DEPARTMENT OF BUSINESS AND MANAGEMENT

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International Mergers and Acquisitions in BRICS versus Developed Markets.

A Comparative Study of Different Investment Policies

SUPERVISOR

Prof. Alessandro Marino

CANDIDATE

Ilaria Canestri, 651961

CO-SUPERVISOR

Prof. Paolo Boccardelli

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"There are those who look at things the way

they are, and ask why… I dream of things

that never were, and ask why not?"

Robert F. Kennedy

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ABSTRACT

The primary purpose of this study is to determine the optimal Investment policy for multinational companies from a growth perspective between retaining and distributing the Realized earnings within their subsidiaries, according to the location where M&As are executed: BRICS or Developed countries. The main research question aims to understand whether a higher Retention ratio is meaningful to explain a corresponding higher growth rate. A sample of representative cross-border deals was obtained for the years 2005-2013. There is no evidence of a significant relationship between the Retention ratio and growth rate, expressed in terms of sales volume, when evaluating a general M&A context without taking into account the place where deals occur. However, a positive relationship holds between the two variables for those cross-border transactions with targets in BRICS markets. This means that the fundamental determinant to experience an incremental growth after an M&A strategy, thanks to the retain-and-reinvest approach in earnings management, is the target's belonging or not belonging to BRICS countries.

INTRODUCTION

The globalization process and the recent financial crisis have contributed to change the landscape of international mergers and acquisitions, including variations on the motivations, pattern and deals structure of the M&A process. Traditional mergers and acquisitions were regarded as strategic transactions whose primary objectives were achieving operational efficiencies and increasing market share. Nowadays, establishing presence in foreign markets, especially emerging countries, allows companies to obtain strategic advantages in terms of future growth in their business development and international diversification benefits by spreading the corporate assets around the world to better protect investments from market risk. Within this context of instability fueled by financial turmoil, multinational companies have implemented innovative strategies to ensure the access to new geographies and have shifted the focus of M&A targets from Developed to emerging markets.

Previous M&A activity was concentrated in the USA, Europe and Japan, the world's largest consumer markets. As a result of the global economic recession, the advanced economies suffered more from the financial downturn; while emerging economies were less impacted and continued to experience positive growth conditions. Among these countries Brazil, Russia, India, China and South Africa, the so called BRICS, show the highest growth potential and attract the attention of numerous dealmakers, leading the global recovery. Consequently, cross-border mergers and acquisitions increased in BRICS markets, offering new global business opportunities in terms of innovation and vitality. The current thesis is build up around the dualism between Developed and BRICS countries concerning the M&A activity, with a particular focus on the latter.

After having introduced the topic about M&A in general and having detailed the BRICS environment in terms of motives, critical successful factors and threats for potential investors, the purpose of this study is to determine what Investment policy is more value-creating from a growth perspective for the acquiring entities depending on the location where deals are executed: BRICS or Developed countries. The goal is to evaluate through the use of quantitative statistical analysis the optimal choice for multinational companies among retaining and distributing the realized earnings in the subsidiaries, whether they perform M&A activity in BRICS or advanced markets.

The entire work is established on four core chapters.

The first chapter introduces the general framework of the M&A activity, starting by tracing its historical roots and its evolution over time through six main waves, which contributed to extend the process on a global scale. Following this path, it is presented the description of the most common types of cross-border deals and the related underlying motives which drive those transactions. The remainder of this chapter explains what are the critical factors to succeed in international M&As and illustrates the path that needs to be followed when planning expansion strategies in both Developed and emerging countries, highlighting the differences among them. The last section maintains the distinction about advanced and emerging markets in presenting the corresponding manners to evaluate cross-border deals depending on the location in which they take place.

The second chapter focuses on presenting the BRICS countries as one of the most coveted location within the global investment landscape by multinationals from advanced economies to pursue an M&A strategy. After a brief introduction about the general framework, there are described the main motives that drive the investors' decisions to execute an M&A activity in this region and that explain the reasons behind a quick shift of interest from targets located in Developed countries to targets in emerging markets. Due to the particular features of the specific context, there are some critical factors among those considered when evaluating a general M&A deal that need to be addressed in order to succeed in the BRICS environment. On the other hand, dealmakers have to face several sources of instability in this region that can hamper the execution of any cross-border transaction. The remainder of this chapter describes both the critical successful factors and intrinsic institutional threats of doing M&As in the BRICS and concludes by explaining the strategic choices among which investors can choose to enter those markets.

The third chapter represents the theoretical foundation for the empirical analysis performed in the next one. It explains the strategies adopted by international groups to manage Realized Earnings and use them to finance new strategic projects, such as acquisitions or mergers. In addition, it will present the typical features of an Investment Policy established in a multinational corporation by describing its principles, objectives and functions, with a particular consideration for the task of financial risk management.

After this introduction, the attention will be focused on the core topic: the choice among two different types of liquidity structure to manage the overall funds available within a group: centralized versus decentralized treasury system. Then, this chapter concludes the investigation process by illustrating an additional alternative that international firms can choose to apply: outsourcing the treasury function.

The fourth chapter aims to present and describe the quantitative analysis performed on the basis of the theoretical background detailed in the previous chapters, as well as to interpret the related outcomes. It can be divided into three main sections. The first one introduces the research approach and illustrates the purposes that lead the investigation process, by describing the selection criteria used to choose the experimental units and gather qualitative and quantitative data; and by taking into account the two most important methodological problems encountered in every scientific research: the reliability and validity of the collected data. The second part focuses the attention on the core analytical process, by describing the final sample; formulating the underlying hypotheses; and presenting the regression model employed in the study. The third section displays the empirical outcomes and closes the chapter with the resulting implications. What is essential to remember is that the core focus of the whole work is represented by the analysis of the BRICS area, while the Developed markets are just considered a basis for comparison in order to deeper investigate the topic.

CHAPTER 1: THEORETICAL BACKGROUND

The first chapter introduces the general framework of the M&A activity, starting by tracing its historical roots. M&A began on a domestic scale in the early 1900s, when American companies executed deals in order to achieve market share and operational efficiencies within the home market. It has evolved over time through several merger waves and has expanded its dimension beyond national boundaries acquiring global perspectives and reaching new geographical areas like Europe, Asia and Africa with the purpose of following international diversification strategies. After the description of the merger wave pattern and its six main phases, the chapter illustrates all the kinds of possible cross-border deals that can be executed by multinationals and the related underlying motives that drive those transactions. Once the deal has been undertaken, there are only two possible outcomes: success, resulting in an increase of shareholder value compared to the industry trend; and failure, resulting in a value destruction. The remainder of this chapter explains what are the critical factors to succeed in international M&As and describes the path that needs to be followed when planning expansion strategies in both Developed and emerging countries, highlighting the differences among them. The last section maintains the distinction about advanced and emerging markets in presenting the corresponding manners to evaluate cross-border deals depending on the location in which they take place.

1.1 M&A Waves

Mergers and merger waves along with the main factors that contributed to their rise have been subject to intense interest for more than a century. Martin Lipton[1] defined merger deals as an integral part of the market capitalism, whose roots can be traced since the evolution of the industrial economy in the last part of the 19th century, followed by a flow of intense activity and continuous waves with interruptions occurred when fundamental external forces depressed the general economic framework. Historical economists agree upon the identification of six main merger waves, that show

[1] Martin Lipton, September 2006, *Merger Waves in the 19th, 20th and 21st Centuries*, The Davies Lecture, Osgoode Hall Law School, York University

several differences among each other in terms of motives and themes, including economic and regulatory factors, underlying nature about the type of predominant business, the behavior of the involved companies as well as the purchase considerations. The starting date and duration of each of those streams can be assessed in a less punctual way compared to the ending dates of those who terminated as a consequence of a war or financial disaster, more easily to determine. As a result, the global M&A historical trends overview has been characterized by a dynamic sequence of crises and growth periods, resulting in a cyclical effect. Before starting the description of each time frame, it is essential to remember another premise: the first merger activities began in the US context due to the emergence of Wall Street as the core worldwide financial center and so they mainly refer to the American historical and regulatory framework. However, soon after the globalization process they started to spread out all over the world by investing Europe and several Asian countries.

First Period – from 1893 to 1904. The first merger wave arose within the US framework at the end of the 19th century due to the combination of a rising stock market and the issue of the Sherman Antitrust Act (1890), a landmark federal statute designed to prohibit the agreements and trusts between entities that could potentially harm and limit the competition and trade among different states and countries. Since the previous law did not address specifically the growing phenomenon of merger and acquisition activities nor prohibited to realize those transactions with a stock for stock exchange. Following this path, many firms tried to exploit the possibility of establishing near monopolies without the legislator interference. The first merger wave began as the outcome. This period was essentially characterized by major horizontal mergers, which contributed to a massive reorganization of the US industrial landscape, due to the increasing formation of new companies, and to the emergence of the main strategic players in the manufacturing, oil and transportation American industries. However, the financial crisis of 1907, known as the Bankers' Panic, together with the First World War explosion are generally considered as the events which pointed out the end of the first wave.

Second Period – from 1919 to 1929. The second merger wave took advantage from the positive trend within the stock market and the corporate tendency of issuing equity to fund new transactions, but was also influenced by some regulatory changes occurred during the previous years. In particular, in 1914 the US Congress issued the Clayton Act as the primary active response to the recent break-up of the Standard Oil Company, which after the suit in front of the court for discriminatory practices, abuse of power and excessive control of its market, lost the legal battle and was forced to drastically reduce its subsidiaries and influence over the industry. The previous reform was introduced to strengthen the current legislation and drive the existing companies from a monopolistic structure towards an oligopolistic approach. The American corporations sought to increase their value creation by integrating backward to the source of raw materials and forward to better control the distribution chain, eliminate the outside dependency as well as the risk of price gouging. For this reason, it was said that the second merger wave was mostly characterized by vertical integration deals which resulted in a further industry consolidation especially in the automotive sector. The terrible stock market crash on October 24 1929 along with the following Great Depression represented the major causes for the end of this period.

Third period – from 1955 to 1973. Merger and acquisition activity fluctuated throughout the 1940s and 1950s but without achieving a consistent level in order to be deemed a new wave period. A fresh flow of deals started in the middle of the 1950s, after the recovery followed to the Second World War, when the whole market experienced a bullish phase and the stock market began to rise again. These positive conditions led to the third merger wave, where lot of profitable companies, more willing to invest their large cash flows on the market to fund a further expansion rather than distribute dividends to their shareholders, undertook a diversification strategy. The most notable features of this period were the diversified conglomerate deals pursued by the firms to extend their presence in other industries or markets in order to lower their risk profile. The strength of this trend was illustrated by the fact that the number of conglomerate firms increased from 8.3% of Fortune 500 firms in 1959 to 18.7% in 1969[2]. The result of the conglomerate wave was also influenced by the development of specialized managers in structuring, analyzing and executing more sophisticated transactions. In particular, during this period the global investment banks emerged as the major counselors for corporations in providing advisory services. As a consequence, the availability of specialized lawyers, consultants and accountants, that ensured support to the merging companies, was an additional incentive to increase the number and

[2] R.P. Rumelt, December 1974, *Strategy, Structure, and Economic Performance*, Division of Research, Harvard Business School

volume of transactions. This period of growth was roughly interrupted by the Oil crisis of 1973-74, which caused a sharp increase in the inflation rate and an international economic downturn.

Fourth period – from 1980 to 1989. The fourth wave was triggered by a combination of several factors which acted together in determining an extraordinary intensity of activity in terms of volume and deal size. Firstly, the changes in the antitrust policy decreased some of the restrictions on takeovers enacted by the previous laws, resulting in an unprecedented numbers of unfriendly bids[3] (Shleifer and Vishny, 1991). The major investment banks started to launch hostile takeovers on behalf of their corporate clients, so that almost half of all American companies were the designated target of an unsolicited offer during the 1980s[4] (Mitchell and Mulherin, 1996). Another possible explanation for the flourish of hostile takeovers in the fourth wave can be traced in the return to horizontal mergers as opposite to the diversification strategy followed during the 1960s. Several conglomerates failed after the end of the third wave and lot of companies were forced to divest from unrelated business areas in order to concentrate their efforts on industries where they were already present and efficient. Secondly, the deregulation in some specific sectors (financial, air transport, broadcasting) contributed to intensify the transactions volume. One of the most notably example was represented by the reduction in capital gains' taxes from 49.5% to 28% issued by the US Congress in 1978, allowing corporations to own a larger amount of proceeds ready to be invested in order to finance new strategic acquisitions. In addition, the fourth merger wave was characterized by a further development in the debt capital market, with the birth of new financial instruments such as the high-yield bonds, also known as junk bonds. A type of non investment-grade which offered a higher remuneration but also carried a greater default risk, whose primary use is mostly speculative. Besides that, this period was also distinguished by an increasing volume and size of leveraged buyouts, in which new deals were almost entirely financed through debt. During this time horizon the merger activity continued to flow, pausing only for few months after the Black Monday of 1987, but sharply declined as a consequence of the global economic recession started in

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[3] Andrei Shleifer and Robert W. Vishny, December 1991, *Takeovers in the '60s and the '80s: Evidence and Implications*, Strategic Management Journal, Vol. 12, pp. 51-59

[4] Mark L. Mitchell and Harold J. Mulherin, 1996, *The Impact of Industry Shocks on Takeover and Restructuring Activity*, Journal of Financial Economics, Vol. 41, pp. 193-229

the US with the savings and loans crisis of 1989-91 and soon after expanded to the international framework with the Japanese asset price bubble in 1990 and the Swedish banking crisis of 1990-94.

Fifth Period – from 1993 to 2000. The fifth wave was the era of mega-deals and cross-border mergers as a consequence of the external globalization process and the internal corporate necessity to cope with the international expansion in order to compensate for the low organic growth of the previous period. Within this context mergers of unprecedented size occurred, such as the deals between Chrysler and Daimler Benz, Exxon and Mobil, Vodafone and Mannesmann, Citibank and Travelers. Although the trend towards horizontal deals continued, in every other terms the 1990s merger wave was totally different to its predecessor. It was almost characterized by friendly acquisitions with just 4% of deals considered as hostile bids[5] (G. Andrade, M. Mitchell, and E. Stafford, 2001). In addition, this period saw the development of new technologies, like the Internet, with the consequent creation of new-end markets and so additional potential opportunities for further growth. Notwithstanding the prosperity, it ended between 2000 and 2001 with the burst of the tech and dot-com bubble and the sadly well-known huge accounting scandals, such as Enron and WorldCom, which identified a lack of attention on corporate governance issues.

Sixth Period – from 2003 to 2008. The sixth merger wave was born only after three years from the end of its predecessor and was characterized by a great potential from the buy-side perspective due to the huge availability of liquidity on banks and corporate balance sheets. Among the factors that triggered this new period of growth the most important were: shareholder activism through which specialized activist equity holders, like hedge funds and institutional investors, attempted to influence the Board's decisions in order to pursue growth strategies based on strategic acquisitions designated to increase value, extend product line or expand in new geographic areas; industry consolidation; encouragements by some countries (Russia, Italy and France) to create national and global champions; and the availability of low-interesting financing on the debt side. Furthermore, the Golden Age of private equity funds (2003-2007) with a simultaneous increase in leveraged buy-outs contributed to enhance the current merger

[5] Gregor Andrade, Mark Mitchell and Erik Stafford, 2001, *New Evidence and Perspectives on Mergers*, Journal of Economic Perspectives, Vol. 15, No. 2, pp. 103-120

activity. The sixth merger wave was abruptly ceased due to the blast of the recent financial crisis in 2008, bitterly known for the Lehman Brothers' collapse, some governments' bailouts and the global economic recession. In addition, the critical juncture, initially born as a subprime and liquidity crisis, expanded its boundaries reaching Europe, where in 2010 provoked a sovereign debt crisis in several nations. As a consequence, the international economic downturn generated a credit crunch, resulting in a reduction of credit availability which halted the merger and acquisition intensity by ending the sixth wave.

1.2 M&A Types

Mergers and acquisitions cannot be generalized into a broad category because they represent very different strategic activities. Joseph Bower[6] (2001) identified five distinct classes according to the main motives behind the deal: facing overcapacity through the consolidation in mature industries; extending product lines or expanding into new markets; rolling-up competitors in geographically fragmented industry; making acquisitions in place of investments in research and development; and exploiting industry boundaries by inventing new business.

Scenario 1 – Overcapacity Deal. The overcapacity deal is a kind of horizontal M&A between competitors that operate in the same business environment and occurs due to the substantial overcapacity available in the target industry (especially in capital-intensive sectors). The rationale behind the acquisition is to remove the excess capacity through the rationalization of all administrative processes and less efficient human and material resources, in order to gain market share and create more productive operations. The new combined entity is expected to exploit synergies related to the excess capacity by increasing the productivity level and lowering the average manufacturing costs.

Scenario 2 – Product/Market Extension. The product or market extension M&A consists in extending a company's product line or alternatively expanding its international presence. The likelihood of the deal's success is critically affected by the

[6] Joseph L. Bower, March 2001, *Not all M&As are alike – and that Matters*, Harvard Business Review

size of both the acquirer and the target: if the merger occurs between equal players it will be more difficult to impose processes, resources and values to a well established business. By contrast, if a large company purchases a small entity the probability to be successful will increase on the buy side. When a company is considering the strategy to growth through strategic acquisitions made in a foreign market by increasing its international coverage, it is crucial to carefully manage cultural differences in order to avoid future clashes.

Scenario 3 – Geographic Roll-ups. The geographic roll-up deal typically occurs at an earlier stage in the industry's life cycle, when a company expands its business by acquiring several local competitors in adjacent territories. Usually, the acquired rivals are kept operating as local business units, whether the relationship with local consumers is deemed important. Its strategic rationale is based on the necessity to create economies of scale and scope in order to build up giant players within the industry. This type of M&A offers some competitive advantages for both the interested parties: being acquired by large companies can help smaller firms to gain better access to capital markets and technology as well as to avoid threats from bigger rivals. On the other hand, the acquirer can solve the problem of geographic expansion and local management.

Scenario 4 – M&A as a Substitute for R&D. The M&A transactions done as alternative to internal investments in R&D aim to achieve better access to new updated and sophisticated technologies, in order to obtain dominating positions within the industry as well as to quickly increase market share, in response to shortening product life cycles. One huge challenge that the acquirer should carefully consider refers to the ability of retaining key employees after the deal's conclusion, usually by offering different kinds of incentives. The secret is relying on talents during the post-integration phase.

Scenario 5 – Industry Convergence M&A. Industry convergence deals take place between two companies that bet on the emergence of a new industry or invent a new business model and want to have a prominent position in it. This fifth category is totally different from the previous ones, because it implies the invention of a new business area where the major synergies can be achieved by pooling diversified resources together from distinct industries whose boundaries seem disappeared. Following this path, pursuing the success is even more difficult compared to the other M&A types because in this case positive results depend not only from the deal's structure and strategy but mainly from the investor's vision.

1.3 Motivations behind Cross-Border M&A

The globalization process has substantially changed the international framework and its boundaries, encouraging firms to expand across their borders in order to catch attractive profitable opportunities by accumulating new assets, entering new markets and discovering new segments. Traditionally, the focus of attention has been developed towards two distinct targets: Developed versus emerging countries. According to the criteria identified by the World Bank, Developed countries are those having significant and sustainable per capita economic growth, globally integrated capital markets, advanced industrialization levels, well-established legal systems and stable forms of government. Instead, the emerging countries are characterized by lower-per-capita incomes along with higher growth rates and volatility due to several social and economic changes undertaken to shift from traditional economy, mainly based on agriculture and raw materials' exports, to more industrialized production. In recent years, Developed and emerging economies have become increasingly interdependent and have contributed to shape globally integrated capital markets. The new structure has fueled the companies' enthusiasm to follow international expansion and diversification strategies. Mergers and acquisitions are usually explained by two groups of factors: strategic and financial drivers, aimed at enhancing corporate performance, and managerial intentions, focused on top management's personal ambition and private prestige. Among the strategic and financial incentives the most important are: the aspiration to achieve diversification, create synergies, stimulate growth, consolidate industries, and quickly obtain the access to new resources and technology. Besides the previous impulses more connected to the firm's business model, sometimes the M&A activity can also be driven by the executives' personal decisions, structured in empire-building theory, hubris, fear and mimicry phenomena.

Diversification. Companies may decide to diversify by expanding their operations into different industries in the same country, the same industries in different countries, or different industries in different countries. The goal of geographic or industrial diversification is to minimize the corporate risk profile by decreasing the overall volatility of the firm's earnings and cash flows, which become more predictable and less riskier, as well as by ensuring a lower cost of capital. Several studies[7] (Chan, Karolyi, and Stulz, 1992) demonstrate that companies with broader diversified international portfolio experience lower earnings' volatility and better mix of risk-return opportunities for investors. They often exhibit a lower cost of capital compared to those who are not well diversified, supporting the hypothesis according to which foreign acquisitions are preferred vehicles for risk reduction than domestic acquisitions.

Synergies. Acquiring firms seek to improve their corporate performance by combining multiple operations and activities in order to increase productive capacity and reduce related expenses, generating as a result higher long-run profitability and growth potential. In general, expected synergies are important drivers of wealth creation through mergers and they are oriented towards to two complementary directions: cost reductions and revenue enhancements. The basic equation affirms that the combinations of two entities is more profitable than the sum of their individual components. There are two main types of synergies: operating and financial. Operating synergies are developed at different levels: economies of scale in order to increase the productivity either by lowering the average manufacturing cost or eliminating the redundancies within the organization; increased market power to strength the competitive position and control price determination; cross-sales to enrich the consumer base by selling one firm's product to the other firm's costumers; and more efficient internal distribution system through a better flow of information in order to reduce asymmetries. On the other hand, financial synergies result in lower risk and cost of capital thanks to the resource combination of two or more entities. They bring benefits to both parties by ensuring an easier access to globally integrated capital markets at a lower cost of capital due to the prestige of being an international diversified company. In addition, the acquiring firm can further extend and develop its financial network by purchasing the target's financing sources[8] (Seth, Song and Pettit, 2000).

[7] K. C. Chan, G. Andrew Karolyi, and René M. Stulz, February 1992, *Global Financial Markets and the Risk Premium on U.S. Equity*, Journal of Financial Economics, Vol. 32

[8] A. K. Seth, P. Song and R. Pettit, 2000, *Synergy, Managerialism or Hubris? An Empirical Examination of Motives for Foreign Acquisitions of U.S. Firms*, Journal of International Business Studies, Vol. 31, pp. 387-405

Accelerating Growth. Companies to fuel future expansion plans may decide to extend their activities across the national boundaries to discover new opportunities and catch the hidden ones within foreign markets. Sometimes this motive is encouraged by a saturated home market, whose receptivity to the company's offering has decreased over time, leading to potential losses.

Industry Consolidation. Firms which hold cash in excess and show overcapacity are motivated to plan and execute new transactions in order to strengthen their position within the market, by achieving economies of scale and scope as well as increasing bargaining power with customers and suppliers. Once that the selected industry has reached a smooth level of concentration, smaller rivals are more willing to merge and in doing so they accelerate the path of industry consolidation.

Access to and acquisition of new resources and technology. Acquiring companies pursue the goal of gaining access to key and complementary resources, both tangible and intangible, through the M&A activity. Several studies[9] (Dunning, 1988) highlight as the emerging countries were deemed a preferred destination for those investors who want to take advantage from the easier availability of material resources at lower costs. Examples of firms that move their production process in such areas where the labor and raw material costs are significantly lower are not uncommon. In addition, strategic acquisitions in foreign markets are an opportunity to acquire new capabilities and knowledge, like patent-protected technology and superior managerial skills, in order to establish entry barriers for potential competitors. This line of reasoning is consistent with the theory developed by Caves[10] (1982) according to which firms that own a well-known reputation and brand recognition in their home markets can successfully apply their brand strategy also within foreign environments.

Managerial Drivers. Merger and acquisition activity is often driven by obtaining enhancements in corporate performance, but it can also be connected to personal executives' decisions, mainly focused on increasing individual power and prestige along with financial rewards. One of the most common case is the empire-building theory:

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[9] J. H. Dunning, 1988, *The Eclectic Paradigm of International Production: A Restatement and Some Possible Extensions*, Journal of International Business Studies, Vol. 19, pp. 1-31
[10] R. E. Caves, 1982, *Multinational Enterprise and Economic Analysis*, Cambridge University Press

managers want to improve corporate size and influence following a specific growth strategy in order to maximize their own utility instead of shareholder value. Sometimes, top management is also pushed by the research of personal glory and public recognition, with the result of overestimating future synergies due to its hubris. Under other circumstances managers may act out of fear by realizing defensive acquisitions to prevent future reverse deals or simply to survive in the competitive environment; while in other cases, they just show the tendency to copy other firms, a phenomenon called mimicry.

1.4 Successful Factors in Cross-Border M&A

The main drivers of M&As refer to different growth opportunities such as expanding into new geographical areas, extending product lines or acquiring new customers, with the goal to increase the overall profitability and strategic positioning. Although the deal motives play an essential role in the preparation phase because set the objectives to achieve, they do not generate success by themselves. Once that the deal has been undertaken, there are only two possible outcomes: success, resulting in an increase of shareholder value compared to the industry trend; and failure, resulting in a value destruction. Many research studies conducted in recent years show that the percentage of companies who failed to achieved the proposed goals after an M&A activity is about 83%. The previous findings could lead to the conclusion that top managers should find alternative growth strategies to improve the corporate value and profitability. However, the reality displays an opposite trend. According to an economic study performed by WilmerHale[11] (2012) between 2010-2011 the global M&A volume rose by 11%, passing from 27.460 transactions in 2010 to 30.366 in 2011. Similarly, the global M&A deal value increased by 53%, passing from $2,03 trillion in 2010 to $3,11 trillion in 2011. In addition, the process of globalization and the international dynamism will encourage cross-border mergers and acquisitions. Furthermore, prospective forecasts predict a continuous positive trend for the future. Within this context, it becomes crucially to identify and investigate the critical successful factors to succeed in doing

[11] WilmerHale, 2012, *2012 M&A Report*

international transactions. Weber, Oberg and Tarba[12] (2014) distinguish the following elements as the keys to achieve success: integration planning, synergy evaluation, due diligence process, cultural issue and communication.

Integration Planning. Integration projects identify: the mechanisms through which synergies will be attained; the relevant corporate strengths to further enhance but at the same time protect; and the path that firms should follow after the deal execution, in order to stabilize and consolidate its position within the industry. Integration is an ongoing and iterative process that involves the pre- and post-acquisition strategy to mitigate the deal-execution risk. Ideally, acquiring companies should begin designing the integration process even before the deal announcement. After the public release, top management has to recognize the most important priorities for the business along with the similarities and differences of the target compared to the own corporation. Good integration plans take these factors into account and will success or fail depending on the acquiring company's knowledge about the local assets and environment.

Synergy Evaluation. Synergies are considered one of the most important motives to perform an international acquisitions, because they create additional value for the existing shareholders, the primary objective to achieve for each manager. Detailed pre-deal synergy evaluation is required to assess the degree of strategic fit between the two entities, to confirm the validity of synergy assumptions and to provide evidence during the negotiation that prospected benefits are consistent and robust. This process also ensures that an appropriate due diligence valuation has been made to estimate the target's value, in order to avoid extra premiums and price overestimation.

Due Diligence. Due diligence is the process of investigating the financial, operational, legal and regulatory feasibility of an investment before entering in a legally binding agreement. In an M&A activity it is realized during the preparation phase to assess all the relevant factors that effectively and potentially affect the target's value. It can include market reviews, synergy analysis, management skills and capabilities considerations or operational impact. Due diligence is essential in mitigating risks, both country and target specific, and in facilitating price negotiations. At the beginning, the

[12] Yaakov Weber, Christina Oberg and Shlomo Tarba, January 2014, *The M&A Paradox: Factors of Success and Failure in Mergers and Acquisitions*, Financial Times Press

audit process is performed by a smaller team, but when the negotiation enters crucial stages the number of people increases. It is vital that the team selected to perform the analysis is comfortable in working together and shares the same vision. In conclusion, due diligence relies on the right timing of execution and on the accurate choice of the team members.

Cultural Integration. Culture plays a crucial role in capturing value from M&A transactions, considering this element during the initial preparation phase increases the likelihood of success. Several empirical studies[13] (Chakrabarti, Gupta-Mukherjee and Jayaraman, 2009) discovered the presence of positive correlation between cultural distance and long-term M&A performances, defining the cross-border deals more successful than the domestic transactions. However, in order to achieve such results firms must engage in a two-step process: 1) pre-deal analysis about the existing analogies and differences related to cultural issues, in order to become aware about them and start planning the integration project by highlighting the most serious threats to avoid future clashes; 2) post-deal cultural synergies, to facilitate the combination among cultures resulting from the merging entities and improve company's performance via diversity. Diversity should be viewed as source of enrichment and opportunity that brings a set of benefits to the entire enterprise. It may enhance operational efficiencies through capability transfer and resource sharing. Cross-border M&As face the additional challenge of dealing with both national and organizational cultural differences. Consequently, it entails a sound integration plan on multiple levels due to the greater efforts required. Epstein[14] (2004) describes five key essential elements to achieve successful post-merger results: designing a coherent pre-transaction combination strategy; building a strong and diversified integration team able to operate in a challenging environment and under time constraints; engaging in a frequent and transparent communication with the multiple stakeholders of both the acquired and acquiring companies, especially with employees; updating the plan due to possible variations; and constantly monitoring and measuring the process and its outputs.

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[13] R. Chakrabarti, S. Gupta-Mukherjee and N. Jayaraman, February 2009, *Mars-Venus Marriages: Culture and Cross-border M&A*, Journal of International Business Studies, Vol. 40, pp. 216-236

[14] M. J. Epstein, 2004, *The Drivers of Success in Post-Merger Integration*, Organizational Dynamics, Vol. 33, No.2, pp. 174-189

Communication. Planning and executing a strong and effective communication strategy is a critical cornerstone to achieve successful post-merger integration. Its primary goal is to ensure the complete flow of information within the organization in order to involve and motivate employees throughout the deal. This contributes to build a trustful environment in which higher transparency results in greater commitment from all the committed parties. The consulting firm Pwc[15] (2014) has highlighted four fundamental steps to design an efficient communication tactics.

1)Assembling the communication team to prepare, develop, review and distribute the key messages to all stakeholders, particularly towards those most impacted by the deal. Both internal and external communication is essential. Most of the time the acquiring company focuses its attention in dealing with the target's employees ignoring to engage an active dialogue also with its corporate workers. Maintaining equilibrium between the parties is often one of the greatest risk of the blending process in order to avoid future departures. 2)Identifying the key stakeholders and their representative groups to anticipate them the potential concerns and issues that might arise from the deal's completion. Managers should recognize the opinion leaders within each group, which are able to spread the message and influence the ideas of the other members. 3)Preparing the deal's announcement by deciding the nature of its delivery, public or private. Public announcements have broader effects on the investors community and increase the likelihood of a greater impact on the share price, but guarantee higher transparency. Alternatively, private releases ensure higher confidentiality and decrease the risk of potential leaks, but contribute less to build trust within the overall organization. 4)Releasing the announcement at the right time. Several studies[16] (Asquith, Bruner and Mullins, 1983) report that when firms disclose their plans for strategic acquisitions, their share price rises significantly. These findings suggest that the M&A activities and in particular the time of the announcement's disclosure are typically recognized by the market itself as source of value creation for companies. Choosing the right timing to declare the beginning of an international transaction to the general public crucially affects its future success.

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[15] PwC Report, April 2014, *M&A Communications. Communicating to engage and motivate people throughout the deal*

[16] Paul Asquith, Robert Bruner and David Mullins, 1983, *The Gains to Bidding Firms From Mergers,* Journal of Financial Economics, Vol. 11; 1987, *Merger Returns and the Form of Financing,* Proceedings of the Seminar on the Analysis of Security Prices, Vol. 34

Besides the previously described factors, which are predominant keys to successfully engage in an international deal, another element that a firm should not underestimate is the support received from a good Corporate Governance. Most of the successful mergers and acquisitions take place in countries which implies better shareholder protection and transparent information disclosure. Bris and Cabolis[17] (2004) in one of their empirical studies found out that cross-border deals which occur within markets with poorer investor protection by companies with developed Corporate Governance produce beneficial effects on the targets by increasing shareholder safeguard and transparency level. The transfer of Corporate Governance through M&A activity improves the shareholder protection and in turns the corporate value. This happens because target firms with weaker investor protection often adopt the best practice of the acquiring entity and by doing so they strengthen their Corporate Governance system.

1.5 Planning Cross-Border M&A

All business organizations are based on national laws: the law of a particular nation or jurisdiction within each country which legitimates the formation of a business entity and legally recognizes its operations. This is valid for corporations, limited liability companies, partnerships, sole proprietorships and other types of enterprise forms. Despite the increased role of the world trade and the higher interdependency between regional economies, it does not exist an international law that establishes a common regulatory framework about the rules which govern the creation of an organized business entity. As explained by Truitt[18] (2006), when a company begins its international expansion in foreign markets its corporate governance continues to rely on the law of the home country, the place where the incorporation has occurred. However, the organizational form drawn to run the business depends on the law of the foreign country in which it has chosen to operate, the so called host country. Nowadays, within the global context, a firm that chooses to go international has two main options: extending its business in Developed countries or focusing the attention on emerging countries, deemed to be high-growth markets. Planning the entry approach in both

[17] Arturo Bris and Christos Cabolis, January 2004, *Adopting Better Corporate Governance: Evidence from Cross-border Mergers*, Yale Working Paper
[18] Wesley B. Truitt, 2006, *The Corporation*, Greenwood Press, pp.139-159

competitive environments requires accurate macroeconomic researches in order to find out: the best acquisition vehicle to be employed; the purchasing form and payment method to be applied; and the integration strategy to be adopted.

1.5.1 Planning and Implementing Cross-Border M&A in Developed Countries

When a company decides to expand its presence beyond the national boundaries by undertaking an M&A strategy, the first issue to address on the agenda refers to the choice of the acquisition vehicle, the external enterprise form assumed by the target. Cross-border deals in Developed countries face two different challenging jurisdictions: civil law and common law legal systems.

In civil law countries (Western Europe, South America and Japan), whose primary source of law are written codes, smaller enterprises often use a limited liability company, while larger enterprises usually take the form of share companies, the corporations. The main difference among them regards the ownership structure: the former issues quotas, not tradable on the market but only among the members and upon their general approval; while the latter issues shares, freely exchanged between investors on public markets. Share companies generally have stricter procedures to follow in order to start their operations. The first step consists in filing the registration form to the competent local authority of its principal business location, and await for the positive response to acquire legal personality. It may take time from several weeks to several months between the filing of all the necessary documents and the delivery of the legal approval, due to bureaucratic delays which are often considered harmful elements for potential new investments. Share companies do not put restrictions about the nationality of potential shareholders, but usually require more than one equity holder. They are run by executive directors that should act in the best firm's interests avoiding personal conflicts and agency problems. Some jurisdictions reserve specific positions for local directors. By contrast, the limited liability company has a more flexible structure compared to the previous one, because it involves less requirements. Even if they can differ slightly from one country to another they share basic common features. Firstly, its ownership structure is divided into quotas, instead of shares, that can be exchanged only among members and upon the agreement of all holders. Secondly, members of a LLC own limited liability towards the organization's debt and debt-like items, meaning that they can be deemed liable only for the corresponding amount of invested capital.

In common law jurisdictions (USA, United Kingdom, other Commonwealth countries and former British colonies), characterized by a judge-made system grounded on the legal precedent, in addition to the corporation and limited liability forms, enterprises often use partnership vehicle to acquire foreign entities. The partnership can assume two different forms: general or limited partnership, depending on the role of its members. The former includes only general partners which share unlimited liability against creditors; while the latter distinguishes between limited members, who hold limited liability but cannot manage the firm, and general partners who are personally liable for the firm's obligations, but has the power to run the business and control it.

After having decided the business form that best fits the purchasing strategy, the next step refers to the choice of the acquisition and payment methods. M&A activities that take place within Developed countries typically involve share acquisition, since it is deemed the simplest mechanism to transfer ownership. In fact, this method allows the share ownership transfer without physically moving the assets and liabilities from the corporate balance sheet. Since assets remain with the target, fewer transfer documents are required and transfer taxes may be limited or avoided. Consequently, most of the purchase considerations are executed by all-cash deals because immediate liquidity availability is more attractive compared to stock-for-stock transactions, subject to fixed or floating exchange rate computations.

1.5.2 Planning and Implementing Cross-Border M&A in Emerging Countries

Companies that plan to execute merging or acquisition strategies within emerging markets have to face additional challenges to the ones encountered in domestic deals or when the target is located in Developed countries. Emerging environments are surrounded by instability due to the combination of political, economic and legal risks. They include a broad range of issues: poor corporate governance, excessive regulatory restrictions, weak institutional systems, uncertain tax policies, political instability, corruption and frequency in breach of contractual provisions.

The key hurdle to overcome when planning a deal in an emerging country is the manner through which gathering the necessary information about the nature of the business and the underlying macroeconomic environment, in terms of quality and quantity. It becomes essential more than under other circumstances the due diligence process, employed to identify the risks that can harm the success and to determine which of them can be mitigated. Sometimes, when the audit process results too difficult to be performed, acquirer companies may protect themselves by including financial options in the sale and purchase agreement to subordinate the deal at the occurrence of pre-specified circumstances. Alternatively, the execution provision of the binding contract may contain purchase price adjustments.

Although executing international transactions within emerging markets entails several threats, it may offer better combinations in terms of risk-return trade-off. This strategy proves to be more geographically adventurous, but at the same time implies greater remunerative opportunities, especially in those areas whose growth rates have experienced consistent accelerations. According to a survey conducted by the Baker & McKenzie[19] law-firm (2013), the distribution and flow of the foreign direct investments have known a substantial shift from Developed towards fast-growing markets. These findings match the results of the global statistics[20] concerning the M&A trend, which has pointed out the large increase by 9% year-over-year in 2012 of cross-border deals directed to emerging countries compared to the average smooth increase by 2% of the whole international activities. The previous outcome can be explained by a combination of factors due to the recent economic events. During the last years, the international M&A environment has faced several challenges caused to the recent financial crisis, which considerably reduced the volume and number of deals. The global recession along with the fiscal anxiety within the US context and the European sovereign debt crisis decreased the corporate enthusiasm in following cross-border expansion strategies with targets in Developed countries. The combination of all these elements contributed to reshape the worldwide transaction context. Companies restructured their M&A strategies by shifting the focus of attention from deals executed in advanced markets towards deals realized in emerging markets. The latter suffered significantly less from

[19] Baker & McKenzie, April 2013, *Opportunities Across High-growth Markets: Trends in Cross-border M&A*
[20] Thomson Reuters, 2012, *Mergers and Acquisitions Review*

the financial downturn and continued to fuel plans to foster international growth. They result particularly attractive for strategic buyers who typically have better understanding of the core business and environment, focusing more on synergy achievement and additional value creation, compared to financial buyers driven only by the desire to achieve superior financial results. The classification of emerging countries does not mean that one market is alike the others. Each nation has its own profile, political and economic policies as well as legal and regulatory framework. Among this group of high-growth markets the investors' attention has been attracted by the so called BRICS area, an acronym to identify Brazil, Russia, India, China and South Africa, the new growing powers emerged from the globalization.

1.6 Valuing Cross-Border M&A

The methodology for valuing international deals using discounted cash flow analysis is similar in its core procedures to the approach employed to value domestic transactions. The main difference refers to the fact that, when considering cross-border M&As, it is necessary to convert the realized cash flows from foreign currency into domestic currency and adjust the corresponding discount rate for the specific country risk.

Converting Foreign Target's Cash Flows into Acquirer's Domestic Cash Flows.

Cash flows of the target firm can be expressed in several ways: in nominal terms using local currency (including expected inflation), in real terms (without inflation) or in the acquirer's own currency. Nominal cash flows are typically used in practice, but there are some exceptions when the inflation rate of the target country is significantly high. In this case, the real cash flows are preferable, because through the use of the deflator the additional inflation effect is eliminated. In order to avoid further distortions, usually the expected cash flows are computed in the target's local currency and then they are converted into the acquirer's own currency by the use of the future exchange rate, called the future spot exchange rate, that is in force between the target and acquirer's currency. There are two main manners to estimate the predicted exchange rate among two countries and the choice of each method depends upon the nature of the specific capital market. In Developed countries, the future spot exchange rate is computed by the use of the interest rate parity theory, according to which the forward currency exchange rate equals the difference between the interest rates of the two countries adjusted by the current exchange rate. On the other hand, in emerging countries the future spot exchange rates can be calculated in two ways: through the interest rate parity theory and alternatively, when information about the interest rate of the emerging markets is not available, through the purchasing power parity theory. The latter follows the same rationale of the former, but instead using the difference between the interest rates, it considers the difference among the inflation rates of the two countries adjusted also in this case for the current exchange rate.

Selecting the Correct Marginal Tax Rate

In evaluating cross-border transactions an additional challenge is represented by the choice of the marginal corporate tax rate, whether the ones adopted by the target or the acquirer. Its role is essential in determining both the company's expected cash flows and the firm's cost of capital. The general rule states that the correct marginal tax rate to consider should be the one used within the country where cash flows are produced, because it should represent the place where taxes are owed to the central government.

Estimating Cost of Capital in Cross-border Transactions

Once the estimation of the expected cash flows and the choice about the marginal corporate tax rate have been computed, the last calculation refers to the firm's cost of capital, the appropriate discount rate which incorporates the cash flows' riskiness. Also in this case different adjustments are required whether investing in Developed or emerging countries. Normally, practitioners when evaluating an international transaction within Developed markets use the Global CAPM formulation to estimate the equity cost of capital r_e:

$$r_e = r_f + \beta_{e(developed,global)} * (R_m - r_f) + FSP$$

r_f: the risk-free rate, represented by the local government bond rate if the cash flows are measured in local currency or the US Treasury bond rate if they are measured in dollars.

$\beta_{e(developed,global)}$: the measure of systematic, non diversifiable risk which affects the economy as a whole in reference to a global well-diversified portfolio, such as the

S&P's 500 stock index, that contains only market risk. Its main components are interest rate, inflation rate, exchange rate, oil price and economic cycle. By opposite, the specific risk has been totally eliminated as a result of the diversification effect. This hypothesis holds within Developed countries, where the capital markets are fully integrated and investors own globally diversified portfolios.

$(R_m - r_f)$: the equity risk premium, represented by the difference between the expected return of the market and the risk-free rate. It is the additional reward required by investors for taking on the riskier assets in the equity market.

FSP: the firm size premium. It reflects the additional return earned by investors who have invested in smaller firms compared to larger enterprises, since the former carries higher default risk.

Since Developed economies show higher degree of interdependency and integration between their capital markets, the equity cost of capital is not subject to any adjustment except for the firm size factor. On the other hand, emerging countries, whose markets are more fragmented, require several risk adjustment factors in estimating the equity cost of capital. This range includes: country specific market risk, industry specific risk and other elements like exchange rate, political and liquidity risk. The main method used to calculate the equity cost of capital in emerging countries is the adjusted Global CAPM Formulation:

$$r_e = r_f + \beta_{e(emerging,global)} * \left(R_{Country} - r_f\right) + FSP + CRP$$

r_f: the local risk-free rate or US treasury bond rate. The limited data availability, or in some circumstances the lack of data, often precludes the use of local government bond rate as the risk-free rate. For this reason, it can be employed the US Treasury bond rate (usually the 10-year Treasury Bond Rate).

$\beta_{e(emerging,global)}$: the emerging country firm's β_e, which takes into account the country's market proxy portfolio and the global diversified market portfolio.

$\left(R_{Country} - r_f\right)$: the difference between the expected return of a well diversified portfolio in the local country and the risk-free rate.

FSP: the firm size premium. It reflects the additional return earned by investors who have invested in smaller firms compared to larger enterprises, since the former carries higher default risk.

CRP: the specific country risk premium. It reflects the riskiness of the local environment and is usually measured as the difference between the domestic government bond rate and the US Treasury bond rate. This difference is called spread and represents the additional remuneration required by investors in order to invest in those emerging markets. The rating agencies are responsible to assign grade to the sovereign bonds of each country. When it is used the local government bond rate as the risk-free rate the equity cost of capital should not be adjusted for the country risk premium, since it is already reflected in the domestic effect, otherwise the effect would be double counted.

CHAPTER 2: DOING M&A IN BRICS COUNTRIES

The second chapter focuses on presenting the BRICS countries as one of the most coveted location within the global investment landscape by multinationals from advanced economies to pursue an M&A strategy. After a brief introduction about the general framework, there are described the main motives that drive the investors' decisions to execute an M&A activity in this region and that explain the reasons behind a quick shift of interest from targets located in Developed countries to targets in emerging markets. Due to the particular features of the specific context, there are some critical factors among those considered when evaluating a general M&A deal that need to be addressed in order to succeed in the BRICS environment. On the other hand, dealmakers have to face several sources of instability in this region that can hamper the execution of any cross-border transaction. The remainder of this chapter describes both the critical successful factors and intrinsic institutional threats of doing M&As in the BRICS and concludes by explaining the strategic choices among which investors can choose to enter those markets.

2.1 The Rise of BRICS Economies

The importance of the emerging economies within the international framework has increased exponentially during the last decades, since these markets provide huge opportunities for sales and enormous potential for growth. Among the developing nations, the analysts' attention was grabbed by a set of countries with outstanding growth projections for the long-term horizon. They were defined with the term BRIC, an acronym coined by Goldman Sachs[21] in 2001 to identify Brazil, Russia, India and China, whose economies had outperformed the investors' expectations. These countries presented the most relevant parameters on both economic and demographic size in order to become global dominant players able to challenge the major Developed economies in terms of influence and weight. Some years later, it was added another country member to the original group: South Africa, the largest economy in the region, whose growth

[21] Jim O'Neil, November 2001, *Building Better Global Economic BRICs*, Goldman Sachs, Global Economics Paper No. 66

potential was deemed comparable to the previous four largest emerging economies. Consequently, the acronym was transformed into BRICS, which nowadays still identifies one of the most dynamic region within the international investment landscape.

The BRICS area has emerged as one of the most important worldwide center where multinational companies choose to locate their strategic investments in the forms of mergers and acquisitions as well as a favorable position to establish their subsidiaries. Over the past decades, foreign direct investment inflows to BRICS more than tripled to an estimate of $263 billion in 2012. As a result, their share in international FDI flows kept rising even during the recent global financial crisis and reached a record of 20% in 2012, almost three times more than the 6% share registered in 2000. The great portion of FDI flows in this region was represented by cross-border mergers and acquisitions. In this region the merger wave took place from 2003 to 2008, growing from $77 billion to $281 billion, with China and Russia accounting for the lion's share of growth[22] (UNCTAD report, 2013).

According to a survey conducted by the Baker & McKenzie[23] law-firm, the distribution of M&A activity has experienced a substantial shift from Developed towards emerging markets. These findings match the results of the global statistics[24] about the M&A trend which highlights the persistent increase of cross-border deals directed to emerging countries by 9% year-over-year in 2012, compared to the average smooth increase of 2% in the overall international activities. This outcome can be explained as the consequence of the recent financial crisis which restructured the worldwide transactions context. The aftermath of the global recession, the fiscal anxiety within the US framework along with the European sovereign debt crisis contributed to decrease the corporate enthusiasm in following an expansion strategy with targets located in advanced economies. On the other hand, emerging markets were less impacted from the current downturn and continued to fund their plans for future growth. Following the economic events, lot of multinationals restructured their M&A strategies by shifting the focus from deals executed within Developed markets towards deals realized in emerging markets. Among this group of high-growth countries, the BRICS played a

[22] UNCTAD report, March 2013, *The Rise of BRICS FDI and Africa*
[23] Baker & McKenzie, April 2013, *Opportunities Across High-growth Markets: Trends in Cross-border M&A*
[24] Thomson Reuters, 2012, *Mergers and Acquisitions Review*

predominant role, accounting for 60% of the total deals value of the M&A activity performed within emerging nations.

2.2 Motivating Factors to Invest in the BRICS

BRICS nations are regarded as the new engine of the world economy, where dealmakers from Developed countries can exploit new opportunities to foster incremental growth. Within this region, markets are growing at substantial rates, consumers are even more acquiring purchasing power increasing the general consumption level, and formerly protectionist economies are removing trading barriers and opening to foreign investments. The rapid pace of economic development has underlined three main investment themes[25] behind the attractive factors of this area. Firstly, the large accessibility to and availability of energy and natural resources intensifies the investors' interests. Inputs like industrial metals and agricultural commodities are essential to promote rapid economic improvements. In particular, power generation and distribution companies plan strategic acquisitions and mergers within the BRICS with the purpose of playing leading roles in the markets' fast-rising demand for electricity.

Secondly, the continuous expansion of the middle class and the evolution of its consumption pattern have contributed to find out more profitable investment opportunities. During the past decades, the emerging markets were seen as the most favorable locations for multinationals to delocalize their production activity by setting up manufacturing facilities and service centers, thanks to the lower operating and labor costs. Nowadays, the fast-growing giants, especially the BRICS, are regarded not only as advantageous places to establish delocalization processes, but mostly as end-markets of the entire value chain. Their massive population and growing middle class represent an extraordinary potential of new costumers, particularly for consumer goods companies which attempt to acquire consistent shares of their income. Recently, this trend appears even more evident for the luxury consumer goods, since customers' preferences have become more sophisticated and closer to the Western life-style. Last but not least, the third element which contributes to raise the interest over the BRICS is

[25] Jens Kengelbach, Dominic Klemmer and Alexander Roos, August 2013, *BRICs Versus Mortar? Winning at M&A in Emerging Markets*, The Boston Consulting Group

the ongoing research for technological advancement and corporate governance improvement, undertaken by these countries in order to compete on global scale with Developed economies and achieve dominant positions within the international environment.
Besides the previously mentioned investment themes, there are also some macroeconomic factors that contribute to place these nations at the forefront of the emerging markets' M&A activity[26]. The economic size and growth play a key role in ensuring them a dominant position within the global investment landscape. In less than 40 years the BRICS' economies taken together could be larger than the G6 (USA, Japan, Germany, UK, France and Italy) in US dollar terms. By 2050, China, India, Brazil and Russia will be included within the six largest economies in the world; only the USA and Japan will be able to keep up with them[27]. In order to convert the potential into reality, the BRICS should continue to be progress in strengthening the basic long-term conditions for growth, by adopting and maintaining supportive policies in several areas: institutional development; trade and investment openness; education system; and economic stability. The BRICS markets record the highest growth potential within the international framework, not only compared to other emerging nations, but also to most of the Developed countries. At a time when the trend annual growth is project to be around 2% in the advanced economies, multinational corporations that seek new profitable opportunities must inevitably look at BRICS.

Table 2.1 presents the projections of the annual percentage GDP growth for each country member, from 2014 to 2019[28]. As from the evidence, China and India will experience the most relevant growth compared to the other nations, also due to their massive population. The demographic profile is another important element that drives much of the improvement within a region. Without a substantial population, even a successful growth story could not have a global impact. It is possible to note as China will be exposed to a slightly decrease in the following years, as announced by several analysts, but its leading role will not be undermined. On the other hand, India will continue to pursue its economic development pace, keeping steadily the third position in

[26] Dominic Wilson and Roopa Purushothaman, October 2003, *Dreaming with BRICs: The Path to 2050*, Goldman Sachs, Global Economics Paper No. 99
[27] Pwc report, January 2013, *World in 2050. The BRICs and Beyond: Prospects, challenges and opportunities*
[28] Projections drawn by the International Monetary Fund, October 2014, *World Economic Outlook Database*

the world economy. Brazil and South Africa will achieve positive results thanks to a constant, smooth increase. Among the BRICS only the Russian Federation will face more troubles as a consequence of the Ukrainian crisis of 2013-2014 and the resulting economic sanctions dictated by the US and European Union. However, as evident the country will recover by 2016, starting a slow new improvement.

Table 2.1: BRICS annual percentage GDP growth (2014-2019)

Country	2014	2015	2016	2017	2018	2019
Brazil	0,30%	1,39%	2,23%	2,69%	2,92%	3,05%
China	7,38%	7,09%	6,84%	6,63%	6,42%	6,33%
India	5,63%	6,35%	6,46%	6,63%	6,71%	6,72%
Russia	0,24%	0,51%	1,50%	1,80%	2,00%	2,00%
South Africa	1,48%	2,30%	2,80%	2,69%	2,70%	2,71%

Another important macroeconomic factor that shifts the focus over the BRICS is the pattern of the global demand[29]. This region is experiencing a fast-growing domestic demand in terms of internal consumption, due to the constant increase in the population level, especially in the local middle class, whose tastes and habits have become closer to the Western life-style. On the other hand, the domestic demand of the advanced economies has been affected by a sharp contraction, mainly as the result of the recent financial crisis. The combination of these two phenomena brings to the following outcome: BRICS countries have led the global recovery, by absorbing the overproduction from the Developed nations, and have represented the optimal location for an export-driven strategy conducted by the advanced economies. China was the first country to return to the trend growth at the end of 2010, followed by India and Brazil in 2011. In addition, all the three countries closed their output gaps much earlier than any other. In conclusion, while the advanced economies contributed negatively to the recovery of the world domestic demand in 2009 and barely positive in 2010, its return to a healthy growth rate was significantly driven by the contribution of the emerging

[29] Tetsufumi Yamakawa, Swarnali Ahmed and Alex Kelston, May 2009, *BRICs Lead the Global Recovery*, Goldman Sachs, Issue No.09/05

markets, particularly the BRICS, which were less impacted from the international financial downturn.

2.3 Successful Elements for Mergers and Acquisitions in the BRICS

The BRICS economies are enormously attractive investment opportunities among the other emerging nations, since they are characterized by rapid growth conditions, untapped markets and inexpensive but qualified workforce. International firms from Developed countries generally raise their interest above this region driven by two main objectives: expanding their business development outside their current markets as an alternative to the organic growth, and simultaneously benefiting from geographical and industrial diversification on a global scale. Besides the critical factors described in the previous chapter which are employed to assess the likelihood of success in a general cross-border deal, for mergers and acquisitions that take place in the BRICS, there are some fundamental elements which require greater consideration by managers before executing transactions.

Due Diligence. When a company decides to enter new markets by acquiring a foreign entity, looking for a joint venture with an overseas partner or merging with a local target, an appropriate level of due diligence is required, in order to avoid future problems with anti-corruption and anti-bribery legislation. The US Department of Justice in the "Opinion Procedure Release 08-01"[30] has provided a comprehensive definition of a reasonable due diligence file. It must include the following: independent reports by reputable international investigative firms; advices by foreign business consultants; reports from the US Commercial Service of the Commerce Department; detailed information about all the relevant persons and entities involved in the negotiation; meeting notes from discussions with the US Embassy in the foreign jurisdiction; reports on the target company by outside counsels and independent forensic accounting firms; and additional reviews by a second law firm.
The investigation system should take into account some sensitive issues before that the closing occurs: a)the volume and transparency of the publicly available information

[30] US Department of Justice, January 2008, *Opinion Procedure Release No.08-01*, Foreign Corrupt Practices Act Review

vary from nation to nation and are generally considerably less than the amount accessible within Developed countries. This requires a greater control about the reliability of the different sources from which the news are released and a deeper analysis on the local entity, its management, business partners and intermediaries. b)The boundaries among the political and economic activities are more blurred than the limits existing in advanced nations and the likelihood to encounter politically exposed persons at the top of the target's organization increases, particularly in China and Russia where governments still maintain large influence on the economy. This implies a more extensive due diligence on the acquired executives, directors and shareholders in order to avoid any possible legal violation. c)The set of the available information is not as well organized, complete and reliable as in many advanced jurisdictions, because typically local media and press are directly controlled by central governments which heavily monitor the quality and quantity of the news that should be released to the public. Among the BRICS, China and Russia present the highest level of corruption and the least independent and open press. d)The lack of strong anti-corruption laws and enforcement mechanisms within the BRICS, especially compared to the US and European framework, forces multinational companies to undertake more extensive and time consuming examination of the target's policies, procedures and financial statements. In addition, it is important to note as the due diligence phase within the emerging countries is characterized by higher lead-time, due to more lengthy decision and approval processes. Corporations from Developed countries can follow two different options: adapting to the target's time and making the process slower to allow the counterpart to cope with the pace or offering a premium price to reduce the execution time and reach the closing sooner.

Experience and Simplicity. The complexity of the local environment increases the difficulties for foreign companies which are willing to pursue an M&A strategy within BRICS countries, especially compared to regional competitors. Their better knowledge about local markets, regulations, cultures and languages help them to achieve faster successful results. The experience is a key factor to overcome the hurdles encountered by acquirers from Developed countries. Increasing the number of deals done within the BRICS arena results in higher familiarity with the local framework and expands the likelihood of obtaining repeated successes. Serial acquirers reap the reward of the experience by learning valuable lessons from each successive deal on how to shorten cultural and legal gaps, the main difference met by international firms in executing an M&A activity within the BRICS rather than in advanced economies. The acquired expertise can then be applied to the following transactions in order to improve the final outcome. Understanding the local environment of each emerging market leads to identify the specific needs, more or less hidden, of its consumers and in turn helps to structure the optimal strategy to enter the industry. Capital markets in the BRICS assign beneficial effects to the experience obtained by repeated deals, but they also favor simplicity and transparency. Often in these countries, domestic counterparts share the tendency to build businesses on trust and relationships than on complex sale and purchase agreements. Such cultural differences create several challenges for those advanced nations used to employ contracts to cover every legal detail in a negotiation. The virtue of simplicity within the BRICS refers also to the type of companies acquired by foreign entities from Developed countries. Generally, the emerging markets reward with higher return and lower risk those deals that involve public corporations instead of privately held targets.

Integration Process. One of the main causes of the failure of a merger and acquisition strategy is deemed to be the failed post-integration process. Once that the deal has been executed, managers feel the pressure to demonstrate the positive effects of the investment decision on the future performance and to recover the expenses carried to accomplish the transaction. They stress the attention on achieving synergies; streamlining procedures and operations; realizing economies of scale; and eliminating redundancies, in order to obtain such cost savings and efficiency gains that were the fundamental drivers behind the strategic acquisition. In doing so, executives lose the attention on a crucial task: integrating two entities with different attributes that should find a common ground to operate and run the business together.

Companies may vary to one another in several distinct dimensions: corporate size; industry characteristics; products, markets and customers features; financial performances and reporting standards; as well as business models and organizational cultures. When firms plan to pursue an M&A activity, they should establish an internal team which devotes its efforts and energies to structure the new architecture after the conclusion of the deal. This iterative process must start from the beginning, when the investment decision is only a potential opportunity, by identifying and evaluating the analogies and differences between the two independent enterprises. It continues during the execution phase and after the closing by undertaking the necessary changes to restructure the entire organization and by ensuring continuous communication at all levels. The post-merger integration involves four different areas in order to create long-term value: financial, organizational, business process and market integration[31]. Financial integration aims to achieve the same degree of standardization in the whole group to share a common language through which recording the operations. It is realized by defining the liquidity structure that needs to be established in the acquired target; by aligning the reporting periods and accounting standards; and by consolidating the financial statements as well as tax issues. In addition, it is essential to ensure that both entities meet the guidelines of the corresponding domestic and foreign jurisdictions.

Organizational integration focuses on combining different cultures, as well as human and technological capital among the related entities. Managing proactively cultural diversity is a crucial element to ensure future success and avoid potential clashes. It also represents an opportunity to learn and increase knowledge and skills. The purchasing company should not substitute the entire target's management but try to involve people from both the organizations in the core business tasks and it should cultivate relationships with key executives at the operating unit to win their support and secure their retention after the deal's closing, also by offering additional incentives.

Business process integration requires cooperation between the acquirer and acquired to effectively promote the transfer of knowledge, expertise and best practices. Traditionally, the emerging countries have weaker corporate governance guidelines compared to advanced economies. An M&A activity among a Developed nation and an emerging nation can easily facilitate the sharing of the best practices relating to procedures and operations, like in the case of optimizing the supply chain management or the inventory control process.

Market integration implies acquiring a clear understanding of the diversity between the domestic and foreign contexts in order to exploit the most profitable opportunities in

[31] Nirmalya Kumar, May 2009, *How Emerging Giants are Rewriting the Rules of M&A*, Harvard Business Review

both markets. At a time when the advanced economies are experiencing a sharp contraction in the internal demand, identifying the locations where their overproductions can be absorbed represents a competitive advantage for multinational firms. Currently, the emerging countries, particularly the BRICS, whose fast-growing domestic demand is a powerful driving force of an export driven strategy, are recognized not only as places where to delocalize production processes, but mostly as end-markets where it is possible to reach new potential consumers.

2.4 Institutional Threats of Doing M&A in the BRICS

Although BRICS countries offer profitable investment opportunities thanks to their fast-growing economies, multinational companies which plan international strategies in this region must be aware about the possible threats that can hamper the execution and implementation of their projects. The most common challenge faced by corporations from Developed nations are the so called institutional voids[32], which refer to the lack of specialized intermediaries, effective regulatory systems and contract-enforcing mechanisms that affects emerging markets like BRICS. In general, Western companies take for granted the role played by such underlying structural conditions in their economies, since they can rely on sophisticated market intermediaries which provide updated and reliable information about the economic trend, as well as on structured and enforced regulatory systems which seek to ensure a high degree of fairness to all potential investors.

Within this framework, multinationals often enter BRICS markets by adopting the same approaches undertaken in their home markets, without taking into account the crucial differences between the institutional contexts. When those companies decide to invest in BRICS countries, senior managers usually employ the country portfolio analysis, to identify local market size and growth potential, along with the political risk assessment, to evaluate political and economic stability for the surrounding environment. Corporations often base their globalization strategies on country rankings through the evaluation of several parameters such as global competitiveness, governance's quality,

[32] Tarun Khanna, Krisha G. Palepu and Jayant Sinha, June 2005, *Strategies that Fit Emerging Markets*, Harvard Business Review

corruption perceptions and importance in the reference markets. Table 2.2 shows the corresponding composite indices for the BRICS countries.

Table 2.2: BRICS Composite Indices

	Brazil	Russia	India	China	South Africa
Global Competitiveness Index ranking* (out of 148 countries; 2013)	56	64	60	29	53
Governance Indicators (percentile ranking)** (out of 215 countries; 2013)					
Voice and accountability	58,77	18,96	61,14	5,21	65,40
Political stability	36,97	22,27	12,32	27,01	44,08
Government effectiveness	51,2	43,06	47,37	54,07	66,51
Regulatory quality	54,55	37,32	33,97	42,58	64,11
Rule of law	52,13	24,64	52,61	39,81	57,82
Control of corruption	55,02	16,75	35,89	46,89	54,55
Corruption Perception Index ranking*** (out of 177 countries; 2013)	72	127	94	80	72
Weight in Emerging Markets Index (%)**** (September 2014; out of 23 emerging markets)	10,28%	4,65%	7,06%	19,29%	7,38%

Sources:
*World Economic Forum, "The Global Competitiveness Report", 2013-2014
**World Bank Governance Research Indicator Country Snapshot, 2013 (0-100: low-high level)
***Transparency International, Corruption Perceptions Index, 2013
****AGF Investment, "MSCI Emerging Markets Index Overview", September 2013

Applying these devices can give back advantageous results only when the domestic and target markets share comparable characteristics. When the two markets have completely different institutional contexts, the first step before doing further advanced analysis is understanding the fundamental differences between the home and foreign environments, as well as the inner diversity among each of the emerging markets. Only by studying the soft structures of BRICS countries, corporations are able to identify those institutional voids that represent potential threats for investors and to transform them into investment opportunities. Executives map the institutional context of the key selected markets on a base of five main factors: political and social system; openness; product market; labor market; and capital market.

Political and Social System. Political and social systems affect the efficiency of an economy and define the stability of a nation. Countries with stable governments ensure greater security and liquidity for investments and remove the threat of potential bankruptcy and internal insurrections. On the other hand, higher centralized governments can extend an extreme control over the economy, frustrating business activities and foreign investments. When managers evaluate a BRICS market under this perspective, they should consider several issues: the identification of the country's power center; the independence of the governing bodies; the ties among the legislative, executive and judiciary systems; the role played by the bureaucracy; the frequency of political elections; the policies directed towards the economic system; and the corruption degree.

Also the social environment influences corporate decisions from multinational firms. They should carefully consider the relationship among ethnic, religious, linguistic and regional groups that are prevailing in BRICS countries. India, for instance, is characterized by a massive population where multiple ethnic groups coexist with different languages, religions, tastes and habits. Having understanding of the internal diversity offers local supremacy to international firms over their rivals. Besides the population composition, executives should also identify the regions with the highest level of concentration among urban, sub-urban or rural areas and the corresponding consumption patterns. In China, for example, most of the population is clustered on the external east coast where the famous first, second and third tier cities, the most populated, are located. In this case, dividing China into specific local categories provides advantages in understanding consumer behavior, income level and local trends and enables foreign companies to customize their strategies to fit local conditions and better succeed. Within the social context, it is included the assessment of the education system which is a prerequisite to ensure further economic development.

Openness. Openness to trade and foreign investments has a positive impact on the national productivity and is a fundamental condition to encourage incremental growth within emerging nations. The more open is a country's economy the more welcome are investments from international firms which easier enter local markets, due to the absence of tight government restrictions concerning the entry modes and the presence of foreign intermediaries. The globalization process has contributed to remove most of the previous existing trading barriers and as a consequence, international markets result more integrated. However, multinational companies can establish their operations overseas also in those markets that do not allow foreign direct investments by entering joint ventures or licensing local partners. In addition, international firms benefit from the presence of multiple intermediaries, since they can rely on services offered by both global and local entities, according to the needs of their strategies.

Similarly, openness affects also the development of local capital markets by allowing the presence of either domestic and global champions. When financial systems become more sophisticated and dynamic within emerging countries like BRICS, foreign corporations that run businesses there gain advantages from the increase in the financial supply availability and reliability. When multinationals evaluate the degree of an economy's openness to enter the region, they should also consider the presence of different policies about the protection granted to local and foreign business, as well as the subscription of free-trade agreements with other nations, a sign of more open economy.

Openness is a complex concept which includes not only the economic dimension but also entails the free flow of ideas and people across national boundaries. Russian Federation, for instance, does not have complete press and expression freedom, since media and newspapers are deeply controlled and influenced by the central government. Within the BRICS framework another example can be offered by the general belief according to which Chinese economy is more open than the Indian system due to the better reception given by the government to international firms. However, India is undoubtedly more open to external ideas from the Western world and allows its people to freely move within and outside the country. On the contrary, China has placed several internal firewalls to avoid the circulation of ideas which are different from those stated by the central government and does not allow easily the free mobility of its citizens. As a result, it may be true that multinational companies can faster enter Chinese market rather than in India, but the Indian local managers are more market oriented compared to the Chinese, and it represents an advantage for foreign companies.

Product Markets. Foreign companies from Developed countries must observe the structure of the BRICS markets before entering in order to correctly select their targets and establish their presence. In the BRICS, the structure of the product market is similar to the ones of the other emerging markets and can be divided into four distinct components[33]. At the apex of the market pyramid is the global segment, represented by customers who desire products with the same quality and features of the goods and services in Developed countries and are willing to pay global prices. Immediately below it, there is the "glocal" segment, where costumers want products of global quality but with local attributes and pay a price slightly less than global consumers do. Following, there is the local segment, where costumers search for products of local quality with local characteristics and local prices. At the bottom of the pyramid there are people who can afford only the least expensive products due to their low income level.

In general, international companies when enter BRICS countries locate themselves in the top layer of the market pyramid. In the emerging nations there are not sophisticated market research firms that provide reliable database on the consumption pattern, disclosing local tastes and preferences. In addition, distribution channels do not reach all consumers like those who live in rural areas, but only people concentrated in urban locations and, when companies extend their logistics management and networks, sub-urban regions. Furthermore, in some BRICS countries there is not a defined law that protects the intellectual property rights. In China, for instance, copying is regarded as regular way to implement business by local firms. The combination of these elements, also known as institutional voids, represents threats for firms who plan to expand their operations in the BRICS. Multinationals' success depends on the ability to deal with those institutional voids and to understand local preferences in order to adapt their global strategies to the special characteristics of customers and environments.

Labor Markets. Although BRICS countries have massive populations whose growth rates are among the highest compared to all the other emerging nations, foreign international firms deal with two different dimensions within local labor markets: the recruitment of managers and workers. The market for managers is more developed and dynamic, since it is possible to find high-quality talents with a good proficiency in

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[33] Tarun Khanna and Krisha G. Palepu, October 2006, *Emerging Giants. Building World-Class Companies in Developing Countries*, Harvard Business Review

English, the most common language used in Finance. In Brazil, for example, the presence of talented managers with varying degrees of proficiency in English has ensured the reliance on both local and international managers by multinationals. Most of the time, at the beginning local executives are supported by global senior managers. This approach has a double advantage: on one hand local managers are prepared and trained about global strategies by the latter; on the other, international managers can benefit from the local knowledge and expertise of the former. If the managers' market represents an elite, the market to recruit workers is characterized by a larger amount of people. In the past decades, emerging countries like the BRICS were the preferred locations chosen by companies from advanced economies to delocalize their production activities by setting up manufacturing facilities and service centers where the skilled workforce was relatively inexpensive. Nowadays, the labor market as a whole has become more developed thanks to the presence of recruitment agencies and more active trade unions which constantly try to enhance working rights. However, trade unions are not allowed in all BRICS countries. In communist societies like China, for instance, workers do not have the possibilities to form independent trade unions in the labor market that may affect wages level and working hours.

Capital Markets. In the last decade, capital markets within the BRICS have pursued a faster development pace than the other emerging countries and have made several efforts to close their financial gaps, by attracting many global intermediaries which further contributed to the establishment of more sophisticated infrastructure. In addition, they have better recovered from the recent financial turmoil compared to advanced economies and have emerged as the leaders of the global recovery by efficiently contributing to the return of healthy growth rate for the world economy. However, multinationals still face some challenges due to several financial constraints, since they cannot easily rely on local debt and equity capital to finance their operations.

Historically, capital markets in the BRICS have played a secondary role in providing access to multiple financial sources to foreign companies, because of the inadequate availability and reliability of the local financial means[34]. Within this context, Western firms have generally relied on the internal self-financing by employing the retain-and-

[34] Svetlana Borodina and Oleg Shvyrkov, February 2010, *Investing in BRIC Countries*, McGraw-Hill

reinvest approach for the realized earnings management. Although capital markets in the BRICS share common characteristics and perspectives towards future growth, they internally vary from one another. In Brazil and India, the local banking system is well developed and funds are available to both domestic and foreign investors. By contrast, in China, international corporations find difficulties to raise capital locally because they compete with state-owned enterprises, which are usually fund by public sector banks and run by the central government. In addition, financial reporting standards in China have a less degree of corporate transparency, even if companies are listed on the stock exchanges. In South Africa, the capital market's development has been affected by the social policies undertaken by the government, which decided for the transfer of several public assets to the native African community. When the transfer occurs, these assets are usually arbitrarily priced without taking into account their market values. Consequently, it makes difficult for foreign companies to correctly assess the value of local enterprises and to find reliable local partners. In Russia, the high level of corruption and the local banking system dominated by state-owned banks force companies from Developed countries to sign agreements with local entities to raise capital. To conclude, corporate governance practices are notoriously weaker in the BRICS than in advanced economies. In particular, Russia and China, where copying is considered a standard method, record the lowest protection for the operations, interests and assets of foreign companies, especially about the intellectual property rights.

BRICS countries represent certainly profitable investment opportunities for multinationals, but they also require serious attention to overcome all the potential threats filled in their institutional contexts that can harm foreign presence. Successful companies who intend to invest in this region accurately study the previously mentioned macro economic and market factors before doing the industry analysis and work on the institutional voids to transform these challenges into profitable opportunities.

2.5 Three Strategic Choices to Enter BRICS Markets

When international firms decide to expand their business within BRICS countries, they should follow several consecutive steps. Firstly, foreign companies must assess the general institutional context that surrounds the regional environment to become accustomed with the overall atmosphere and to recognize the main differences among emerging and advanced markets' features. Secondly, once that they have obtained a general overview, they should focus on identifying the critical factors to succeed in a specific location as well as the corresponding threats that can hamper the execution and implementation of the business. Comparing the benefits and costs of an investment decision means forecasting its projected cash flows in order to ensure that the future profits will entirely cover the initial expenses. Once that all the required analyses have been performed, the final step consists in selecting the market that offers the best available opportunities on which companies can capitalize and establish their competitive advantage according to their underlying business model. After the choice of the specific location, multinationals are ready to execute their strategies.

In general, when foreign corporations enter the BRICS they can go for three different strategies: adaptation strategy, transformation strategy and "stay away" strategy. Companies can choose to adapt their business model to the specific country's profile while maintaining their value proposition constant. In this way, they do not alter the manner through which create and deliver value to customers as well as convert the received payments into profits. As a result, they preserve their competitive advantages of global scale, global branding and reputation. At the same time, they get closer to the local environment and can better customize their global standardized approach to fit the specific institutional context. Smart companies modify their business model without destroying the most valuable components of it that ensure them supremacy over rivals, either national or international ones. Multinationals that choose to adapt their strategy to the local framework apply the managerial assumption according to which to succeed within a foreign market and achieve superior profits it is necessary to think globally but act locally. Adapting to a specific environment does not involve only the business model but the entire organizational culture to effectively manage cultural differences.

An alternative strategy undertaken by international corporations who want to enter the BRICS consists in changing the local institutional context, instead of adapting to it. Many Western enterprises are powerful enough to retain their global standard approach and to bring fundamental changes that reshape the product, labor and capital markets. Their entrance has the effect to foster new development and growth, especially in technology; to increase quality standards; to close some productive gaps; and to help these emerging giants to improve their potential. In addition, new investment opportunities can arise in the future thanks to the presence of global and more sophisticated intermediaries. However, sometimes it may be impractical for the international companies adapting the business model to the local framework and transforming the institutional context, or it does not add additional economic contribution to the future corporate profits. When the costs of entering new markets exceed the benefits of the investment decision, multinationals should change their target location in order to avoid future losses and select another market whose features are more suitable to their business model. International corporations cannot use the same strategy in all BRICS countries, but can take advantage of the underlying synergies by treating different markets as part of a whole system and establishing connections among them.

CHAPTER 3: STRATEGIES FOR INTERNATIONAL TREASURY MANAGEMENT

The third chapter represents the theoretical foundation for the empirical analysis performed in the next one. The attention is focused on the strategies adopted by international groups to manage Realized Earnings and use them in order to finance new strategic projects, such as acquisitions and mergers. Throughout the chapter the study must be observed from the perspective of a multinational company and its subsidiaries located across the globe.

A continuing debate within the investment community concerns the investigation process about the relevance of the realized earnings and their two basic components, retained earnings and distributed earnings, in determining the primary source of value for a Company, essentially measured and reflected by its share price. The choice among the two possible alternatives is usually set by the Investment policy and managed by the Treasury Department, responsible of three core functions: asset and liability management, cash management and financial risk management. Dividend distribution is considered important in order to ensure, maintain and enhance shareholders satisfaction, since this allocation represents what stockholders actually receive from the firm as the return of their previous investments. However, Modigliani and Miller[35] (1961) argued that the underlying source of value for the corporate share price was represented by earnings, not dividends. This theory was developed by further researches[36] (Khan and Ali Shah, 2012) which highlighted how the portion of the reinvested earnings within an enterprise provides a more meaningful contribution in order to achieve a stable long-term profitability and in turn results in a higher share price. In addition, several models[37] (Charles, 2010) assume that the firms' investments depend only on their retained profits, employed as internal funding to finance the growth strategy. Following this path, the current study assumes that, when deciding about the future allocation of realized earnings, the primary choice is retaining earnings to fund new investments. The

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[35] Franco Modigliani and Merton Miller, October 1961, *Dividend Policy, Growth, and the Valuation of Shares*, The Journal of Business, Vol. 34, No.4

[36] Allah Bakhsh Khan and Syed Zulfiqar Ali Shah, February 2012, *The Impact of Retained and Distributed Earnings on Future Profitability and Stock Returns in Pakistan*, International Research Journal of Finance and Economics, Issue 84

[37] S. Charles, 2010, *Explaining Persistent Cycles in a Short-run Context: Firms' Propensity to invest and Omnipotent Shareholders*, Journal of Post Keynesian Economics, Vol. 32

perspective of this work places the Retention Ratio as the most important variable to be further investigated[38].

Capital budgeting decisions follow the instructions included within the corporate Investment Policy which outlines the investment strategy to undertake for the whole group. Although the structure and content of an Investment Policy may vary from company to company, it is always based on three main principles: forecasting, managing and segmenting future expected cash flows, which represent the available cash ready to be invested. This chapter will present the typical features of an Investment Policy established in multinational corporations by describing its principles, objectives and functions, with a particular consideration for financial risk management. After this introduction, the attention will be focused on the core topic: the choice among two different types of liquidity structure to manage the overall funds available within a group: centralized versus decentralized treasury system. The explanation of the model typically adopted by BRICS countries, the permanent focus of the entire study, is left to the following chapter, where the solution will be supported by the results from the empirical analysis. It concludes the investigation process by illustrating an additional alternative applied by many international firms: outsourcing treasury function.

3.1 Establishing an Appropriate Investment Policy

The Investment Policy represents the foundation of any corporate strategy and contributes to design its underlying financial structure, in order to ensure the optimal use and allocation of internal capital sources as well as to minimize the cost of external borrowings. Although the configuration and content of an Investment policy vary from company to company, it plays a central role in all organizations in allocating the available funds among the corporate departments and subsidiaries, as well as in exercising control over different activities. This document outlines the overall strategy for investing. It defines the short and long-term goals that managers should achieve and the process by which investment decisions are taken. At the same time, it provides a comprehensive guide for the operating procedures to the treasury department, by specifying clear spending parameters within which it is permitted to proceed as well as a mechanism trough which it is possible to modify these parameters in the future, if

[38] The empirical analysis will follow in chapter 5

required. Technically, the corporate Investment policy designs the overall strategy that should be followed according to the Company's risk profile in deciding whether to retain earnings, in order to reinvest cash in future projects or preserve cash for precautionary reasons, or to return funds to shareholders in the form of dividend distribution. Once that the policy has been established, before its execution, it must be approved by the Board, which becomes aware about the possible alternative decisions representing different levels of risk and understands the potential implications of each specific proposal in terms of advantages and disadvantages for the corporate value.

Treasurers play a key role within any organization, since they are responsible to define and then execute the Investment policy. Before establishing the overall guidelines that will lead every capital budgeting decision, their primary task is to focus the attention on the expected future cash flows. Earnings are only an accounting measure of the firm's performance and do not represent real profits, since cannot be used to buy goods and services, fund new investments or distribute dividends to shareholders[39]. In order to perform these actions a company needs liquidity in the form of cash flows, the available cash ready to be used within the organization. Proactive treasurers must accurately forecast, manage and segment future cash flows. The next step to develop a sound Investment strategy is defining the three core objectives that every project or instrument should entail: security, liquidity and yield. The available cash will be invested according its features in order to satisfy at least one of these purposes. When the Investment policy has been decided, treasurers must continue to monitor and implement its principles in order to hedge against financial risks, included in all activities. Financial risk management is core treasury function essential to avoid future financial distress and to prevent adverse impacts on the chosen corporate strategy.

3.1.1 Forecasting, Managing and Segmenting Cash Flows

Following the description realized by the International guide[40] to invest cash, issued in 2014, in every company the Investment policy is generally based on three main principles: forecasting, managing and segmenting expected cash flows. Treasurers must follow this sequential order when performing their tasks, in order to obtain the necessary amount of information and data to structure a sound borrowing and

[39] Jonathan Berk and Peter DeMarzo, January 2010, *Corporate Finance: the Core*, Pearson Education Limited, chapter 7
[40] HSBC Global Asset Management, 2014, *The Treasurer's Global Guide to Investing Cash 2014*

investment plan. This is an ongoing process, since it must be constantly and consistently controlled and improved to maintain an updated perspective on the overall corporate cash balance.

Forecasting cash flows accurately. Understanding the projections of the future cash flows allows proactive treasurers to efficiently organize the company's borrowing and investment strategy, instead of facing unexpected events and just react to the circumstances. Furthermore, having detailed information about the future cash balances provides a twofold advantage: on one hand the company better manages its internal funds; on the other, it reduces its reliance on external debt, and so lowers its cost of capital. This is particularly important within a group architecture where cash surpluses can easily move from more productive departments and subsidiaries towards less wealthy units. In addition, this process provides a longer-term view for the investment decisions by displaying the future tendency of projected cash flows and pointing out the peaks and declines of corporate inflows and outflows, respectively based on the predicted incoming and outgoing payments. It also encourages firms to create more diversified corporate portfolios, since a wider range of instruments and potential counterparties results available. The combination of the achievable advantages can be extended, because these projections are also considered powerful indicators for actual and future business performances as well as for corporate finance activities, especially concerning the debt/equity ratio. In order to improve efficiency, companies usually prepare cash flows' forecasts according to different time horizons: short-term (from a daily basis up to one or three months); medium-term (up to a year); and long-term (over a year). Following this path, treasurers usually employ two main techniques to compute those projections on different time frames: short-term forecasts are estimated through the receipts and payments method, whose main source is the account receivable and account payable recording system. On the other hand, for longer-term periods, practitioners tend to apply accounting data extracted from pro forma balance sheets and income statements. In both cases, the main challenge is represented by the difficulty to deal simultaneously with estimated and certain data and to replace the former with the latter when they become known. Treasurers must also consider that estimates are based on historical data and economic conditions of the specific period. Consequently, they must account for the corresponding effects in computing current and future variables.

Managing cash flows effectively. One of the most important treasurer's duty is to maximize the use of cash within an enterprise in order to develop the corporate strategy and investment plan accordingly. His primary responsibility is to ensure that the company has sufficient liquidity to meet payment obligations at their due date. However, his tasks increase within a group, where funds should be moved between subsidiaries as efficiently as possible, to offset cash deficits with cash surpluses without incurring external loans. In order to accomplish all the treasurer's functions, it is necessary to establish an effective liquidity management structure, which gives overall visibility on the available cash and enhances deeper control over its movements, especially at an intra-group level. The liquidity system has the objective to identify cash surpluses ready to be invested; reduce the precautionary balance held for unexpected events; and minimize the reliance on external debt. Every company has its own process to manage internal liquidity: some corporations allow their subsidiaries to retain cash surpluses and employ them in an independent way, with reports that must be periodically sent to the holding. While others decide to centralize their treasury departments to the headquarters or strategic locations (the two alternatives will be further investigated). The choice depends upon cultural and regulatory issues as well as considerations concerning the place where subsidiaries are situated. It does not exist an ideal system, but each company can select the liquidity technique that best fits its own organization, business and operating functions. What really matters is the degree of flexibility ensured by the adopted scheme, since firms are not willing to continuously change their cash management organization every time that a new strategic investment is undertaken. There are three key factors to consider in building up an effective liquidity structure: a)the destination of cash concentration: it may depend on investment objectives, social and cultural factors, legal and regulatory requirements as well as political and tax environments; b)the frequency of the liquidity cycle: it refers to the relationship established between the center and the periphery about the flow of cash within the group; c)the location which is kept outside to the liquidity system: it includes the local subsidiaries that do not belong to the central cash management structure, due to strategic (the entity will be divested from the group), regulatory (local legal framework makes the participation too difficult) and cultural factors. In this last case, the treasury department should regulate the authority granted to the decentralized operating unit and the way through which it must periodically report to the headquarter.

Segmenting cash flows intelligently. Having a clear understanding of the future cash flows and establishing a sound liquidity structure allow treasurers to obtain more reliable information in terms of volume and timing about the expected available cash. Higher amounts of information help to cope with the uncertainty and volatility spread within global financial markets, and contribute to plan the appropriate investment strategy. Once that all the necessary data have been collected, the available funds should be segmented into different categories in order to identify the most profitable opportunities for each group in accordance with the corresponding risk-return combination. Cash can be distinguished by the nature of its underlying business purpose in three main classes: a)working capital: the cash needed by the firm for its daily operations to finance the ongoing activities. It should not be locked for more than few days and is typically invested in instruments accessible overnight; b)short-term predictable cash: the funds invested by the firm for less than 12 months to meet the expected business requirements in the near future; c)medium/long term cash: money at the company's disposal ready to be invested in projects with longer time horizon. It is interesting to note that for the first two categories the most important investment objectives are: security of principal and immediate liquidity availability, to ensure a quickly disposal whenever required. Conversely, the last group relaxes the previous priorities in favor of higher returns, achievable by investing in instruments with longer maturity, even if it entails greater exposure to the market risk. Nowadays, practitioners tend to use a more real classification, differentiating between operating and strategic cash. Operating cash refers to the funds likely to be required within a year and includes the previously mentioned working capital and short-term cash. In the aftermath of the recent global financial crisis, where economic conditions adversely changed and markets became more volatile and suddenly illiquid, treasurers have become more cautious in investing this type of cash, assigning even more than in the past the priority to security and liquidity. On the other hand, strategic cash includes medium/long-term cash that the company plans to invest in longer dated instruments and projects. This second category accepts to bear a greater risk in order to achieve a higher return, sacrificing security and liquidity. Strategic cash is mainly employed to finance further growth through internal ways (investments in R&D) or external ways (acquisitions and mergers). Alternatively, the Board can decide to distribute dividends as payments to shareholders or use cash for a repurchase share program.

3.1.2 Investment Objectives

A successful investment strategy should satisfy the organization requirements according three main objectives: security, liquidity and yield. Corporate treasurers must focus on the investment portfolio's stability by preserving the principal sum invested and by ensuring the cash availability whenever is needed to meet the obligations at the due date. In addition, they also seek to achieve the optimum rate of return on the cash already invested, by looking at its risk profile and volatility.

After the global financial crisis of 2008, a greater emphasis was placed on the safety and liquidity requirements. Several securities were downgraded and from top-level investments were transformed in low-grade instruments, typically employed for speculative purposes. Some practitioners[41] identified the credit research as the key factor to establish a successful long-term investment strategy. As a consequence, treasurers assumed more conservative behaviors to ensure principal security and cash accessibility, in order to fulfill the corporate obligations at the corresponding due date.

The Investment policy tries to balance security, liquidity and yield when structuring a corporate portfolio. Although they represent three different objectives, it is not always possible to achieve them simultaneously, but treasurers should find a compromise by setting a list of priorities according to the character of cash. By identifying the importance of security, managers are able to avoid potential loss on principal which otherwise could negatively impact the realized profits, forcing the firm to find an alternative source in external debt, more costly. At the same time, a similar situation could occur when liquidity is compromised, because the company is compelled to borrow from outside while having additional cash immobilized in illiquid assets. In this case, it is useful the distinction between operating and strategic cash. When investing operating cash, the core objectives are represented by security and liquidity, because firms need to finance the ongoing activities and meet the ordinary obligations to survive. Within this framework enhancing the return on short-term invested funds is not considered the top priority. Proactive treasurers typically select financial products with higher yield but shorter maturity when they have to choose among alternatives which can be comparable in terms of security and liquidity. By contrast, strategic cash is

[41] Jennifer Yazdanpanahi, 2013, *Security, Liquidity and Yield: the Case for Cash Management*, State Street Corporation

generally employed to purchase longer dated instruments, since treasurers accept to carry a greater risk in order to achieve a higher return, sacrificing security and liquidity. In conclusion to summarize, security and liquidity are primary objectives of all investments, especially the ones with short-term horizons, because they directly affect the survival of the firm. Instead, the research for a higher yield is mainly pursued when investing in longer-term projects, whose greater riskiness is compensated by additional return.

3.1.3 Financial Risk Management

All investment activities involve some degree of risk. Risk can be defined[42] as the extent to which a corporation may incur in losses as a result of adverse movements of money and capital markets prices or rates (interest rates, foreign exchange rates, commodity and securities prices, …) and/or the hostile change occurred within financial markets. A sound Investment strategy should reflect the overall corporate approach to risk and constantly keep track of it. Several reasons explain why it is crucial to appropriately monitor financial risk. Firstly, treasurers when evaluating an investment opportunity must match its specific risk to the corresponding expected return, in order to ensure an adequate compensation to the company's shareholders. Investing cash in riskier projects requires additional compensations, because of the higher returns' volatility. Secondly, treasury departments must present and describe how alternative risk scenarios may affect the choice among different financial instruments in terms of security, liquidity and yield, in order to prevent adverse impacts on the corporate strategy. Identifying in advance the range of all potential situations which may arise, with the corresponding likelihood of occurrence, helps to define a proactive approach in order to avoid unexpected changes on the original strategy. In addition, the risk management activity has the purpose to preserve the firm's financial stability and avoid future losses. The challenge for treasurers is to figure out the source from which risk arises and how it affects the existing investments, to consistently manage its impact on the overall profitability. This task can be accomplished by classifying risks into the following categories.

Credit risk. Credit risk arises when the counterparty fails, totally or partially, to repay its obligations at the corresponding due date, resulting in a loss of either some or all the

[42] Petr Polak and Ivan Klusacek, 2010, *Centralization of Treasury Management*, Business Perspectives

principal and/or related coupons. It is also known as default risk and may be provoked by temporary or longer-term systematic liquidity issues on the counterparty side. One of the most useful tool used by corporations to control and mitigate this risk is the credit rating analysis, which provides a measure of the probability of default for financial instruments and their issuers. This type of study is typically performed by rating agencies, which are responsible to produce and release updated assessment about the creditworthiness of the players on the market. By collecting information about the credit quality of instruments, issuers and other financial subjects, they create a relative ranking through which investment opportunities can be compared and distinguished in two broad macro categories: high-grade investments, the most secure and reliable, and low-grade investments, generally used for speculative purposes.

Rating agencies provide reliable methodologies to evaluate credit risk and treasurers often rely on their estimation. A major problem can appear in evaluating more complex products, such as derivatives, whose value and exposure are more difficult to be correctly estimated by credit ratings. Furthermore, the recent financial crisis has required more scrutiny on the role played by the international rating agencies, because they were deemed responsible to fail in correctly assessing the value of several financial players, like in the case of the Lehman Brothers' collapse. Following this path, it has become clear that the credit ratings should be considered as a starting point and not the final destination in evaluating a counterparty's profile. Despite their ease accessibility and wide availability, treasurers must extend the credit risk analysis by using other tools, such as more sophisticated models and market inputs like share prices and bond yields, in order to keep track of the counterparty's historical performances.

Market risk. Market risk refers to the adverse movements within the external environment that influence the value of an investment and its future expected cash flows. It is also known as systematic risk, because it cannot be eliminated through the diversification and affects the economy as a whole. Its impact depends on the sensitivity of the specific instrument to the market trend, the extent to which it moves with the economy. Price sensitivity is typically greater for products with leverage, longer maturity and derivative contracts. Several elements are included in the market risk: equity prices, interest rates, foreign exchange rates, commodity prices, and other indicators whose values are set on a public market. They are the so called market factors.

Equity risk refers to the risk of holding an investment in the equity form and is mainly connected to the moves in the share price. It can arise in an acquisition or merger situation, when the target's share price increases and simultaneously the stock price of the acquirer decreases, if the company has chosen to close the transaction using the stocks payment method. Equity risk may also appear when firms adopt share option plans to additionally reward employees. The difference between the market price of the share at the time when employees exercise the option and the opportunity cost of having provided such option is an expenditure for the firm. In addition, companies are subject to equity risk when they decide to launch repurchase share programs, because they may face increases of their own share price. The best way to offset the equity risk is building up a diversified investment portfolios with shares from different geographical locations and business areas.

Interest rate risk is linked to interest rate fluctuations within the market. When analyzing alternative investment opportunities treasurers have to choice among fixed and floating interest rates. Theoretically, if interest rates are falling, fixed rates ensure higher protection; instead, if interest rates are increasing, floating rates provide greater returns. The main challenge in managing interest rate risk concerns the uncertainty about the future, which increases as the investment horizon increases. Consequently, changes which affect the operating cash have lower effects than fluctuations which influence strategic cash. In addition, before taking capital budgeting decisions, treasurers must consider the corporate structure, because enterprises with a higher leverage are more exposed to interest rate risk, compared to those where debt has a marginal role.

Investments must also face the currency risk, which is connected to the foreign exchange movements within the global market. On one hand, it affects cross-border transactions in which goods and services are exchanged in foreign currency. The related cash flows may be influenced by fluctuations happening in the foreign exchange markets. On the other, companies with overseas subsidiaries suffer from translation risk, since the value of their realized profits and assets is subject to movements in the conversion rate between local and domestic currencies. For firms that operate within an international framework the Investment policy must be clear about the flexibility assigned to the choice of the currency or currencies to use in making foreign investments. As for the interest rate risk, treasurers can apply a hedging strategy with structured derivatives to face the foreign exchange risk.

Other types of risks. Besides the previously mentioned risks, proactive treasurers must monitor also other sources of uncertainty such as liquidity and operational risks. Liquidity risk refers to the lack of funds' availability when they are needed to cover payment obligations at the due date. In particular, treasury should avoid to use external debt while some cash surplus is locked-up in illiquid investments. In order to help managing liquidity risk, a sound Investment policy must clearly define the correct proportion of investable operating and strategic cash and the maximum term of their investment duration. Furthermore, companies should also manage operational risk when investing. It refers to the errors occurring when executing the business operations and includes a broad categories: personnel risk, fraud risk, information risk, legal risk, physical and environmental risk,… Basel II[43] defines the operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events".

3.2 Treasury Centralization

The rapid shift of economic growth and activity from Developed markets in North America and Europe towards emerging areas in Africa, Asia and Latin America has placed greater emphasis on the importance of enhancing treasury performance. For those corporations which have extended their businesses within the international framework, many professionals[44] identify the best liquidity management structure in the centralization system. The ideal model requires to centralize: the policy setting, decision making and execution phases at the company's headquarter. However, firms that have chosen to consolidate their treasury functions have implemented the pattern in various ways. Some have preferred to concentrate those activities in a single location from which all the subsidiaries are directly controlled; others have decided to maintain treasury still as a single operation, assigning the main power to key central treasurers, but allowing for greater support and flexibility the regional treasuries.

The first shared service centers were developed by American corporations at the end of the 1980s, with the purpose of maximizing the investment and borrowing strategy.

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[43] www.bis.org/publications

[44] Tim Hesler, Kevin Laczkowski, and Paul Roche, November 2011, *Five Steps to a more Effective Global Treasury*, McKinsey & Company

Nowadays, multinational companies have become aware about the competitive advantages achievable thanks to a centralized treasury system and seek to accomplish it. Concentrating the liquidity structure ensures higher efficiencies in terms of cost savings and efficiency gains: by improving the working capital management through a better allocation and use of cash, resulting in a lower cost of debt and an enhanced return on equity invested; and by reducing the number of bank accounts, resulting in fewer transaction fees and operating costs. Furthermore, centralizing treasury function provides greater transparency and access to real time information across very distant geographical areas and many entities. As a consequence, the visibility over the company's cash flows and investment portfolio is intensified, resulting in a more effective management of the overall group inflows and outflows. In addition, in order to comply with the increasingly complex international legislative environment, consolidating such a structure ensures the opportunity to achieve standardized and unified processes within the whole group architecture for all the participating entities. Other benefits include centralized expertise, which delivers better efficiency in terms of quality and timeliness and higher compliance to the corporate strategy thanks to more concentrated decision-making.

When corporations decide to pass from decentralized to centralized system, there are several critical factors to consider in order to ensure a smooth transition. Firstly, it is essential the support from executive managers in providing all the necessary resources and coordination between the center and peripheries, as well as advanced technological platforms and infrastructures, such as the enterprise resource planning (EPR) system. Secondly, corporate managers must involve regional and local financial personnel, whose knowledge about local markets, players and regulations is crucial to preserve the acquired competitive position. Lastly but not least important, firms must search to establish the right banking relationships on a global, regional or local basis depending on the specific requirements.

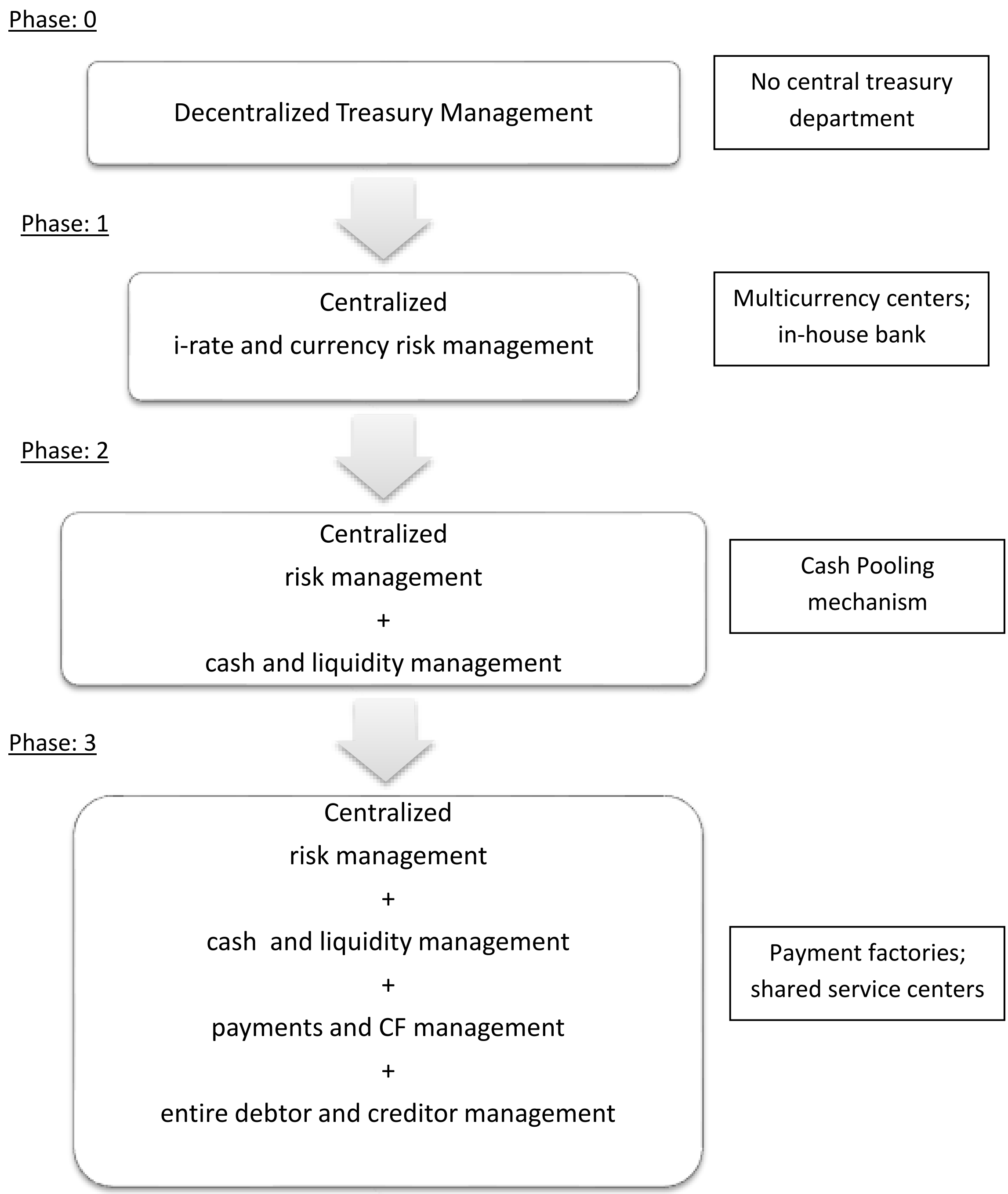


Fig. 3.1: Three Phases of the Centralization of Treasury Management

As with every strategic approach there are substantial costs in developing a fully centralized treasury. They must be carefully analyzed in the light of the corresponding benefits. In practice, there are three sequential phases[45] of the centralization treasury process: centralized foreign exchange and interest rate risk management; concentrated cash and liquidity management; and fully centralized business transactions including all group inflows and outflows. The description of each stage follows below.

[45] Petr Polak, November 2010, *Centralization of Treasury Management in a Globalized World*, International Research Journal of Finance and Economics, No.6

3.2.1 First Phase of Centralization

The first action to undertake in order to establish a centralized treasury concerns the creation of a central treasury department, which is responsible to perform two main functions: interest rate and foreign exchange risk management for the whole organization. There are two typical types of central treasury department: multicurrency centers and in-house bank.

A multicurrency center is a concentrated account set up in a single location rather than in the country of origin of each operating currency, into which funds flow from the subsidiaries' accounts. Periodic transfers to and from central treasury occur at scheduled intervals or when cash is available. Several tasks are accomplished by a multicurrency center: short-term funding and investment plans, long-term funding programs and inter-company netting. However, its most important activity, which represents the reason of its creation, is to manage cross-currency exposure for the entire group. In this way the responsibility of hedging against foreign exchange and interest rate fluctuations is transferred from the local treasuries to the central department, where key employees oversee and run international deals. The multicurrency center option is usually preferred by companies that operate in a range of different currencies and want to organize the centralized cash management activities separate to the in-country specific operations[46]. It enables to concentrate the overall liquidity in one central location, ensuring a better administration of group liquidity, as well as to minimize operating costs by establishing a more effective payment organization. Corporations that have chosen this system have achieved important improvements in their liquidity structure.

The complementary step to start a treasury centralization process is the installation of an in-house bank, which acts as a banking infrastructure within the group, providing all the necessary financial services to the subsidiaries, as an external bank does. The most common services offered are: inter-company payments and cross-border transactions, but it can also performs more typical commercial functions such as deposits taker and loans maker. The in-house bank is like a big central hub where the overall liquidity is pooled, while the affiliated entities continue to operate their business locally. The central treasury or in-house bank manages internal accounts of each subsidiary and executes the settlement of inter-company transactions by shifting funds to and from

[46] J.P. Morgan, 2014, *International Cash Management*

these internal accounts. In order to keep track of the movements of all these operations, the in-house bank provides an account statement to each related unit on which recording the cash flows' moves. Instead of holding multiple bank accounts with external partners, the internal activities are organized by the in-house bank, while the external relationships are generally committed to a single global financial institution in order to ensure constant international coverage on business operations. Companies which have adopted such a structure have experienced substantial cost minimization and efficiency gains, thanks to the reduction of banking fees as well as to the more rationale administration of the accounting system. The in-house bank is a powerful tool to realize the treasury centralization also in terms of better risk management. With this approach, subsidiaries can buy and sell in their own currency, obtained from the center already converted, and by doing so they completely transfer the foreign exchange risk to the in-house bank. As a consequence, the cross-currency exposure is fully centralized. In addition, it relieves local treasurers from domestic cash management and foreign exchange hedging, reduces interest expenses and lowers idle cash. Besides these favorable advantages, before establishing this system, multinational firms must carefully consider the specific features of each country in which they invest. The main challenge is represented by legislative restrictions. Since an in-house bank performs all the typical financial services of a banking entity, some legislations explicitly require to satisfy all the corresponding capital requirements. In such cases, corporations which are willing to set up the in-house bank structure can overcome the legislative hurdle by purchasing a bank to perform the task. In general, following a centralization strategy through the in-house bank is a transformation project which involves different business areas and its design should be carefully planned by a diversified team considering the whole corporate structure and its branches.

3.2.2 Second Phase of Centralization

The second stage towards the consolidation process is the centralization of the overall cash and liquidity in a single account, the so called master account, which is located in a single place, typically an international financial center. This mechanism is known as cash pooling and is particularly adopted in practice by firms which extend their business overseas, as a tool to minimize costs and mitigate risks. Generally, multinational companies hold different bank accounts in different currencies and often in very distant locations. Cross-border cash pooling helps corporation to overcome the complexity of some jurisdictional and regulatory barriers that make difficult the portability of funds across national borders. By concentrating all the available financial means within the header account, treasurers can consistently increase the visibility over the total group balance and extend control over the liquidity structure. As a consequence, they collect a greater volume of information and data that can be employed to improve the future cash flows forecasts, resulting in more possible investment opportunities.

International firms have two primary purposes in pursuing cash concentration: associating cash to maximize the availability of internal sources of capital; and making financial more effective to internally offset cash deficits with cash surpluses by shifting money from one subsidiary to others. Within this framework, the additional benefits achievable through the use of cash pools can be extended to: centralized decision-making, implemented control over financial position and reduced operating costs. It is important to remind that cash pooling is a banking service, so usually there is a big international financial institution that assists multinational companies in developing the pooling system. In practice, two main methods are applied for cash concentration: real cash pooling and notional cash pooling.

Real cash pooling is based on the physical movements of funds from the participating accounts to the master account at the end of each working day. This money transfer can follow two opposite directions: upstream transactions when funds are swept from the members' accounts to the central treasury; and downstream transactions when financial resources pass from the top-mother account to the operating accounts. These movements of funds between subsidiaries are generally treated as intercompany loans. This mean that the surplus in a participating account automatically becomes a loan to the holding company. The financial resources remain an asset on the subsidiaries' balance sheets, but restated as note receivable. The inverse procedure works as well. When a subsidiary experiences a deficit on its account it obtains an injection from the central treasury, to which the participating entity pays an interest. The fundamental target to achieve for pooling is the optimization and use of surplus that was previously dispersed across the globe. In a physical cash pooling system treasurers can choose to operate in three different ways depending on the financial agreement defined in the Investment policy: zero balancing, target or constant balancing. In a zero balancing system, the most commonly employed, subsidiaries' accounts have automatically zero balances at the end of each working day, since all the money flows to the central account. When deficits arise the member accounts are refunded by the central treasury accordingly. For the target balancing upstream transactions occurs a similar mechanism at daily intervals, leaving participating accounts with a zero balance. Then the transfers of funds follow the opposite route to constantly maintain the pre-agreed target balances. In a constant balancing only the surplus cash moves from the operating accounts to the leader account, since the former must always maintain the predetermined threshold. Real cash pooling encounters some difficulties in countries whose legislations prohibit the unrestricted cross-border movements of funds, as in the case of Brazil, China, India and Korea[47].

In a notional cash pooling scheme no physical movements of cash flows between corporate entities is involved. For this reason, it is also known as fictive concentration. Subsidiaries continue to manage their accounts independently and retain funds within their own accounting statements. However, the balances are theoretically combined by the central treasury for the purpose of interest computation. Because of its simplicity, notional pooling is the technique generally employed for single currency pools in a country where a company holds several member accounts. The point radically changes if considering multinational enterprises with multicurrency cash pooling. When this structure is adopted by firms which operate in an international environment, money remains in the country in which the participating entities hold their accounts. Due to an ongoing speculation about certain riskier countries, proactive treasurers must consider the potential impact of the specific country risk on the funds' stability in that particular location, in order to avoid local currency devaluation (as for example when overseas transfers of cash were blocked in Cyprus, in March 2013[48]). On the other hand, real cash pooling thanks to the physical shift of funds between company's accounts reduces such a risk. In addition, sometimes notional pooling must deal with adverse regulations. Since it involves the combination of funds only on a fictive basis, some local authorities may interpret this differently. For this reason notional cash pooling is not allowed in all countries (Germany and USA are only the most notable examples where it is not permitted[49]).

[47] Susan Hillman, March 2011, *Notional vs. Physical Cash Pooling Revisited*, International Treasurer
[48] HSBC Global Asset Management, 2014, *The Treasurer's Global Guide to Investing Cash 2014*
[49] Susan Hillman, March 2011, *Notional vs. Physical Cash Pooling Revisited*, International Treasurer

3.2.3 Third Phase of Centralization

After the centralization of foreign exchange and interest rate risk management as well as the concentration of liquidity within the central structure through the use of cash pooling, the final step to achieve a fully centralized treasury function is the consolidation of the whole business transactions. This process is realized through two different mechanisms: payment factories and shared service centers. Both of them are advantageous for companies that manage large volumes of money in different currencies, especially when among the set of the held currencies some are subject to appreciation while others to depreciation. The aggregation of liquidity allows to minimize cross-currency risk exposure and maximize the availability of funds. Furthermore, the centralization of all business transactions is particularly useful for firms with subsidiaries dispersed across the globe, which simultaneously may experience cash surpluses and deficits in different regions. Here, the payment factory and shared service center consent to offset the balances within the group without employing external debt.

A payment factory is a central business entity that collects all the incoming and outgoing payments of a group. It can be established either as a physical facility or a virtual electronic system. In both cases by centralizing all the payment orders, a company can consolidate the internal standard accounts and mechanisms for processing transactions from a single location, in order to obtain unified procedures in all the subsidiaries. Once that the payment factory has collected all the group orders, it is responsible to handle the relationships with the network of external banks on behalf of the entire group. It may also organize and manage all the intercompany transactions among the operating entities by executing netting or in-house operations. The payment factory acts as a great hub where all payments are concentrated, allowing central treasury to exercise a full control over liquidity, cash flows and other operational issues. By monitoring all the foreign business operations, this system helps to minimize the foreign currency risk and simplifies the process for the subsidiaries, since their exposure is fully transferred to the center. In addition, this is a powerful tool also to increase cost reduction, because it enables firms to considerably lessen banking fees, thanks to the fact that the participating entities do not need any more to directly interface with financial institutions, but they just continue to hold internal accounts with the central treasury or payment factory which becomes the principal agent for external connections.

The shared service center is an independent business unit responsible for the centralization of all accounting and administrative tasks. Its core function is the account payable and account receivable management, so it is an extension of the payment factory which is just designated to gather and execute payment orders. The first structures were developed by American corporations at the end of the 1980s as a way to maximize the availability of internal sources of capital to finance strategic investments. Nowadays, establishing a shared service center takes time and several stages. At the beginning, it operates like a payment factory collecting all the group orders, only later with additional investments it extends its functions and is transformed in a fully centralized shared service center. However, this path requires numerous investments especially in terms of trained employees and advanced technology. During the transition process from local to central treasury, companies need to retain key staff by offering additional compensations like bonuses to the ordinal remuneration, in order to avoid losses of expertise and knowledge, difficult to be replaced. On the other hand, firms must implement their technical infrastructure to achieve more sophisticated reporting systems. While cost savings is the initial driver to set up shared service centers, this structure provides further advantages for financial supply chain management and resources optimization by allowing greater visibility over liquidity, control over payment timing and more effective collection of cash in the entire group.

3.3 Decentralization Model: Regional Treasury Centers

In a typical decentralized environment a company allows its subsidiaries to manage all the aspects of their business. The general model includes a global treasury center from which instructions and guidelines about the firm's strategy and policies are sent to all the operating entities. The corporate headquarter is supported by one or more regional treasury centers located in key markets where the company holds its main strategic investments. As the group experiences international growth, firms can decide to expand the decentralized approach by establishing local payment factories and foreign exchange centers[50]. The regional treasury centers run the core treasury functions: asset and liability management, sales and trading of currency as well as financial risk

[50] John Herrick and Michael Gallanis, February 2010, *The Pros and Cons of Treasury Centralization*, Treasury Strategies

management. Some authors[51] (Zink and Griffiths, 1995) defines regional treasuries as the "vehicle increasingly considered by multinational companies to assist in offsetting financial costs and risks of multiple currency/location international businesses". These services are provided to the participating entities situated in different regions than the corporate center. This liquidity structure offers higher flexibility compared to the centralization process, allowing the subsidiaries to independently manage foreign transactions. By exploiting the knowledge and expertise about local environments, competitors and regulations, they can choose the most appropriate hedging instruments, offsetting in this way the lack of a centralized cross-currency exposure. From this perspective, it is important to strategically organize and divide the operational duties between global and regional treasury centers, in order to avoid redundancies and so additional operating expenses within the whole organization. Typically, due to the proximity to the local markets the execution tasks are driven by regional treasury centers, while the accounting reports and risk control are centralized at the group level.

When multinational companies select the decentralized treasury system to manage the overall group's liquidity, the most critical decision that will affect the future success concerns the location of the regional treasury centers. The most important factor to consider is the underlying tax environment[52]. Treasurers must focus their attention not only on taxes computed on the realized earnings, the corporate tax, but also on the total tax contribution that the firm owes to the state, including: withholding tax on interest, dividend and royalties; prices for foreign incoming and outgoing payments; thin capitalization rules; value-added tax; and double tax treaty agreements. In addition, there are other crucial elements to carefully analyze when building up regional treasuries such as: political stability and legislative framework; geographical criteria about distances between subsidiaries placed in different regions; availability of qualified and trained employees; well-integrated and liberalized financial markets; currency environment; and technological infrastructure as well as developed communication networks. A powerful tool to investigate the feasibility of a place to establish a local center is the rating comparison among a set of countries located in the same time zone that represent potential alternatives. Through rating analysis corporations can measure

[51] W.J. Zink and S.H. Griffiths, 1995, *US and Foreign Tax Implications of International Treasury Centers*, Corporate Cash Flow Magazine, Vol. 16, No.4

[52] Petr Polak and Rady Roswwanndy Roslan, May 2009, *Location Criteria for Establishing Treasury Centers in South-East Asia*, Journal of Corporate Treasury Management, Vol. 2

the business atmosphere and financial outlook of a country in terms of its overall liquidity and solvency. Furthermore, reliable information and data can be drawn from macroeconomic indicators to assess the prevailing local corporate culture and the banking sector quality. A modern and effective banking system along with a dynamic competitive landscape which includes both domestic and international banks is considered an attracting factor for the placement of regional treasuries.

The first decentralized models were developed by American and European corporations in Developed countries where the positive combination of financial market conditions, advanced infrastructure and skilled workforce supported the creation of local pooling centers. As the globalization process increased the integration between international markets, while these areas still remain appealing, many corporations sought to install local treasuries especially in emerging countries like China, India and Brazil, where substantial advantages from both cost and strategic perspectives can be achieved. Although with some variations from region to region, these high-growth nations offer relatively favorable cost structures, high technological systems, vibrant financial markets as well as appealing economic growth rates that capture the attention of international groups. Within this framework, it is interesting the Asia Pacific case.

During the Asian financial crisis of 1997-98 global treasurers faced several challenges with higher country risk profiles, due to rising interest rates, and they were forced to deal with a sharp devaluation of the major local currencies[53]. After the recovery period, the whole region experienced a new growth era and local centers started to emerge as international logistic hubs for those multinational companies which had extended their operations abroad. Early regional treasury organizations were established in Singapore and Hong Kong due to the availability of expertise, advanced infrastructure and English language, the dominant communication tool in Finance. Following this path, numerous Asian countries started to revise their legislations and open their economies by issuing regulation reforms to allow international enterprises to build up their subsidiaries for treasury function. In particular, China and its major financial center Shanghai, thanks to the opening of its banking industry in 2006[54], started to attract significant volume of foreign investments from corporations whose main headquarters were located in

[53] P. Wong, 2007, *The Reinvention of the New Asia*, included in HSBC's Guide to Cash and Treasury Management in Asia Pacific 2007
[54] M. Leung, 2003, *How to make your mark on China*, The Treasurer

Developed countries and that began to set up regional treasuries in this area. Contextually, in order to compete with the existing local establishments, also the other emerging countries started to improve their internal environment in terms of regulation applicable to foreign investors and recently they have become an attracting choice for those firms that want to decentralize their treasury operations.

It is not possible to define what is the most profitable model among the centralized versus decentralized treasury, since every company must select the most appropriate option according to its own organization, business and operational functions. However, from a practical point of view it is possible to observe that many companies still remain loyal to the assumption "domestically centralized, internationally decentralized"[55]. This means that they prefer to centralize the treasury function in their country of origin, where it is possible and easier the cash pooling with a single currency. On the other hand, for the overseas transactions they delegate the responsibility for cash management and other financial tasks to the subsidiaries' controllers when a multicurrency cross-border pooling would be more complex. In such cases, what is essential is the standardization and automation of the internal payment system across all the participating entities to avoid incorrect processing and data redundancy. In addition, since the subsidiaries drive and manage the core treasury functions, local treasurers must be well-prepared and trained about the regional cash and risk position to correctly and periodically report information to the corporate headquarter.

3.4 Outsourcing the Treasury Functions

The general dilemma is to centralize or decentralize the treasury system. However, when with both the alternatives no further cost reductions are achievable, multinational companies can decide to outsource the treasury function. This means removing the process from the internal structure and assigning its execution to external service providers. There are several reasons behind the outsourcing decision. Most of the time corporations are willing to outsource in order to concentrate their attention on the core strategic business, leaving the operational tasks to outsider professionals. Furthermore, they can take this decision to avoid the expensive investments in technology and infrastructure that an in-house treasury would require. Alternatively, they want to obtain

[55] Stephen Baird, 2007, *Five Trends Transforming Global Treasury*, Treasury Strategies Inc.

more professional and detailed approach from specific service providers in order to achieve superior results. When firms decide to outsource due to the lack of internal expertise and skills the future performances can be compromised. In any case, companies must have the basic knowledge about treasury operations to handle internally the most critical processes or alternatively, to be able to manage the services provided by the external partner, in order to ensure greater protection towards corporate interests.

When considering the outsourcing alternative managers often debate about which treasury functions are better to remove from the internal organization. The discussion involves core versus non core competencies. Core competencies are those activities able to create unique competitive advantages and to produce added value. Instead, non core competencies indirectly affect the business growth and expansion without realizing any income. From this perspective, it is easy to understand as practitioners prefer to outsource non core competencies such as: cash pooling and netting, foreign exchange transactions and payment processing.

The decision to displace specific tasks from the treasury function must be carefully considered and a high degree of analysis is required in selecting the external partners, since the relationship will be established in a long-term horizon. Firms have two different possibilities: selecting a bank service provider or a specialist company. The choice is usually driven by several factors: the analogies between the company's culture and philosophy with the ones of the partner to assess the degree of compatibility; the nature of the business to outsource to pick up the provider with the highest qualification in the industry; the need to customize the service to better match the future expectations; and the range of world-class service offered by the partner. This last point is particularly important for those international groups with subsidiaries dispersed across the globe which need worldwide coverage.

CHAPTER 4: EMPIRICAL ANALYSIS

The fourth chapter aims to present and describe the quantitative analysis performed on the basis of the theoretical background detailed in the previous chapter, as well as to interpret the related outcomes. It can be divided in three main sections. The first one introduces the research approach and illustrates the purposes that lead the investigation process, by describing the selection criteria used to choose the experimental units and gather qualitative and quantitative data; and by taking into account the two most important methodological problems encountered in every scientific research: the reliability and validity of the collected data. The second part focuses the attention on the core analytical process, by describing the final sample; formulating the underlying hypotheses; and presenting the regression model employed in the study. The third section displays the empirical outcomes and closes the chapter with the resulting implications. What is essential to remember is that the core focus of the whole work is represented by the analysis of the BRICS area, while the Developed markets are just considered a basis for comparison in order to deeper investigate the topic.

4.1 Research Approach

The primary purpose of the current study is to determine what Investment policy is more value-creating for the acquiring entities from a growth perspective, according to the location where deals are executed: BRICS or Developed countries. The goal is to evaluate the optimal choice for multinational companies between retaining or distributing the realized earnings whether they perform M&A activity in BRICS or advanced markets. Following the theoretical background described in the previous chapter, the focus is concentrated on the retain-and-reinvest approach as a source of value creation for the firms and so the most relevant predictor variable is assumed to be the Retention ratio. The research has been established on two different but connected levels. Firstly, it seeks to explore the main effect by defining the type of influence that flows among the independent variable, the Retention ratio, and the dependent variable, the growth rate expressed in terms of sales volume, within the context of an international strategic acquisition or merger. Simultaneously, it is included in the analysis a moderator to develop the 2-way interactions, which is represented by the place where the cross-border transactions occur: BRICS or Developed countries. It aims to investigate whether the retain-and-reinvest approach is more profitable for corporations with subsidiaries in the BRICS or advanced nations. From the obtained results, it can be drawn several implications to determine which liquidity structure is preferred by international groups to manage the realized earnings and use them as the primary source of internal financing to fund strategic projects such as acquisitions or mergers. It is not possible to define just from a theoretical point of view which is the most valuable model among the centralized versus decentralized treasury, because every company must select the most appropriate option according to its own organizational design, underlying business, operational functions, but most of all subsidiaries' location. Since this thesis is built up around the dualism BRICS-Developed countries, the following analysis will also provide some suggestions about the most profitable cash management technique to employ by the operating units located in BRICS countries. In this case, the liquidity structure is considered a fundamental vehicle to help increasing the overall group's profitability, thanks to the efficiency gains and cost savings that it implies.

After having clarified the underlying purposes that will lead the investigation process, the first step of this quantitative study consists in collecting a reasonable amount of data, in order to create a sound database. This is obtained according to specific criteria used in selecting the experimental units that create the balanced sample. In order to verify the accuracy of the employed methodology, it is necessary to consider two complementary aspects, which are fundamental cornerstone of the scientific research: reliability and validity. Once that the data have been collected and the sample has been drawn, the next phase entails the core statistical analysis, which is undertaken by employing the multiple linear regression 2-way interactions with the fixed effects model with robust standard errors. It is done by using the software STATA which gives back the empirical findings as a result. The description of this process follows below.

4.1.1 Data Collection

Collecting data represents the starting point for any quantitative research, because they constitute the ground on which building the whole analysis. For the current study, they were collected with the purpose of creating an almost balanced sample to ensure an evaluation as possible unbiased between deals occurred within BRICS countries by foreign companies and transactions undertaken in Developed countries. Seeking to obtain an equal number of each type of experimental units is essential to achieve balance, which is a guarantee of fairness in a statistical examination. The research is directed towards two distinct targets: on one hand firms who have done international transactions exclusively within BRICS countries and at the same time that do not belong to this region; on the other hand, enterprises who have planned and executed M&A activity only in Developed countries and may belong to this area. This dichotomy aims to find out which of the two different environments could employ in a more advantageous way the retain-and-reinvest policy concerning the realized profits. The investigation process observes the following criteria in collecting data.

- The acquiring companies are divided into two mutually exclusive categories: the first group is represented by international firms which have done mergers and acquisitions only with a target located in the BRICS without belonging to them. The second set is composed by international enterprises which have carried out deals only within Developed countries and they may belong to one of those. This strict division enables to identify which of the two selected locations has experienced the positive relationship between the Retention ratio and the actual change of the growth rate expressed in terms of sales volume.

- The adopted time frame refers to international deals that were executed between 2005 and 2013. It was a well-conceived choice because since 2005 lot of countries around the world embraced the adoption of the International Financing Reporting Standards (IFRS), designed to establish a common global language for business affairs, allowing to understand and compare corporate accounts across international boundaries. While on the other hand, the year 2013 was chosen as the ending point because data of 2014 are not completely available for all companies yet.

- The buying companies chosen for this study are all public corporations listed on an international stock exchange (no restriction about its location), at list during the occurrence of the deal, without considering future possible delisting. This parameter allows to take into account companies that provide a considerable amount of data due to their disclosure requirements and that follow similar standards in accounting practice recognized at an international level, even if with some local differences. Instead, the targets are not required to own a public status since the focus of the research is upon the wealth increase from the buyer's perspective.

- The purchasing companies have been selected from the most relevant industries in the global marketplace: nutrition, luxury, automotive, electronics, petrochemical, telecommunications, retail and textile, metallurgic, entertainment as well as aviation. It was decided to omit the banking and insurance sector, because it generally follows specific rules in accounting practice, especially for capital requirements. In addition, the selected enterprises occupy top and leading positions within the corresponding industries, according to the worldwide ranking provided by international sources.

- The acquiring firms have adopted the International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) to draw up their financial statements. This parameter allows to easier understand and compare the corporate accounts of companies from different legislations that pursue an M&A activity beyond their national boundaries.

- The targets and the acquirers do not necessary belong to the same industry. This criterion enables to consider both mergers and acquisitions that take place in related or unrelated sectors, in order to include international firms which have undertaken a diversification strategy as well as enterprises which have followed a focus strategy.

Both quantitative and qualitative data are used to perform the analysis. All the collected information refers to secondary data, since they were already available and were gathered by several reliable Bureau van Dijk databases. The list of merger and acquisition activity was obtained from Aida and Osiris, which also provide the accounting and share price information about the acquirers. On the other hand, data about the specific features of the deals were extrapolated from Zephyr, which contains the description about the nature and type of the acquisition, the country of incorporation and the amount of transactions performed by the same firm. However, some data were not available from the previous sources, so an additional support was represented by DataStream, especially to find out information about market share price, indices and returns.

Following this path, the process led to the creation of an almost balanced sample for a total of 310 observations. Concerning the sample there is a problem of selection bias, since it was not randomly selected but rationally composed. This choice, even if can be considered a limitation, aims to be functional with regard to the study, whose purpose is to focus the attention on evaluating where the M&A activity has realized the highest growth as a consequence of a particular Investment policy adopted, whether within BRICS or Developed countries. In addition, it is important to underline that the final sample has experienced several changes during more advanced stages in the analytical process respect to the beginning, because of the removal of all incomplete observations that missed any accounting or share price information.

4.1.2 Reliability

Reliability is the ability of generating the same results by replicating the study under similar conditions and with the same methodology. Joppe[56] (2000) defines reliability as: "…the extent to which results are consistent over time". This idea implies the stability of the approach used to perform the analysis. A high degree of stability indicates a high degree of reliability, which means in turn that the final outcomes are potentially repeatable. In order to see if the current thesis can be deemed reliable, it is necessary to consider two aspects: the way through which data are collected and the methodology used.

The information was gathered by accurate databases such as Aida, Osiris, Zephyr and DataStream, which are commonly employed by practitioners to accomplish their empirical studies. In addition, to further verify the precision of the research, some observations were cross-checked from different sources and the achievement of the same results was a proof about their stability. Furthermore, several data come from the corporate official financial statements which should be prepared according to well-defined accounting standards and are subject to specific disclosure requirements, which contribute to a higher reliability.

[56] Marion Joppe, January 2000, *The Research Process*

The other perspective refers to the accuracy of the analytical approach used to conduct the research. It was chosen the multivariate linear regression 2-way interactions with the fixed effects model with robust standard errors, run by the statistical software STATA which employs the OLS technique to compute the coefficients. Since this program is generally used in practice by researchers to quickly perform quantitative analysis, the corresponding outcomes can be considered reliable.

4.1.3 Validity

Validity along with reliability is a fundamental cornerstone of the scientific research and it includes two different aspects: internal and external validity. Joppe[57] provides the following definition: "Validity determines whether the research truly measures that which it was intended to measure or how truthful the research results are". It implies verifying that the tools used for measurement are accurate and fit the research objectives.

Internal validity refers to how well an experiment is done in defining the specific criteria used to select the experimental units, in collecting data and performing the analysis. With reference to the current study, it can be considered internally valid since all the information is gathered from the same databases and is analyzed following the same regression model. Although some observations were omitted due to the lack of accounting or share price information, the final sample remains almost balanced and quite representative to consider the study valid.

The other perspective, the external validity, applies to the possibility of generalizing the empirical findings to broader groups and populations for the same time frame taken into account. On average, the results of the study can be extended to other deals undertaken in BRICS countries for the findings relative to the former and to Developed countries for the findings concerning the latter. This is possible because all the experimental units occupy a leading or relevant role within the corresponding industries and they can be deemed a representative sample for the other players. Instead, for other groups of countries, even if closed to the reference areas, during different periods the outcomes of this thesis cannot be generalized due to different economic, financial, political and social conditions that affected the corresponding internal environment.

[57] Marion Joppe, January 2000, *The Research Process*

4.2 Analysis

The analytical process is based on different steps. The first action that a researcher performs consists in defining the research question from which it is possible to draw the hypotheses that will lead the quantitative study. Once that the hypotheses are formulated, it is presented the final sample on which the study is performed and is chosen the statistical model to adopt. Nowadays, the empirical analysis is generally run by advanced software and programs based on the preselected statistical models. For the purpose of the current dissertation, it has been applied the multiple linear regression 2-way interactions with the fixed effects model with robust standard errors and it has been used the software STATA. The choice of the model is based on the nature of the study, since the regression analysis is the most appropriate tool to explain the relationship between a dependent variable and an independent variable. After the description of the model, are presented and described the final outcomes as well as the implications that they entail.

4.2.1 Hypotheses

The proposed dissertation is based on the following research question: *"Whether or not a higher Retention ratio is meaningful to explain a higher growth rate within the subsidiaries located in BRICS countries between 2005 and 2013?"*. It aims to determine what Investment policy is more value-creating for the acquiring entities from a growth perspective, according to the location where deals are executed: BRICS or Developed countries. The research question stresses the attention on three main elements. Firstly, it identifies the presence of a relationship between the Retention ratio and the growth rate, respectively the independent and dependent variable. The nature and direction of this relationship will be found out by the empirical analysis. Besides this main effect, a key role is played by the location where deals occur, BRICS or Developed countries, which crucially affects the final outcome. This additional influence is called interaction effect. Secondly, the research question outlines a specific time frame to consider: they must be taken into account only those international transactions that took place between 2005 and 2013. This has been elected an important selection criterion in building the sample. Lastly, the previous statement reminds that the whole work must be observed with the perspective to validate the generally accepted principle by both authors and practitioners, according to which cross-border mergers and acquisitions represent a value-creating opportunity for firms.

In light of the preceding research question and after having clarified the dependent and independent variables, now it is possible to formulate the hypotheses that illustrate the main issue of the research and its direction. In this case, since there is a main effect which is influenced by an interaction effect, two different but related hypotheses must be stated.

The core: Retained Earnings reinvested by companies create value.

1. *Hypothesis*: Retention Ratio is positively related to the subsidiaries' Growth Rate.

2. *Hypothesis*: The execution of M&A deals in BRICS countries is a condition that positively moderates the relationship between the Retention Ratio and the subsidiaries' Growth Rate.

A continuing debate within the investment community concerns the investigation process about the relevance of the realized earnings and their two basic components, retained earnings and distributed earnings, in determining the primary source of value for a Company, essentially measured and reflected by its share price. Dividend distribution is considered important in order to ensure shareholders satisfaction, since this allocation represents what stockholders actually receive from the firm as the return of their previous investments. However, Modigliani and Miller[58] (1961) argued that the underlying source of value for the corporate share price was represented by earnings, not dividends. Although they developed the irrelevance dividend theory under several specific assumptions (perfect capital markets, rational behaviors and perfect certainty about future results), it continues to hold also in an uncertain environment, when removing the previous suppositions. Within this framework, the best option is to retain earnings and reinvest them in strategic projects that offer a superior internal rate of

[58] Franco Modigliani and Merton Miller, October 1961, *Dividend Policy, Growth, and the Valuation of Shares*, The Journal of Business, Vol. 34, No. 4

return compared to other alternatives. The current study follows this perspective and assumes the retained earnings as the major source of a firm's growth[59] (Chasan, 2012).

Retained earnings refer to the portion of a company's profit that is internally retained in order to be invested in future strategic projects such as mergers or acquisitions, instead of being distributed to shareholders as dividends or for share repurchase. Lazonick[60] (2014) remembers that the retain-and-reinvest approach for funds allocation within an organization was adopted for the first time by major US corporations from the end of World War II until the late 1970s, in order to fuel further expansion, in an attempt to achieve sustainable prosperity. Following this path, other international companies recognized soon the advantages achievable through this approach and how funding the firm's growth through retained earnings could be a powerful strategy. It does not raise any concern on the corporate debt profile, avoiding to have additional expenses due to principal repayment and/or periodic coupons. In addition, this conservative option allows executives to maintain the full control over the entire business, rather than involving outsider investors, such as creditors, that may extend their influence over the ongoing operations[61] (Decker). Furthermore, some authors[62] (Khan and Ali Shah, 2012) highlight how the portion of the reinvested earnings within an enterprise provides a more meaningful contribution in order to reach a stable long-term profitability and in turn results in a higher share price, one of the most common measure used to asses a company's value. It follows that earnings retention directly contributes to share price appreciation. It also determines the level of a firm's investment and its future growth[63] (Charles, 2010). Besides to the previous financial and economic benefits, profit retention plays a key role also in creating value for the company's shareholders. Retaining earnings creates incremental value to the overall company and as a consequence to the existing stockholders, which should select as a first choice the retain-and-reinvest approach to obtain additional profits. A strong supporter of this

[59] Emily Chasan, July 2012, *Mid-Size Firms Tap Retained Earnings to Fund Growth*, The Wall Street Journal
[60] William Lazonick, September 2014, *Profits Without Prosperity*, Harvard Business Review
[61] Fred Decker, *Pros & Cons of Financing Expansion Through Retained Earnings*, Small Business by Demand Media
[62] Allah Bakhsh Khan and Syed Zulfiqar Ali Shah, February 2012, *The Impact of Retained and Distributed Earnings on Future Profitability and Stock Returns in Pakistan*, International Research Journal of Finance and Economics, Issue 84
[63] S. Charles, 2010, *Explaining Persistent Cycles in a Short-run Context: Firms' Propensity to Invest and Omnipotent Shareholders*, Journal of Post Keynesian Economics, Vol. 32

thesis is the famous top manager Warren Buffet[64], whose most notable statement declares: "For every dollar retained by the corporation, at least one dollar of market value will be created for owners". The ability to use cash from the ongoing operations wisely as the major source of growth capital can be considered a sign of good corporate management. In order to have a substantial amount of cash surplus to reinvest within the organization, it is essential to maintain sustainable and repeatable earnings in a long-term horizon. The earnings quality depends on some external factors like macroeconomic conditions and industry environment, but it is also crucially affected by several firm-specific elements such as the underlying business model, adopted accounting standards, corporate governance and effective management to avoid misrepresentations on financial statements[65] (Campbell et al, 2013).

4.2.2 Sample Description

Following the selection criteria previously described, it was created an almost balanced sample for a total of 310 observations, since the same company may have undertaken more than one deal within the same year. The final sample consists of 310 observations. During the course of the analysis it has experienced several changes, especially in more advanced stages of the analytical process, compared to the beginning, due to the removal of all incomplete observations that missed any accounting or share price information.

Table 4.1 presents the distribution of deals over time in terms of number of M&A transactions occurred each year, from 2005 to 2013. It was not possible to consider also the corresponding deal values, because of the lack of information which affected several observations, whose values were not disclosed. It can be observed that the occurrence of deals over time follows the sixth merger wave pattern. The years with the greatest activity are: 2005 (15,16% of total deals), 2006 (15,48% of total deals), 2007 (13,23% of total deals) and 2008 (13,55% of total deals). This dynamism within the international framework can be explained as a result of the sixth merger wave. It was characterized by a great potential from the buy-side perspective, due to the huge availability of liquidity and cash on corporate balance sheets. In addition, during this period another

[64] Richard J. Connors, December 2009, *Warren Buffet on Business: Principles from the Sage of Omaha*, John Wiley & Sons Inc.
[65] Ilia Dichev, John Graham, Harvey Campbell and Shiva Rajgopal, December 2013, *Earnings Quality: Evidence from the Field*, Journal of Accounting and Economics, Vol. 56

factor played an important role: shareholder activism. Specialized activist equity holders attempted to influence management's decisions in order to pursue growth strategies based on strategic acquisitions and mergers. Furthermore, the Golden Age of private equity funds (2003-2007) contributed to enhance the M&A activity. As a result, the concentration of deals over time is particularly clear in 2005 and 2006, the core phase of the sixth merger wave. However, the decline of this positive trend is evident especially in years 2009 (10,32% of total deals) and 2010 (8,07% of total deals) due to the burst of the global financial crisis. As a consequence, the international economic downturn generated a credit crunch, resulting in a reduction of credit availability that halted the merger and acquisition intensity. Starting from the year 2011 (11,94% of total deals), it is possible to note a recovery in the M&A activity, even if it did not reach the pre-crisis levels. The data collected cannot be considered representative for the year 2013, since some transactions are still waiting for regulatory approval, the final agreement or the conclusion of the closing.

Table 4.1: Sample Distribution over Time

Period	Total Number	% of Total
2005	47	15,16 %
2006	48	15,48 %
2007	41	13,23 %
2008	42	13,55 %
2009	32	10,32 %
2010	25	8,07 %
2011	37	11,94 %
2012	36	11,6 %
2013	2	0,65 %
Tot	**310**	**100 %**

Source: Zephyr

4.2.3 Regression Model

The empirical analysis is performed by employing the multiple linear regression 2-way interactions with the fixed effects model with robust standard errors. An interaction occurs when the magnitude of the effect of one independent variable (X) on a dependent variable (Y) varies as a function of a second independent variable (Z), which is called the moderator[66] (Preacher et al, 2006). This is also known as the moderation effect. The adopted model aims to estimate in terms of sign and magnitude the main effect on the dependent variable of a variation occurred in the independent variable as well as simultaneously the interaction effect of the moderator variable; while the other control variables are held fixed. In this way, it is possible to isolate the impact of the independent variable on the dependent variable and define the relationship that exists among them. The choice of the model is based on the nature and purpose of the study, because the regression analysis is the most appropriate tool to explain the relationship between a dependent variable and an independent variable. In addition, the model provides the regression of Y on X at particular values of Z. The interaction can be between two dichotomous variables, two continuous variables, or a dichotomous and a continuous variable. This dissertation takes into account the moderation effect between a continuous (X) and a dichotomous (Z) variable. In several cases the interaction effect adds benefits to the multiple linear regression model, especially when the main effect does not result significant, because the moderator variable Z allows the regression of Y on X to move from non-significance to significance.

The multiple linear regression 2-way interactions model applies the following formula:

$$Y_i = \alpha + \beta_1 X_{1,i} + \beta_2 X_{2,i} + \beta_3 X_{3,i} + \beta_4 Z_i + \beta_5 \left(X_{1,i} Z_i\right) + \gamma_t + \varepsilon_i$$

With $i = 1, \dots, n$ and identifies the i-th observation within the sample.

Y_i: the dependent variable, represented by the growth rate of the acquirer. It is a continuous variable in the form of a ratio variable. The growth rate is expressed in terms of sales volume. It is computed as the annual percentage change between the revenues of the year immediately following the deal and the revenues of the current year when the deal takes place. It provides an immediate overview of the M&A’s impact on a firm’s size and consequently on its profitability.

$$\Delta g_{sales} = \frac{sales_{(t+1)} - \ sales_{(t)}}{sales_{(t)}}$$

With t = the year when deal occurs

[66] Kristopher J. Preacher, Patrick J. Curran and Daniel J. Bauer, 2006, *Computational Tools for Probing Interaction Effects in Multiple Linear Regression, Multiple Modeling, and Latent Curve Analysis*, Journal of Educational and Behavioral Statistics, Vol. 31, pp. 437-448

α: the intercept, which expresses the expected value of Y_i when $X_{1,i}, X_{2,i}, X_{3,i} = 0$. Graphically, it determines the point where the regression crosses the y-axis.

$\beta_1, \beta_2, \beta_3, \beta_4$: the regression coefficients or slope which are estimated through the OLS technique. They show the relationship among the independent and dependent variables in terms of sign as well as the amount of variation in the dependent variable that would be predicted by 1 unit variation in the corresponding predictor. For instance, β_1 measures the effect on Y_i due to the marginal variation of $X_{1,i}$; keeping $X_{2,i}$ and $X_{3,i}$ fixed.

$$\beta_1 = \frac{\Delta Y_i}{\Delta X_{1,i}}$$

With $X_{2,i}$ and $X_{3,i}$constant.

$X_{1,i}$: the independent variable, represented by the Retention ratio, which is the percentage of earnings kept back in the business as retained earnings. It is a continuous variable in the form of a ratio variable. This predictor variable is manipulated in order to observe the main effect on the change in the growth rate. It is also known as plowback ratio.

$$Reten.ratio = \frac{Net\ Income - Dividends}{Net\ Income} = \frac{1 - Dividends}{Net\ Income} = 1 - Payout\ ratio$$

Z_i: the moderation variable, represented by the location where deals occur, BRICS or Developed countries. It is a dichotomous variable, since it assumes value 1 if the M&A takes place within the BRICS area, otherwise value 0 (Developed countries). Dichotomous variables, in fact, are categorical variables that imply only two categories and are designed to provide a response just about two mutually exclusive alternatives. It intends to measure the interaction effect on the final outcome and how it influences the main effect.

$X_{2,i}$: the control variable, represented by the industry relatedness. It is a dichotomous variable that assumes value 1 if deals occur in related industry (both horizontal or vertical M&As), otherwise value 0 (diversification strategy). Control variables are kept constant in order to minimize and so monitor their effects on the experiment. They represent possible alternative explanations to the ones considered in the current study.

$X_{3,i}$: the control variable, represented by the majority acquisition. It is a dichotomous variable that assumes value 1 if deals entail majority acquisitions (> 50%), otherwise value 0 (= < 50%). Control variables are kept constant in order to minimize and so monitor their effects on the experiment. They represent possible alternative explanations to the ones considered in the current study.

β_5: the amount of change in the slope of the regression of Y on X when Z changes by 1 unit.

$X_{1,i}Z_i$: the product between the two independent variables, the continuous variable $X_{1,i}$ and the dichotomous variable Z_i. It represents the interaction effect.

γ_t: the company fixed effects to control for time-varying heterogeneity, with $t = 1, \dots, T$, since the dataset of the current study is represented by a panel data.

ε_i: the error term. It represents all the other additional factors that influence the dependent variable but are omitted from the equation. Statistically, it is the deviation of the observed values from the true function values. Graphically, it is the distance of an actual data point from the regression line.

Substituting for the previous variables, it is possible to obtain the following formula:

$$\Delta g_{sales} = \alpha + \beta_1 Retention\,ratio + \beta_2 Ind.relet. + \beta_3 Maj.Acquis. + \beta_4 BRICS + \beta_5 (Ret.ratio * BRICS) + \gamma_t + \varepsilon_i$$

The interpretation of the empirical findings obtained from the regression model is developed through the examination of the regression coefficient β_1, which determines to what extent the change in the growth rate can be explained by the corporate Retention ratio, and so how powerful is the retain-and-reinvest approach in an M&A context for the future growth, without considering the location where the transaction takes place. On the other hand, the regression coefficient β_5 explains the interaction effect, by providing more clarifications about the meaningfulness of the retain-and-reinvest policy when deals occur in BRICS countries. The significance level of the entire analysis is given by the p-value of the regression coefficients. If the p-value is lower than the α-level 0,05 there will be a linear relationship between the independent variable and the dependent variable; otherwise, if the p-value is higher than 0,05 the predictor variable will not be able to explain any relationship with the dependent variable and shall be excluded from the analysis because it has no impact. The choice of an α-level equals to 0,05 follows the approach most used in practice by researchers.

4.3 Empirical Findings

The multiple linear regression 2-way interactions analysis, run with the fixed effects model with robust standard errors on the statistical software STATA by employing the OLS technique, produces the following results:

Table 4.2: Quantitative Results

	(1)	(2)	(3)
Intercept	0.115* (0.067)	0.091 (0.102)	0.170 (0.117)
Industry Relatedness	0.012 (0.041)	0.014 (0.041)	0.015 (0.040)
Majority Acquisition	-0.012 (0.031)	-0.012 (0.031)	-0.009 (0.031)
Retention Ratio		-0.044 (0.045)	0.141* (0.080)
BRICS		0.047 (0.101)	0.074 (0.120)
Retention Ratio × BRICS			0.168** (0.084)
Firm Fixed Effects	YES	YES	YES
R-squared	0.4151	0.4177	0.4268

N=310; robust standard errors in parentheses; $^{*}p< 0.1$, $^{**}p< 0.05$, $^{***}p< 0.01$

The multiple linear regression for the entire sample displays a determination coefficient (R-squared) of 0,4268. This means that the variation in the growth rate, expressed in terms of sales volume, as a result of the transactions is by 42,68% explained by the independent variables included within the model. The R-squared is a statistical measure employed to assess the goodness of fit of a model towards a set of observations and it should ideally be as close as possible to 1, meaning that the model is perfectly predicted by the independent variables. Although the outcome is deemed acceptable, a solid argument to justify the absence of a perfect adherence to 1 is the existence of other possible alternative explanations to describe the actual change in a firm's growth rate after a merger or acquisition.

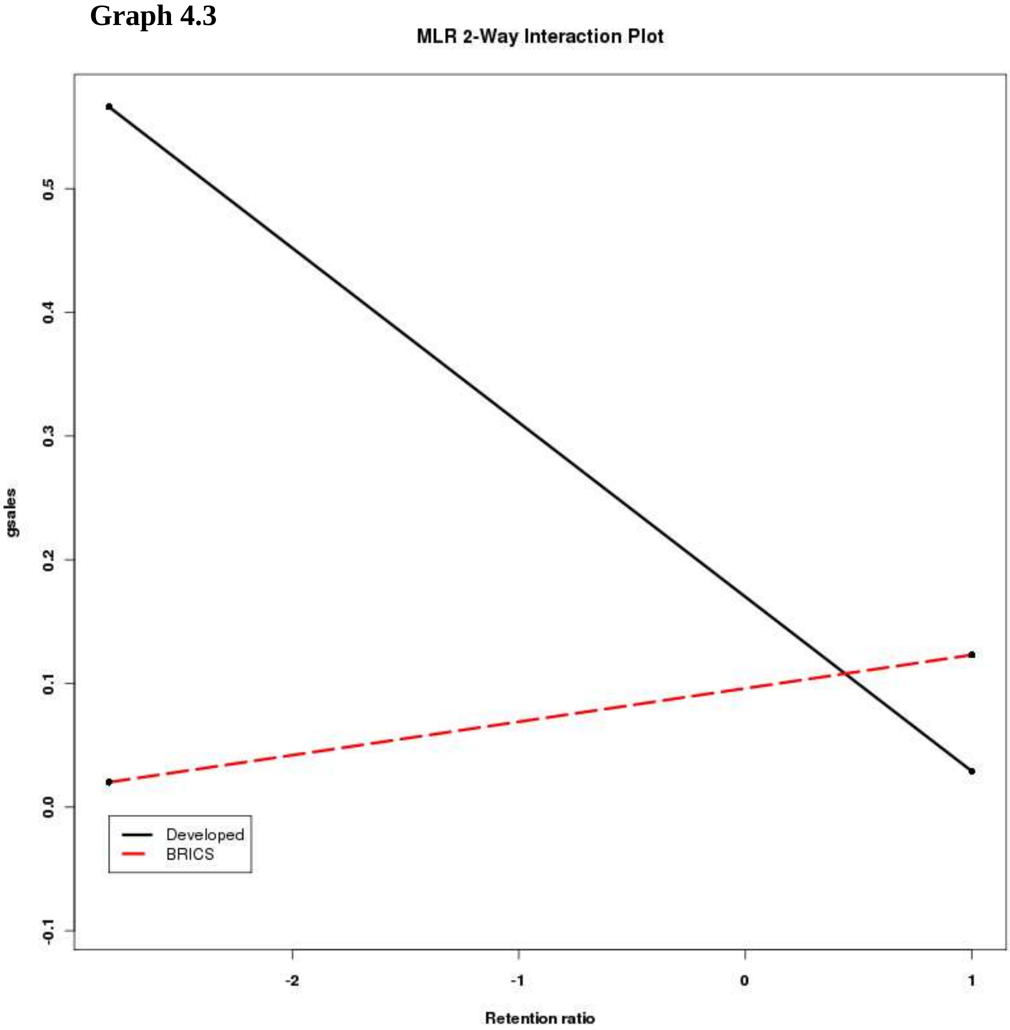
As the evidence shows, it is not possible to define the existence of any relationship between the Retention ratio and the growth rate, expressed in terms of sales volume, since the corresponding p-value (0,079) is greater than the preselected α-level of 0,05 (it would be significant with an α of 0,10). As a consequence, the main effect cannot be considered significant. On the other hand, the interaction effect results significant, because the corresponding p-value (0,045) is lower than the chosen α-level of 0,05. It means that there is a 4,50% probability that the underlying assumption of the moderation effect does not hold. In this case, there is a positive relationship between the Retention ratio and the growth rate for those deals that take place within BRICS countries. The moderation hypothesis is verified. The interaction effect plays a key role in the current analysis, because the presence of the moderator BRICS allows the regression of the actual change in the growth rate on the Retention ratio to move from non-significance to significance. The fundamental determinant to experience an incremental growth after an M&A activity thanks to a retain-and-reinvest approach in earnings management is the belonging or not belonging to the BRICS area.

Graph 4.3 better depicts the empirical findings and displays an interesting trade-off. From a theoretical point of view the strategy adopted by international groups to locate their subsidiaries within emerging markets can produce several benefits to the corporate headquarter. The objective is to exploit the investment opportunities available in this region, which deliver expected returns above the average, by employing the operating units in the BRICS as the group's cash cows to realize higher profits which will fuel the core business of the holding and the other subsidiaries located in the advanced nations. The realized earnings within the subsidiaries in the BRICS are then centralized at the company's headquarter and used to reward the existing shareholders through the dividend distribution, in order to enhance and maintain their satisfaction and avoid agency problems. This "hit-and-run" strategy may seem perfect to be applied in developing markets, where the accessibility is quite easy due to lower entry and exit barriers. However, the evidence reveals the opposite extreme. The mechanism to realize profits through the subsidiaries and then build up the Investment policy around the earnings distribution to stockholders works better when targets are located in Developed countries. The empirical findings demonstrate that for those multinational corporations which have operating units in the BRICS as a result of an M&A activity, there is a positive relationship between the Retention ratio and the growth rate. By increasing the percentage of earnings retained and reinvested as the major source of capital to finance corporate or local projects, the company's growth profile and volume will increase as well. In this case, the retain-and reinvest approach results to be the best option, due to several reasons.

Firstly, in BRICS countries the retained earnings are usually considered the primary source of financing to fund new projects undertaken by international firms, due to several financial constrains. Historically, capital markets in this area have played a secondary role in providing access to multiple financial sources to foreign companies, because of the inadequate availability and reliability of the local financial means[67] (Borodina and Shyrkov, 2010). Sometimes, the lack of structured regulations frustrated lot of cross-border deals. By contrast, enterprises which have a more dominant presence in Developed countries can better rely on multiple external financing sources on both equity and debt markets and as a consequence, they show a tendency to devote greater portion of the realized earnings to the distribution as dividends or share repurchase rather than retention. Following this path, the different Investment policies chosen by the two groups of firms can be explained by the diverse reliance on external financial supply available in the market. Furthermore, it is important to remember that the retain-and-reinvest approach can be more profitable when choosing to invest in the BRICS, whose projected GDP growths are higher than any other country, rather than in Developed nations, since local projects offer above average expected returns to compensate risk-prone investors for the greater riskiness.

[67] Svetlana Borodina and Oleg Shvyrkov, February 2010, *Investing in BRIC Countries*, McGraw-Hill

Graph 4.3



4.3.1 Implications

The empirical findings show that companies which execute deals and open operating units in BRICS countries should adopt an Investment policy based on the retain-and-reinvest approach for the earnings realized through these subsidiaries, in order to achieve higher growth in terms of sales volume. From the previous results, it follows that the optimal liquidity structure for these kinds of international groups is the decentralized treasury management established through regional treasury centers located in key areas. Preferred locations have business-friendly government and commercial policies with a network of investment protection agreements and tax treaties based on the OECD model; strategic proximity to crucial markets where the access is made easier thanks to technological, physical and financial facilities; and critical mass of local knowledge and expertise about the surrounding environment, competitors and regulations as well as ability to manage cross-border transactions. BRICS countries have gained lot of momentum behind these factors and have emerged as the dominant locations for building up local treasury and investment centers that periodically interact with the central office. Although with some variations from region to region, these high-growth nations offer relatively favorable cost structures, high technological systems, vibrant financial markets as well as appealing economic growth rates that capture the attention of international groups. Within the next years, countries like China, India and Brazil, where substantial advantages from both cost and strategic perspectives can be achieved, are intended to become the major international logistic hubs for those multinational companies which will be willing to expand their operations overseas. In this case, the liquidity structure can be considered a fundamental vehicle to help increasing the overall group's profitability, thanks to the efficiency gains and cost savings that it implies.

Furthermore, looking at the preceding empirical outcomes the reader can identify those corporations who have performed M&A activities in BRICS as growth companies and those firms who have adopted an expansion strategy within Developed countries as value companies. Growth companies share the tendency to have very profitable investment opportunities for their own retained earnings. They typically pay little amount of dividends to shareholders, preferring to retain most of the realized profits and reinvest them to expand the business. Growth enterprises base their Investment policy on the Retention ratio. On the other hand, value companies tend to show higher percentages of realized earnings distributed to the corporate stockholders in the form of dividends or for share repurchase, since they prefer to rely on external financing sources rather than internal ones to fund new projects. They focus the Investment policy on the Payout ratio, as opposite to the Retention ratio.

4.4 Limitations

Although this study can be deemed reliable and valid under different perspectives, it presents several limitations. Firstly, concerning the sample there is a problem of selection bias, since it was not randomly selected but rationally composed according to the specific selection criteria previously mentioned. This choice, even if can be considered as a limitation, aims to be functional with regard to the study, whose purpose is to focus the attention on evaluating where the M&A activity has realized the highest growth as a consequence of a specific adopted Investment policy, whether within BRICS or Developed countries. Secondly, the sample includes international companies with leading and dominants positions in their industries, but does not contain all the existing multinational corporations. In addition, the results of the study can be extended for the predefined time frame to other deals undertaken in BRICS countries for the findings relative to the former and to Developed countries for the findings concerning the latter. Instead, for other groups of countries, even if closed to the reference areas, during different periods the outcomes of this thesis cannot be generalized due to different economic, financial, political and social conditions that affect the corresponding internal environment. Among emerging and developing nations, this work project just regards and considers the BRICS.

In conclusion, another limitation concerns the manner through which it has been selected the dependent variable, the growth rate expressed in terms of sales volume. It has been chosen to establish a comparison among the year when deals have occurred and the following one. Typically, in order to see the M&A's impact on the future corporate performance it would be advisable to take into account longer time frame, usually three years. The shorter horizon does not allow to understand if the retained earnings have been invested in external or internal (e.g. R&D) projects. However, this choice is functional to the nature of the study, whose purpose is just to identify the overall impact of the available cash internally retained and ready to be employed in order to fund new investments, without considering its effective use and destination.

CONCLUSION

The primary purpose of this work project is to determine what Investment policy is more value-creating for the acquiring entities from a growth perspective, according to the location where deals are executed: BRICS or Developed countries.

The first chapters aim to introduce the general framework where cross-border deals are executed, by describing the historical roots, motivating factors and critical elements to achieve the success. From the beginning, it has been established such dualism that will lead the entire investigation process among transactions undertaken in Developed and emerging countries, with a particular focus over the BRICS, by highlighting the differences in planning and implementing mergers and acquisitions within these two distinct geographical areas.

Before presenting the quantitative analysis, the current study also describes the role played by Investment policy within every organization, its principles, objectives and functions in defining capital budgeting decisions to plan strategic projects such as acquisitions and mergers. Within a group architecture, it also establishes the overall liquidity structure to be adopted along with the relationships that flow between the center and peripheries, concerning earnings management. Following this path, the research will identify the decentralized treasury model as the preferred liquidity management system to be applied by multinationals which concentrate their subsidiaries in BRICS markets. Building up regional treasury centers in strategic locations with proximity to key markets can be considered the fundamental vehicle to help increasing the overall group’s profitability, thanks to the efficiency gains and cost savings that it implies.

The quantitative analysis and the related empirical findings represent the core of the entire dissertation. The goal is to evaluate the optimal choice for multinational companies between retaining or distributing the realized earnings whether they perform M&A activity in BRICS or advanced markets. The main research question has the objective to understand whether a higher Retention ratio can be meaningful to explain a corresponding higher growth rate as the result of the retain-and-reinvest approach for the earnings management. The final outcomes show that there is no evidence of a significant relationship between the Retention ratio and growth rate, expressed in terms of sales volume, when evaluating a general M&A context without taking into account the place where deals occur. However, things drastically change when introducing the targets' location. The evidence displays that a positive relationship holds between the two variables for those cross-border transactions with targets in BRICS markets. This means that the fundamental determinant to experience an incremental growth after an M&A strategy, thanks to the retain-and-reinvest approach in earnings management, is the target's belonging or not belonging to BRICS countries. As explained before, from this conclusion it can be drawn that the suggested liquidity structure to apply when subsidiaries are concentrated in the BRICS is the decentralized treasury management through the establishment of regional treasury centers placed in key areas.

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