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A Review on Targets of Corporate Control Rights Transactions

Liping Dong[†]

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1 . Introduction

An important function of stock markets is to provide investors with an opportunity to obtain control rights of a company; as such, they are markets for corporate control (takeover market). Market for corporate control is a very important external corporate governance mechanism, which plays a key role in the efficient allocation of resources. Following Jensen and Ruback (1983), market for corporate control is defined as the "a market in which different managerial teams contend for the control rights over company resources". Numerous studies have investigated various issues regarding takeovers such as characteristics of acquirers and target companies, performance (short- and long-term) and financial policy changes following takeovers, earnings management in takeover, and so on (Anagnostopoulou and Tsekrekos, 2013; Bliss and Rosen, 2001; Brav et al., 2008; Duggal and Millar, 1999; Erickson and Wang, 1999; Masulis et al., 2007). These studies predominately focus on developed markets such as US and UK.

This paper reviews the existing literature on target firms of control rights transactions. What are the basic theories of takeover? What companies are more likely to be targeted? Does mergers and acquisitions (M&As) create targets' shareholder value? Do target companies manage reported earnings preceding takeover announcement? We pay particular attention to

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target firms since takeovers are considered to be essential for the efficient allocation of resources of those companies.

This paper firstly discusses several basic theories of takeovers, including agency theory (Jensen and Meckling, 1976), free cash flow theory (Jensen, 1986, 1988), undervaluation theory (Barnes, 1999; Palepu, 1986), inefficient management theory (Manne, 1965), and tunneling theory (Johnson et al., 2000).

Different companies have different probabilities of being a takeover target. Previous studies suggest that firms with inefficient management, severe agency problem of free cash flow are likely to be takeover targets (Barnes, 1999, 2000; Denis and Sarin, 1999; Klein & Zur, 2009). Meanwhile, bidders are more likely to target small and undervalued companies (Ambrose and Megginson, 1992; Bethel et al., 1998; Demsetz and Lehn, 1985; Espahbodi and Espahbodi, 2003; Palepu, 1986).

Previous studies for developed markets commonly document that M&As create value for target firms' shareholders while shareholders of bidders do not enjoy significant economic benefits (Campa and Hernando, 2004; Dodd and Ruback, 1977; Dong et al., 2006; Faccio et al., 2006; Franks and Harris, 1989; Kang et al., 2000; Leeth and Borg, 2000; Martynova and Renneboog, 2008).

Target firms also have incentives manage earnings for various reasons. These firms may engage in upward earnings management either to enhance the transaction price or to convince shareholders they are performing efficiently (DeAngelo, 1988; Easterwood, 1998). At the same time, takeover targets may engage in downward earnings management because they want to facilitate the completion of the transaction or boost financial results in the post-merger period (Anagnostopoulou and Tsekrekos, 2013; Ben-Amar and Missonier-Piera, 2008; Perry and Williams, 1994). Target managers may choose not to manage reported earnings (Easterwood, 1998; Erickson and Wang, 1999) due to the timing of the acquisition. Previous research on earnings management (EM) of target firms presents mixed results.

Given the importance of takeovers for target firms' governance, survey on the aforementioned issues is extremely important. This paper attempts to review the literature of target firms of corporate control rights transactions and provide readers with more comprehensive understanding about causes and consequences of corporate control rights transaction.

The rest of the paper is organized as follows. Section 2 presents the theory of corporate control rights transaction. Section 3 discusses the characteristics of target companies. Previous literature on the target firm performance following takeovers is shown in Section 4. Section 5 reviews the earnings management by takeover targets. Section 6 concludes this study and presents suggestions for future.

2. Theory of Corporate Control Rights Transaction

2.1 Agency Theory (Jensen and Meckling, 1976)

Agency problems, arising from the separation of ownership and control, are the essential element of contractual view of modern corporations (Jensen and Meckling, 1976; Fama and Jensen, 1983a, 1983b). When cooperating parties have different goals and attitudes toward risk, agency problem (a conflict of interest) will arise between agent (managers) and principal (shareholder). Shareholders ask managers to run a company and maximize shareholder value. Managers with insignificant amount of equity, however, have their own utility functions and will pursue their private benefits (e.g., empire building or perquisite consumption) at the expense of shareholder wealth, resulting in agency conflict between shareholders and managers. Good corporate governance can effectively mitigate agency problem; it is vital important for shareholders protection and healthy stock markets. Previous studies generally separate corporate governance into two categories: internal governance (ownership concentration, board of directors, executive compensation, succession, and so on) and external governance (market for corporate control, production market competition, legal systems, bank monitoring). Takeover market has been regarded as an effective external governance mechanism in mitigating agency conflicts between shareholders and managers when internal governance mechanisms are out of order.

2.2 Free Cash Flow Theory (Jensen, 1986, 1988)

Managers are the agents of shareholders, and there are severe conflicts between them over the decision of the best corporate strategy since both parties are self-interested. A cause of takeover activity is the agency cost associated with the conflicts between managers and shareholders over the payout of free cash flow (Jensen, 1986). Jensen (1986) define free cash flow as "cash flow in excess of that required to fund all of a firm's projects that have positive net present values when discounted at the relevant cost of capital." Free cash flow should be paid out to shareholders if the company is to be efficient and to maximize shareholder wealth. However, managers are reluctant to distribute cash to shareholders because cash payment to shareholders reduces the resources under managers' control, thereby reducing managers' control power of company. Meanwhile, eliminating free cash flow subjects managers to capital market monitoring when they need to finance new projects, further constraining their ability to undertake negative net present value transactions. Moreover, managers can use free cash flow for private benefits of control (PBC) extraction like implement of empire-building project at expense of shareholder value. Agency conflicts between shareholders and managers over the payout of free cash flow are especially serious when the firm generates substantial free cash flow. Disciplinary takeover are

solutions to these agency problem.

2.3 Undervaluation Theory (Barnes, 1999; Palepu, 1986)

Undervaluation theory states that mergers occur when the market value of target stocks for some reason does not reflect its true or potential value (Barnes, 1999, 2000; Espahbodi and Espahbodi, 2003; Palepu, 1986). Stock market sometimes misprices securities of target companies. However, acquiring firms with superior knowledge and possible inside information identify undervalued securities and benefit from the difference between the price they pay and the firm's true value. These target firms' stock price is usually below the replacement cost of its assets. Thus, the lower the valuation ratio of a firm (i.e. the market value of the firm divided by its book value), the more is its attractiveness to bidders (Barnes, 1999). In addition, investors are short-sighted and myopically sacrifice long-run benefits for immediate profits. Therefore, firms that engage in long-term planning and make substantial investments in research and development (R&D) are supposedly undervalued by the market and become takeover targets (Stein, 1988).

2.4 Inefficient Management Theory (Manne, 1965)

Takeover is a market mechanism by which resources are transferred from inefficient managers to efficient ones. The most important agency cost explanation of takeovers is that they reduce managerial slack by replacing inefficient management (Manne, 1965). Takeovers are the key mechanism for disciplining managers in the market for corporate control because the takeover bypasses target management and goes directly to the target shareholders for approval, which is different from mergers that require the approval of the target firm's board. Takeovers constrain managers to work in the shareholders' wealth and accordingly keep the capital market competitive.

This explanation is supported by a number of previous studies. Target firms usually earn low rates of return prior to M&As (Asquith, 1983; Palepu, 1986; Barnes, 1999, 2000; Espahbodi and Espahbodi, 2003). Moreover, management turnover is much higher after a takeover than firms without experiencing takeover or firms engage in a friendly takeover (Furtado and Karan, 1990; Walsh, 1988). Finally, there is evidence that target firms performance improve after M&As (Healy, et al. 1992; Jarrell and Poulsen, 1989; Mulherin and Boone, 2000; Campa and Hernando, 2004; Goergen and Renneboog, 2004; Dong et al., 2006). This finding suggests that acquirers are better able to manage target assets, which is consistent with the inefficient management explanation of takeovers.

2.5 Tunneling Theory (Johnson et al., 2000)

Recent studies show that ownership is concentrated to the degree that one owner (controlling shareholder) has effective control rights over the company, especially in many developed and developing countries outside the U.S. and the U.K., such as Western and Eastern European, East Asian and Latin America (La Porta et al., 1998, La Porta et al., 1999; Shleifer and Vishny, 1986). Controlling shareholders pursue large private benefits of control (PBC) minority shareholders do not share (Dyck and Zingales, 2004; Johnson et al., 2000; La Porta et al., 1999) through tunneling. Johnson et al. (2000) defines tunneling as "the diversion of corporate resources from the corporation (or its minority shareholders) to the controlling shareholder." Barclay and Holderness (1989) argue that a prospective buyer evaluates two benefit streams when pricing a block trade. One is the expected stream of dividends and other cash flows that accrue to all shareholders in proportion to their fractional ownership, which can be captured by the exchange price of the firm's stock. Another is private benefits the large-block shareholder can secure through his voting power, to the exclusion of other shareholders. The difference between the block trade price and the post-announcement exchange price (premium) reflect PBC. Therefore, purchasers would like to pay high premium for getting control rights of a company because they believe that they can extract PBC (tunneling) if they successfully obtain control rights and become controlling shareholder of a firm.

3. Characteristics of Target Companies

Firm characteristics are associated with the probability of firms being a takeover target; different companies have different probabilities of being a takeover target. Barnes (1999) argues that value-maximizing acquisitions are a mechanism by which resources are transferred from inefficient managers to efficient ones. Previous studies suggest that firms with inefficient management are likely to be takeover targets (Barnes, 1999, 2000; Espahbodi and Espahbodi, 2003; Palepu, 1986). When potential value of a target company is not fully reflected by stock price, this firm will be a good candidate because bidding on the firm is a relatively safe investment, as well as a cheap deal (Barnes, 1999, 2000; Espahbodi and Espahbodi, 2003; Li and Zeng, 2003; Palepu, 1986). Therefore, undervalued companies are more likely to be takeover targets. Meanwhile, firms that have severe agency problem of free cash flow are more likely to be takeover targets (Klein & Zur, 2009). Targets with large free cash flow provide bidders with opportunities to achieve capital gains by disgorging free cash flow (for instance by repurchases and dividend increases). Moreover, firm size appears to have deterred activist block purchases; wealth constrains prevent bidders from targeting large companies. Consistent with this theory, Ambrose and Megginson (1992), Bethel et al. (1998), and Demsetz and Lehn (1985) and find those

larger firms are less likely to become takeover targets than smaller firms.

4．Target Firm Performance Following Takeovers

It is well-documented idea that bidders take over poorly managed companies and enjoy capital gains by improving the management and increasing firm performance (Espahbodi and Espahbodi, 2003; Palepu, 1986). The question of whether firm performance improvements arise from corporate M&As is one that has been addressed by many researchers all the time. Previous studies commonly document that M&As create value for target companies' shareholders while shareholders of bidders do not enjoy significant economic benefits (Campa and Hernando, 2004; Dodd and Ruback, 1977; Dong et al., 2006; Faccio et al., 2006; Fan and Goyal, 2006; Franks and Harris, 1989; Kang et al., 2000; Lang et al., 1989; Leeth and Borg, 2000; Martynova and Renneboog, 2008; Moeller et al., 2005). A common explanation of these results is that control rights changes create value by improving management of target companies while most of the economic value belongs to target firms' shareholders due to severe competition in the takeover market.

When investigating whether M&As create shareholder value on target companies, one of methods is to examine short-term stock price reactions to the announcement of takeover by using a standard event study. Event studies investigate whether major corporate events or decisions bring shareholders a cumulative abnormal return (CAR) by examining stock price change pre- and post-event in the secondary market. A M&A announcement brings new information to the stock market, such that investors' expectations about the firm's development prospects are captured and reflected in the stock price. Market perceives the takeover activity is a good thing for target firms and there is a positive stock price reaction for target firms at the takeover announcement (Campa and Hernando, 2004; Dong et al., 2006; Goergen and Renneboog, 2004; Jarrell and Poulsen, 1989; Lang et al., 1989; Mulherin and Boone, 2000; Schwert, 2000).

Previous studies also investigate the long-term stock price return and operating performance subsequent to takeover. They test long-term stock price returns of target companies following takeover to examine whether takeover actually create value for shareholders of target companies in the long-run, since short-term stock prices sometimes over- or under-react to new information. To accurately measure long-term stock performance of target companies, they usually adopt the buy-and-hold returns (BHRs) and compute the adjusted BHR (ABHR) which subtracts the matched firm's BHRs from the event firm's BHRs. In the long-term, targets experience significant positive abnormal stock returns after takeover (Klein and Zur, 2009; Loughran and Vijh, 1997). With the respect to long-run operating performance subsequent to takeover, there are mixed results. Clark and Ofek (1994) do not find evidence that takeover activities improve operating performance of target companies. However, previous researches show evidence that

target firms' operating performance has significant improvement (Jarrell, 1989; Healy et al., 1992).

Furthermore, the post-announcement CARs are characterized by significant differences induced by the means of payment, the attitude towards the bid (hostile versus friendly), the acquisition type (tender off or friendly mergers) and so on. Andrade et al. (2001) and Goergen and Renneboog (2004) find that there are more profitable for target shareholders in all-cash bids than in all-equity ones. Target shareholders earn higher premiums in hostile M&As than those in friendly M&As (Franks and Mayer, 1996; Servaes, 1991). Target shareholders in tender offers are offered higher premium (Franks and Harris, 1989; Schwert, 1996).

5. Earnings Management by Takeover Targets

Previous research has identified acquiring companies engage in upward earnings management before M&As (Erickson and Wang, 1999; Louis, 2004), but evidence on earnings management for the target companies around M&A transactions has not been so clearly directional. The results of the studies testing earnings management for target firms in the M&A deals are mixed.

Target managers may engage in income-increasing earnings management. When faced with the treat of hostile takeover, targets managers may have incentives to increase reported earnings either to enhance the transaction price and raise the exchange ratio or to convince shareholders they are performing efficiently and reject the offer (Easterwood, 1998). DeAngelo (1988) finds that managers select income-increasing accounting methods to increase accounting number to convince shareholders that they are doing a good job and avoid losing their job during proxy contests.

Target managers may engage in income-decreasing earnings management. Ben-Amar and Missonier-Piera (2008) find evidence that takeover targets managers engage in downward earnings management either to complete the transaction successfully or to enhance financial results in the post-merger period preceding friendly takeover announcement. Managers of takeover targets may manage accounting accruals to reduce reported earnings in an attempt to reduce the bidding price during the management buyouts (Perry and Williams, 1994). Anagnostopoulou and Tsekrekos (2013) find that UK and Italy engage in downward earnings management but not for France and Germany around "seeking buyer" announcement; a competitive M&As environment may induce earnings management-prone behavior.

Target managers may choose not manage reported earnings due to the acquisition timing (Easterwood, 1998; Erickson and Wang, 1999). Target firm usually cannot anticipate they will be targeted in the future and lack time and opportunity to manipulate reported earnings. Moreover, the risk or cost of earnings management detection is high in takeover situations, impeding managers' incentive from managing earnings.

6. Conclusions

Market for corporate control is a very important external corporate governance mechanism. This paper reviews literature of target companies of corporate control rights transactions: basic theories of takeover, characteristics of target companies, firm performance changes following takeovers, earnings management for takeover targets. Large and undervalued firms, firms with large free cash flow and inefficient management are more likely to be takeover targets. Previous studies commonly document that M&As create value for target companies' shareholders. In addition, managers of takeover targets may engage in income-increasing earnings management or income-decreasing earnings management or choose not to manipulate reported earnings.

Most of previous studies examine corporate control transactions in developed markets. To the best of our knowledge, scant research has addressed those issues in emerging markets, where different institutional characteristics (e.g., poor legal protection of investors, concentrated ownership structure, and so on) exist from developed markets. It is particularly important to focus on the emerging markets' research since emerging markets have some unique institutional characteristics, providing us with an opportunity to test some ideas which cannot be addressed by developed country data. For example, do bidders in emerging markets have different motivations from acquirers in developed countries? Do corporate control rights transactions create economic values under poor institutional environments? What motivations incentivize the target firms to or not to manipulate reported earnings preceding takeover announcement in emerging market? These issues are important task for future research.

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