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

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SUMMARY

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.

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.

The entire work project 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. Table 1 summarizes the main differences among Developed and emerging markets.

Table 1. Developed and emerging markets characteristics

Developed Markets	Emerging Markets
1. Relatively low economic growth rates	High economic growth rates
2. Low inflation	High inflation
3. Stable institutional structure and regulations	Immature or unstable institutional structure and regulations
4. High information availability and reliability	Low information availability
5. High urbanization but low or negative population growth rates	Low urbanization and high population growth rates
6. Small changes in individual economic status	Large changes in individual economic status (Rise of the local middle class)

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. The BRICS economies represent the most attractive investment opportunities among the other emerging nations, since they are characterized by faster growth conditions, untapped markets and inexpensive but qualified workforce. However, 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: due diligence process, experience and simplicity, as well as post-merger integration. 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 so called institutional voids. 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. The procedure is described in Figure 1. Then, this chapter concludes the investigation process by illustrating an additional alternative that international firms can choose to apply when the others are deemed unfeasible and uneconomical: 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 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.

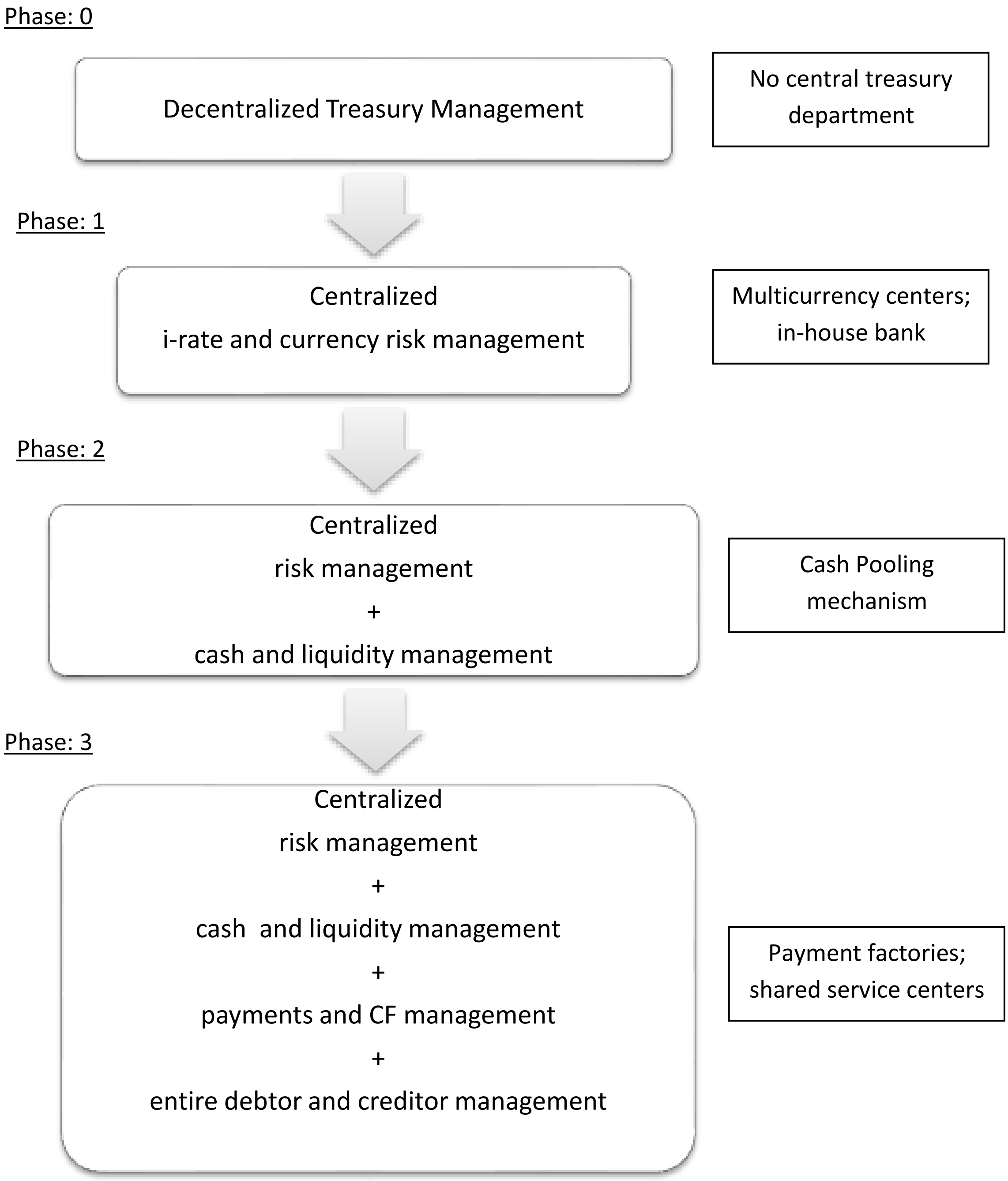


Fig. 1: Three Phases of the Centralization of Treasury Management

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 chapters, the focus is concentrated on the retain-and-reinvest approach as 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.

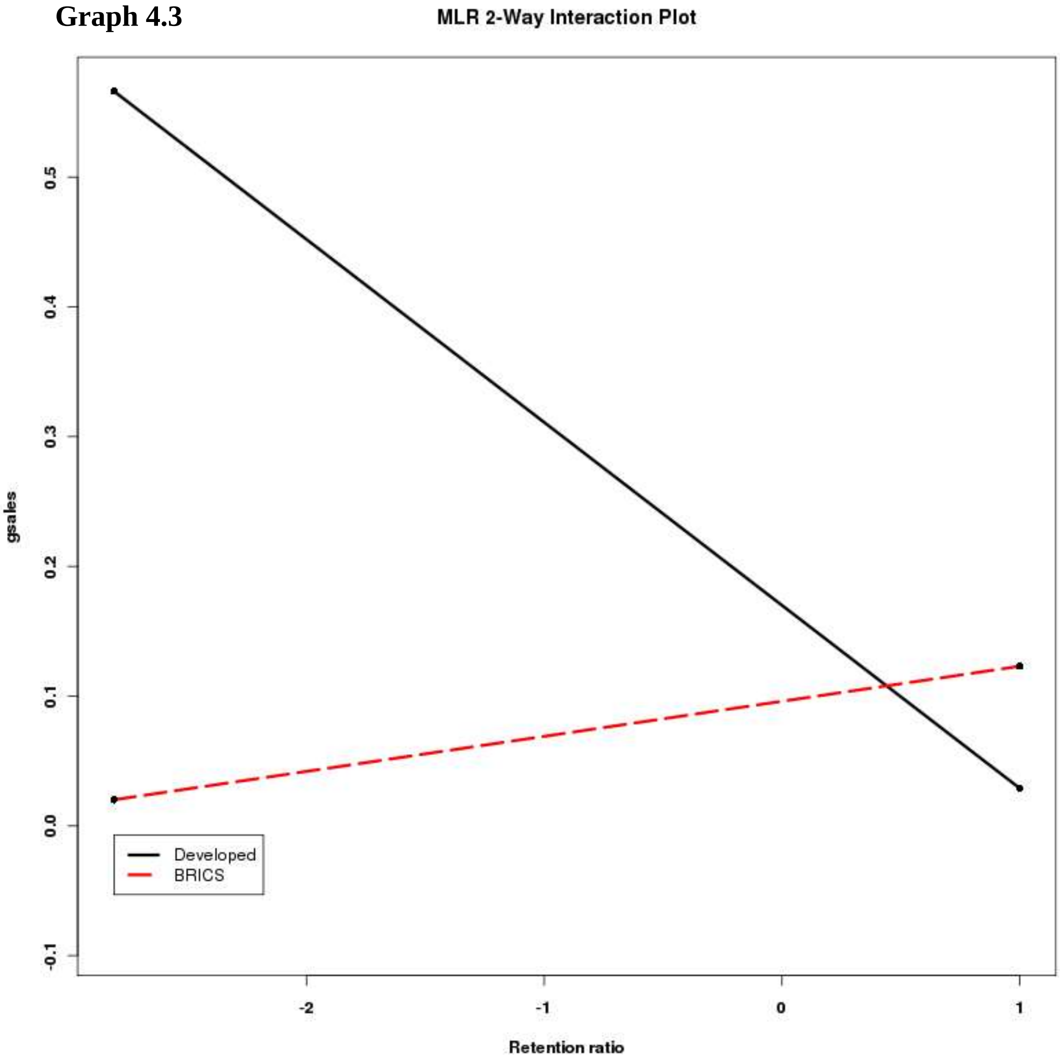
The Results

The multiple linear regression 2-way interactions analysis run on the statistical software STATA by employing a quite balanced sample of 310 observations for the years 2005-2013, produces the following results. The evidence does not show 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. 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 growth rate on the Retention ratio to move from non-significance to significance.

Graph 1 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 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. 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.

Graph 4.3



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.

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 dominant 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.

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