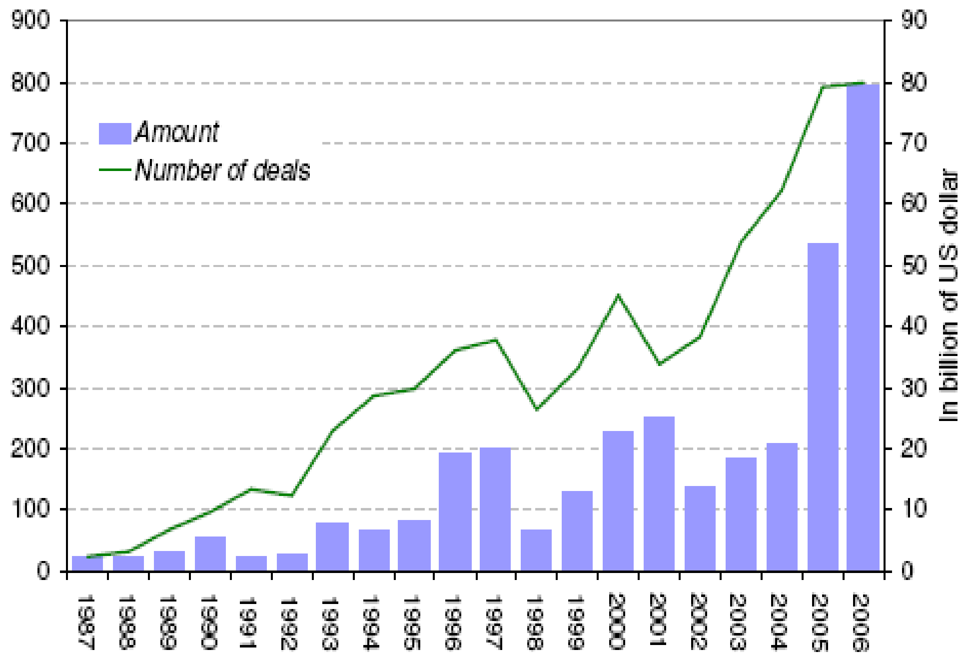
A study undertaken by Mody & Negishi, (2001) after the 1997 East Asia crisis posits that, merger or acquisitions of domestic firms by international firms, CBMA, increased dramatically in East Asia following the financial crisis of 1997. The study showed that cross-border M&A in East Asia's crisis countries (Indonesia, Korea, Malaysia, and Thailand) rose sharply from USD 3 billion in 1996 to USD 22 billion in 1999, before declining to USD18 billion in 2000

Figure2.3: M&A Sales in Developing Asia, 1987-2006



Source: Zephyr M& A Database.

Figure 2.4: M&A Purchases in Developing Asia, 1987-2006



Source: Zephyr M& A Database.

Cross-border M&A's have been increasing in emerging and developing countries over the past decade. Cross-border M&A activity has been a driving force of FDI flows. East Asia countries, Malaysia, Philippines, Indonesia, Korea and Thailand, in particular, have been attracting large volumes of M&A activity since 1997 (table 2.3 and table 2.4). In developing and emerging countries under severe financial distress, cross-border M&A's have been a recommended strategy for immediately provision of liquid and prevention of loss of asset, while improving allocation of resource (Mody & Negishi, 2001).

Table 2.5 Performance of CBMA in five East Asian countries (Nationality of acquiring firms)

Country Name	The United States	Europe	The United Kingdom	Japan	Australia New Zealand and Canada
Malaysia	52	82	26	34	27
Thailand	75	91	27	78	15
Philippines	59	27	19	30	23
Indonesia	43	71	22	35	38
Korea	214	146	38	64	17

Source: International Journal of Economics and Management 4(1): 61-80 (2010)