

## Role of industry relatedness in performance of Indian acquirers—Long and short run effects

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**Abstract** We explore the effect of industry relatedness on the performance of Indian acquirers using both short run and long run performance measures. We argue that mergers and acquisitions are distinct strategies, because of the unique regulatory structure and equity ownership pattern that exists in India. Their choice depends on control considerations on the one hand and regulatory imperatives on the other. Correspondingly, their sources of value creation or destruction do not always correspond to extant theories of synergy or agency. We present a modified synergy story and illustrate that, while related acquisitions create value and non-related acquisitions destroy value, both related and unrelated mergers create value.

**Keywords** Control · Relatedness · Abnormal returns · Event study · BHAR · Mergers · Acquisitions

Theory posits that mergers and acquisitions (M&As) create value when they exploit synergies by way of efficiencies in operations or supply chain, or financial benefits like tax savings and risk or knowledge sharing and talent sharing, or even collusion (Bruner, 2004). However, the manner and extent of achieving these synergies depends on the commonality in industries where the acquirer and target firms operate. For example, operational and collusive synergies are more likely to be achieved when the two firms belong to the same industry, whereas financial synergies have the greatest potential when the acquirer and target firms belong to two industries whose cash flows are imperfectly correlated. These aspects have been extensively tested in extant literature; and it is largely held that related deals generate greater value compared to non-related ones. In fact, non-related diversification has been traditionally associated with a discount; the widely accepted view is that they are driven more by managerial empire

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building motives than shareholder value creation. However lately, the opposite view that diversifications need not be value reducing have also found support (Martin & Sayrak, 2003).

Most of the studies on M&As have been carried out in developed markets. With the rapid growth that is taking place in Asian economies, Asian companies have started using M&As to achieve high growth. In the Asia Pacific region, around 124,000 mergers took place (with a total deal value of US\$4,840 billion) during the time period 1995–2011.<sup>1</sup> During this period, Indonesia recorded the maximum increase in the number of deals (16.86 %), whereas India recorded the maximum increase in the deal values (18.41 %). M&A deal size in ASEAN countries grew from US\$15 billion in 1990 to US\$135.3 billion in 2007—a nine fold growth led by Singapore and Malaysia (Metwalli & Tang, 2009).

It is now well accepted that these markets are quite different from many emerging markets, especially Asian, and hence firms in these different environments would have distinct systems and practices (Carney, Gedajlovic, Heugens, van Essen, & van Oosterhout, 2011), necessitating separate analytical frameworks. For example, unlike corporate settings in Western countries, where firms are managed by professionals and shares are diffusely held, the Asian business environment is characterized by concentrated ownership in the hands of family or business groups, cross-holdings, and pyramidal structures, with more family members than professionals in top management and boards (Globerman, Peng, & Shapiro, 2011). A direct fallout of these features is that, the market for corporate control in Asian countries is characterized by rare occurrence of hostile takeovers, higher control premiums, and occurrence of mergers because of agency problems and not as a solution for the agency problems (Bae, Kang, & Kim, 2002; Claessens & Fan, 2002). It is not surprising then, that studies on Asian M&As report contrary results than what is fairly established in the Anglo-Saxon literature on M&As. For example, Wong and Cheung (2009) found that M&As are good news for bidders and not for targets; Pangarkar and Lie (2004) provided evidence that both related and non-related M&As create value in low market cycles, but destroy value in high market cycles. Thus it is clear that, in order to build any sound theory in mergers, one needs to study the experience of firms that exist in a different institutional environment (Yang, Sun, Lin, & Peng, 2011), including in emerging economies of the Asia Pacific region. In this paper, therefore, we introduce a different institutional setting that exists in India, and illustrate how this setting affects the synergy perspectives that are commonly used to explain M&As in developed economies. Particularly, we show how high ownership stakes in firms and resultant control considerations on the one hand, and regulations on the other, interact to affect mergers; we further argue that these issues render most of the synergy perspectives derived from Anglo-American experiences, inappropriate in the case of mergers. To our knowledge, such an institutional perspective has not been explored in the context of M&A synergies in the literature, including studies on M&As in Asian economies, although a vast literature exists in the context of corporate governance, a meta-analysis of which was recently conducted by van Essen, van Oosterhout, and Carney (2012).

With its unique regulatory structure and equity ownership pattern, the Indian market for corporate control presents an interesting database to study the difference between

<sup>1</sup> Source: [www.imaa-institute.org](http://www.imaa-institute.org)

related and non-related mergers and acquisitions. First of all, unlike in Western countries, where the terms “mergers” and “acquisitions” are used almost interchangeably, there are certain legal and operating differences between mergers and acquisitions in India. In Western countries, most of the acquisitions lead to a merger, where the acquiring company simply merges the target company with itself after acquiring all its shares, either with cash or with stock, or both. However, in India, when an acquirer undertakes a merger, it issues its own shares to the target shareholders as consideration in accordance with the swap ratio, thereby converting target shareholders into acquiring company shareholders, and keeps only one company after the merger. On the other hand, when an acquirer undertakes an acquisition, it only takes over management control of the target, after paying cash to target shareholders as consideration and continues with the legal entity of both the firms post acquisition. In this case, target shareholders do not become acquiring firm shareholders.

The Income Tax Act in India grants certain tax benefits to the acquiring company only if at least 75 % of the shareholders of the target company become shareholders of the acquiring company after the merger. Further provisions of Indian GAAP leads to dilution of earnings per share if at least 90 % of shareholders of the target company do not become shareholders of the acquiring company (Barai & Mohanty, 2013). This implies that the acquiring company will get various financial benefits only for a merger and not for an acquisition. In other words, only a merger can exploit such financial synergies, and not an acquisition. But mergers come at a cost in India. Most of the Indian companies are controlled by promoters. Almost 93 % of the total corporate assets in India are controlled by companies managed by promoters.<sup>2</sup> We find that the median stake of the promoters in the companies is 45 % in 2008. In only about 19 % of the total companies, the promoters have less than 30 % stake in the companies.<sup>3</sup> If the acquiring company and the target company are controlled by two different promoters, then the promoter of the acquiring company may lose control over his own company after the merger and hence may prefer to acquire controlling stake in the target firm rather than merge with it.<sup>4</sup>

To summarize, mergers can avail various financial synergies by saving direct or indirect taxes but promoters run the risk of losing control. On the other hand, acquisitions cannot claim those financial synergies, but there is no threat to control. Usually, in India, considerations of control dominate the decision-making process and companies do not go for mergers when the target is managed by a different promoter (Ramanujam, 2006).<sup>5</sup>

<sup>2</sup> In India, controlling shareholder (usually the founder family) is known as promoter. One finds primarily three types of promoters, namely, Indian Business Groups, Foreign Business Groups, and Central and State Government (Verma, 1997).

<sup>3</sup> The ownership data are based on a total sample of more than 22,000 Indian companies. We obtain their equity ownership data from Prowess database of CMIE.

<sup>4</sup> To illustrate this point, if the promoter of the acquiring company A owns  $\alpha_A$  fraction of the total shares of A ( $n_A$ ) and the promoter of the target company T owns  $\alpha_T$  fraction of the total shares in T ( $n_T$ ), then the stake of promoter of A after the merger will be  $\frac{\alpha_A \times n_A}{n_A + \alpha \times n_T}$  while the stake of promoter T will be  $\frac{\alpha_T \times n_T \times \alpha}{n_A + \alpha \times n_T}$  in the merged company, where ‘ $\alpha$ ’ is the exchange ratio. If  $(\alpha_A \times n_A) < (n_T \times \alpha \times \alpha_T)$  then post merger, the stake of the target firm promoter will be greater than the stake of the acquiring firm promoter, and the acquiring firm promoter would surely prefer a controlling stake in T rather than merge with T.

<sup>5</sup> Ramanujam (2006) describes how Indian promoters take special care to ensure that their equity stake does not fall below 51 % after the merger.

An acquisition in India entails change in management and so various synergistic benefits stemming from operational, marketing, and supply chain efficiencies can be expected to be achieved. But financial synergies, as discussed above, are difficult to achieve in these cases. On the other hand, mergers are undertaken mostly between firms under the same management or business group, or between parent and subsidiary firms. In these cases, since there is no real change in management, no change in strategic direction leading to operational synergies are expected to be achieved. However, in these cases, regulations allow greater potential of achieving financial synergies. As a result, related acquisitions and mergers present greater prospects of value creation, albeit from different sources of synergy, while non-related acquisitions can be construed as empire building attempts, which are normally taken as value destroying.

In this study, therefore, we acknowledge the distinct identities of mergers and acquisitions that prevail in India, and propose that industry relatedness would have distinct sources of value creation or destruction in these two cases. To test our propositions, we examine the effects of merging or acquiring related and non-related targets on the wealth of publicly listed acquirers of India, using both long run and short run performance metrics.

We find that related acquisitions create value both in the short run and long run. But non-related acquisitions have insignificant effects in the short run while destroying value in the long run. These outcomes compare roughly with results reported in Anglo-American literature, essentially because the regulatory and structural features of acquisitions in India are similar to those in the developed world. On the other hand, both related and non-related mergers create value in the short run and over the first two years post merger. These effects differ from findings reported from developed economies, because mergers in India are structured differently, so that the sources of synergies documented in extant literature become irrelevant in the context of mergers, while control and governance issues become more appropriate. Thus, our findings are consistent with our argument that mergers and acquisitions are distinct corporate strategies that derive synergistic benefits differentially. Further, our results suggest that control and ownership should be considered by M&A researchers and practitioners while investigating these synergies and evaluating performance in the Indian context.

## Market for corporate control in India

In Western countries, the acquiring firms usually buy all the shares tendered in a tender offer. Often, the acquirers make conditional offers with a provision to reject the offer in case certain minimum percentage shares are not tendered. In the US, for example, the law allows two companies to go ahead with a merger as long as more than 50 % of the shareholders of the target company agree to the merger.<sup>6</sup> The acquirer can simply buy 50 % of the shares in the target and then force the terms of merger on the remaining shareholders. Since in most acquisitions the acquirer buys all the shares of the target eventually (and then merge the target company with itself), academicians often do not distinguish between mergers and acquisitions in extant literature.

<sup>6</sup> Under the Delaware Law, a simple majority of shareholders can remove the board (even a staggered board) without showing any cause. See <http://delcode.delaware.gov/title8/c001/sc04/>

India provides an exclusive dataset for the study of mergers and acquisitions because of its unique regulatory standards and corporate control mechanism. Mergers in India are regulated by the Companies Act of India 1956 and the Income Tax Act 1961, whereas acquisitions (or takeovers) are regulated by the Substantial Acquisition of Shares and Takeovers Regulations (1997) of Security Exchange Board of India (SEBI). In Western research papers on corporate control, mergers and acquisitions are used interchangeably. However, these two terms have very specific meanings in the Indian context. We show the key differences in Table 1. Mergers involve the amalgamation of two or more companies into either the existing acquirer company, or a new company, subject to the approval of High Courts. The Income Tax Act, 1961 deems a combination to be a merger when the assets and liabilities of the merging companies before the merger become the assets and liabilities of the merged company after the merger *and* when at least 75 % of the shareholders of the target company become shareholders of the acquiring company after the merger.<sup>7</sup> Only when this condition is met, as per Sections 2(1B), 35, 35A, and 36(1)(ix) of the Income Tax Act, the acquirer can avail certain tax benefits including carrying forward of the accumulated losses, amortizing merger-related expenses, non-payment of capital gains at the time of merger, adopting the pooling of interest method of accounting, and so on. On the other hand, in an acquisition, the acquirer acquires shares or voting rights or assets in the target company, such that the “control” of the acquirer becomes greater than the “control” exercised by the largest shareholder in the target firm post acquisition. “Control” implies the right to appoint majority of the directors and control management or policy decisions, directly or indirectly, by virtue of his shareholding or management rights or voting agreements.<sup>8</sup> It must be mentioned here that, in an acquisition, although the management of the target company changes, it (the target company) continues to exist as an independent entity legally even after the completion of acquisition and does not necessarily need to merge with the acquiring company. Also, the above tax benefits that accrue to mergers do not remain applicable for an acquisition. As discussed by Barai and Mohanty (2013), cash-financed acquisitions lead to dilution in earnings per share.

Another unique feature about the Indian M&A dataset is the ownership pattern in these companies. Most of the Indian companies are owned and controlled by promoters. Almost 93 % of the total corporate assets in India are actually controlled by companies owned and managed by the promoters. The median stake of the promoters in the companies is 45 %. There are two interesting implications of such high stake by the promoters in India. First, with promoters controlling almost half of the total shares in most of the Indian companies, one rarely finds hostile takeovers or bear hugs in India—almost all acquisitions are friendly deals. Second, one rarely finds mergers (with stock swap) happening in India between two companies controlled by different promoters. The reason is obvious. The promoter’s stake in the acquiring company may come down substantially after a merger. If both the acquiring and the target company belong to the same promoter, then there is no risk of losing control over the acquiring (or the target) company. But, if they belong to two different promoters then acquisitions become the only available route for the acquiring promoter to control the target firm without risking control over his own company. Since most resolutions can be passed by

<sup>7</sup> Source: <http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx>

<sup>8</sup> Source: [http://www.sebi.gov.in/Index.jsp?contentDisp=SubSection&sec\\_id=5&sub\\_sec\\_id=5](http://www.sebi.gov.in/Index.jsp?contentDisp=SubSection&sec_id=5&sub_sec_id=5)

**Table 1** Mergers and acquisitions: As understood in Western countries and India

	Mergers	Acquisitions
Western countries	A transaction that forms one economic unit from two or more previous ones (Weston, Chung, & Hoag, 1990). The currency of the transaction can be cash, stock, or preference shares.	Can be a tender offer or a bear hug. Usually, the acquiring firm buys all the shares of the target. In a large number of cases, the acquiring company merges the target company with itself after the merger. The currency of the transaction can be stock, cash, or preference shares.
India	The legal definition is similar to that found in Western countries. However, the currency of the transaction is necessarily stock. Both the companies are usually controlled by the same promoter. Mergers are regulated as per the provisions in the Companies Act and the Income Tax Act of India.	Usually a friendly tender offer. Very rare to see hostile offers or bear hugs. The currency of the transaction is usually cash. Both the companies are controlled by different promoters. SEBI regulates acquisitions in India.

a simple majority in India, it is really not necessary to acquire all the shares in the company.

So Indian companies have to choose between (a) going for merger that allows financial benefits but risks loss of control over their own company if the target is owned by a different promoter, or (b) going for an acquisition and maintaining control over one's own company. The primary concern for the promoter in designing a transaction is the change in control over his own company (Ramanujam, 2006). That is why there are very few instances of inter-group mergers. In fact, if one studies about the rare inter-group mergers that have taken place in India, one will notice that in each of them, the promoters have taken adequate steps to ensure that they maintain majority control over the combined entity after the merger. One can study these transactions in Chapter 16 of *Mergers et al.* (Ramanujam, 2006).

Because of the above differences, mergers and acquisitions in India offer different benefits to the acquirer. In a merger, there are immediate financial gains from the various accounting advantages offered by the Income Tax Act; but these are not possible in the case of acquisitions. Thus, while there may be mergers that are driven by financial motives, acquisitions can hardly be driven by the same. In our sample, acquisitions are always associated with change in control. The new management ought to have envisaged some benefit in order to undertake such a costly and risky investment. The benefits might be relevant to all shareholders, through promising synergies, or might bring private gains to the acquirer or even be consummated by over-confident managers. Thus acquisitions, like in any other country, might be inspired by either operational synergy or agency or hubris. But a merger is essentially a status quo, since there is usually no real change in control. As a result, there is very little likelihood that there would be any significant changes in the policies and processes of extracting either synergistic benefits or private gains out of the participating firms. Hence in a merger, there exists limited scope for any increase in shareholder wealth maximization or shareholder wealth expropriation.

## Theory and research hypotheses

The theoretical and empirical search for value-generating strategy from M&As has been one of the oldest and the most intense. Researchers normally agree that a complex pattern of motives affect the decision to go ahead with a merger and that no single motive can fully explain it. Here, we discuss the three main views developed in the strategic management literature on the effects of M&As on firm value and hypothesize their probable effects in the Indian context, namely the *strategic fit hypothesis*, the *diversification discount hypothesis*, and the *diversification benefit hypothesis*.

### Strategic fit hypothesis

The *strategic fit hypothesis* refers to an acquisition strategy that aims to exploit similar resources or skills. Firms operating in the same industry operate in similar products or markets or technological sphere, thereby developing specialized human capital with common skills and knowledge, standard procedures and shared practices, and insights on industry environment. When two of them combine, managers leverage these assets and capabilities to achieve cost reductions through product rationalization, due to economies of scale in production, increasing returns to knowledge diffusion, transactional efficiencies, and lower managerial slack. These synergistic benefits are expected to reduce the cost base of the combined firm. Market power, on the other hand, increases the revenues of the combined firm by exploiting a “dominant position” that facilitates a firm to impose unfair or predatory prices, restrict production or technical/scientific development, restrict market entry, and generally operate independent of competitive forces in the relevant market. The possibility of efficiency and/or market power raises the expectation that focus increasing combinations would translate into greater profitability than the sum of its parts, thereby increasing the acquirer’s stock price.

A number of studies report that synergistic combinations indeed lead to value creation in the short run, *viz.*, Lubatkin (1987), Krishnan, Krishnan, and Lefanowitz (2009), among others. Interestingly, very few studies examine the long run abnormal performance of related transactions. With US data on related acquisitions, Megginson, Morgan, and Nail (2004) obtained positive abnormal returns whereas Agrawal, Jaffe, and Mandelkar (1992) recorded significantly negative returns.

But, because of the unique characteristics of Indian corporate scenario, we argue that the sources of synergy predicted by the strategic fit hypothesis would accrue to the acquirer only in the case of acquisition where there is a real change in control, and not in a merger where there is no real change in control; instead, we propose alternate sources of synergy that mergers in India might exploit.

In an acquisition a new management would be expected to leverage assets and capabilities of the target firm in a different manner than what was being done by the earlier management. There could be either economies of scale or scope in operations, supply chain, or marketing activities. There could be diffusion of more specialized knowledge from one firm to benefit the other firm. In fact, all the synergy effects discussed under the strategic fit hypothesis are expected to hold true in the case of acquisitions.

Hence we propose that:

**Hypothesis 1** Related acquisitions would lead to positive abnormal returns, both in the announcement period and in the long run.

However these arguments do not hold in the case of a merger in India. As we discussed earlier, mergers in India are mostly between firms that are under the same business group or managed by the same promoter. Even without any merger, group headquarters constantly monitor all the firms under their fold, and take decisions that would help them improve on earnings.<sup>9</sup> Consequently, even though pre-merger firms do have their separate legal entity, many firms routinely experience exchange of resources even without a merger. For example, there are many corporate announcements on exchange of top managerial talent across group firms. In fact, these exchanges are followed keenly in the corporate world since they signify the honing of talent for top group positions. Additionally, operational benefits like using the same distribution channel or clubbing together orders to obtain better pricing deals are regularly taken advantage of. For example, a business group might place a single order for all material handling equipment required at different firms under its fold and thus obtain a better deal than would be possible if its individual firms had ordered the same. Financial benefits like transfer pricing,<sup>10</sup> extensive crossholdings (Kakani & Joshi, 2006), internal allocation of capital, and so forth are also exploited. There have been many instances of selling shares in one group firm to fund acquisitions of another group firm, with both firms continuing with their legal identities.<sup>11</sup> Because of these ground realities, we argue that group firms in India need not merge to exploit any operational synergies—even without a merger, they usually exploit all opportunities available to them. Of course we find that while 30 % of mergers do not cite any reason, about 66 % of mergers in India, where a group company merges its subsidiary with itself, cite operating synergies like revenue increase, market share increase, cost reduction, or access to distribution as reasons for merger. As argued here, we cannot use the strategic fit hypothesis to justify such mergers. The subsidiary company was under the control of the same parent company even before the merger and hence, one cannot expect any further improvements in processes and operations after the merger. However, there can be some cost savings because of elimination of redundancies and administrative overheads.

So, we need to identify alternate sources from where related mergers can also generate synergy for the investors in India. Two possible situations are discussed below:

In the pre-liberalization era (prior to 1991), business groups in India were forced to operate multiple business units in the same sector as there were restrictions on the total capacity that a company can have. Using the institution-based framework of Hoskisson, Eden, Lau, and Wright (2000) and Peng (2002), Kedia, Mukherjee, and Lahiri (2006) argued that Indian business groups relied on institutional relatedness (IR) to diversify across product groups before liberalization. The different companies (that are part of a business group) could have access to different types of capital (financial, social,

<sup>9</sup> Khanna and Palepu (1997) discuss the different benefits that group companies get in India.

<sup>10</sup> <http://www.business-standard.com/india/news/transfer-pricing-explained/327373/>

<sup>11</sup> For example, Tata Steel's acquisition of Corus Steel was partially funded by selling shares of Tata Consultancy Services, a Tata Group firm ([http://articles.timesofindia.indiatimes.com/2006-10-19/india-business/27826752\\_1\\_tcs-shares-tata-steel-corus-group](http://articles.timesofindia.indiatimes.com/2006-10-19/india-business/27826752_1_tcs-shares-tata-steel-corus-group)) or Hindalco's acquisition of Novelis was partially funded by Essel Mining & Industries, another unlisted Aditya Birla Group firm ([http://articles.economictimes.indiatimes.com/2011-12-26/news/30559124\\_1\\_essel-mining-industries-iron-ore-aditya-birla-group](http://articles.economictimes.indiatimes.com/2011-12-26/news/30559124_1_essel-mining-industries-iron-ore-aditya-birla-group))



political, and reputational) that are otherwise scarce in emerging markets like India (Carney, 2008; Khanna & Palepu, 1997). However, with the end of the licensing regime, most business groups consolidated their operations in similar lines of business. The Indian business groups started relying on product relatedness (PR) rather than IR to diversify after liberalization (Kedia et al., 2006). Thus for example, between 1998 and 2010, the Aditya Birla Group undertook multiple demergers and mergers to bring all cement producing units managed by various group companies under one entity, presently known as Ultratech Cement (another group company) to ensure that the group's cement business remains under one company. Wherever mergers led to such consolidations, the companies definitely reaped the benefits from consolidating their operations. (In 1998, Aditya Birla Group transferred the cement division of Indian Rayon and Industries Ltd. under Grasim and Grasim acquired two companies—Dharani Cement and Shree Digvijay Cement. Dharani Cement was merged with Grasim in 2002. Grasim acquired Ultratech in 2004, which was the demerged cement business of Larsen & Toubro Ltd. In 2007, Shree Digvijay Cement was sold off. After that, in 2010, the entire cement business of Grasim was divested into Samruddhi Cement following which UltraTech merged with Samruddhi.<sup>12</sup> As of now, Grasim and Ultratech cement both are separate legal entities and are both listed as two different companies.)

But such mergers are rare and far-between. More commonly, however, mergers probably happen in India not for operational synergies but mostly for taking advantage of the various financial benefits that Indian laws accord to them, like sales tax rationalization across different states, excise duty reduction, and tax benefits of combined accumulated losses.<sup>13</sup> When we consider related mergers, we recognize that there is not much scope for operational synergies; however, these mergers can benefit from reduction in excise duties, savings in sales tax if the companies are located in different states, improvement in credit rating after a merger, obtaining advantage of accumulated losses in case of a sick unit merger and all these may lead to increase in value. So, we suggest:

**Hypothesis 2** Related mergers should lead to significantly positive abnormal returns, both in the announcement period and in the long run.

#### Diversification discount and benefit hypotheses

Complementary to the strategic fit hypothesis runs the *diversification discount hypothesis*, that warns on the costs of diversification. There is an overwhelming literature, both theoretical and empirical, that shows diversified firms trade at a discount. Martin and Sayrak (2003) reviewed this literature and found capital misallocation to be the leading cause behind diversification discount. Information asymmetries between central management and divisional managers complicate performance evaluation and compensation design, leading to sub-optimal operational efficiencies. Rajan, Servaes, and Zingales (2000) showed that internal power struggles between different divisions of a diversified firm can lead to inefficient allocation of capital, thereby reducing its true value. There are also agency costs wherein managers pursue private benefits rather than shareholder

<sup>12</sup> Source: [http://www.grasim.com/about\\_us/milestones.htm](http://www.grasim.com/about_us/milestones.htm)

<sup>13</sup> About 4 % of the mergers state tax reduction as the cause for merger

wealth maximization, thereby destroying value. A number of hypotheses have been proposed with this outcome—the free cash flow theory (Jensen, 1986), tunnelling hypothesis (Bae et al., 2002), agency theory from overvaluation (Jensen, 2005), among others. Studies in labor economics demonstrate that, when managers lead large corporations, their prestige, power, and reputation get amplified accordingly. Executive compensation increases disproportionately with size. Managers also get more entrenched, making their removal costly and difficult. Accordingly, agency theory posits that managers' desire for greater power, individual worth, compensations and other private benefits drive them towards non-economic acquisitions (Haleblian, Devers, McNamara, Carpenter, & Davison, 2009). In a similar vein, the free cash flow theory suggests that ambitious and risk averse managers can divert free cash resources of a firm into acquisitions that have no economic basis, with the sole aim of empire-building. The tunneling hypothesis proposes that business groups might undertake mergers to siphon off funds from a more profitable affiliate where they have lower cash flow rights to an affiliate where they have greater cash flow rights, thus expropriating minority shareholder rights in the first affiliate (Johnson, La-Porta, Lopez-de-Silanes, & Shleifer, 2000). Tunnelling evidence has already been presented in Indian business groups by Bertrand, Mehta, and Mullainathan (2002). Jensen (2005) also showed that when past performance extrapolates to investor optimism, leading to over-valuations of corporations, rational, shareholder wealth maximizing managers should attempt to *reduce* the high stock prices to realistic levels. Instead, zealous managers, reluctant to let go of their reputation, undertake non-economic value-destroying investments, including acquisitions, to keep prices artificially inflated for a longer period of time. These actions further erode the true value of the firm, and are thus detrimental to the interests of long term shareholders (Shahrur & Venkateswaran, 2009). Besides, these concerns reduce investor confidence, influencing ex-ante response to announcements of diversifying acquisitions. In fact, many studies report a higher abnormal return for related acquisitions than non-related ones (Akbulut & Matsusaka, 2010, US; Bae et al., 2002, Korea).

The large evidence on diversification discount has lately been challenged. The *diversification benefit hypothesis* predicts value enhancements from diversification and is largely based on financial advantages and survival strategies. Financial motives cited in the literature are risk reduction from uncorrelated cash flows, taking advantage of tax benefits, or higher debt capacity, or any other reason that reduces cost of capital. Further, when external capital markets fail, a diversified firm can increase allocational efficiency through its internal capital market. Also, when a firm faces a technological or product shock, compromising its competitive position, or when its industry conditions lead to falling growth opportunities, it starts trading at a discount. This might push the firm to use its lower opportunity costs to diversify, thereby putting its organizational resources to more productive use. Another source of value creation through diversification is the co-insurance effect—when leverage increases post acquisition, and cash flows of the combining firms are less than perfectly correlated, the value of tax savings on incremental debt can be greater than the incremental leverage-related costs, thus increasing the value of the combined firm and the value of equity (Seth, 1990). Further, firms might diversify in order to grow bigger, thereby gaining political clout to influence regulations in their core business activity.

Some recent studies find non-negative announcement returns for diversifying mergers (Akbulut & Matsusaka, 2010; Villalonga, 2004). The commonest explanation given in these studies is that, diversifying firms have their values discounted before

they diversify, and so, the causes that drive firms to diversify are the causes for which the market discounted their values. These studies demonstrate that if this endogeneity of a firm's diversification policy is controlled for, the diversification discount reduces, or even disappears (Campa & Kedia, 2002).

When we consider mergers and acquisitions separately, we recognize that these hypotheses will be applicable in varying degrees to the two situations. First we take up non-related acquisitions. In this case, certain mechanisms outlined in the diversification discount hypothesis remain relevant while those from the diversification benefit are not applicable. For example, in a country like India, empire-building activities need not be eyed with the same skepticism as in developed economies. We have noted earlier that firms grow bigger in order to gain political clout, and nowhere is it more pertinent than in India (Kedia et al., 2006). In fact, many business groups in India started off with single businesses, then grew through non-related acquisitions and started getting identified as business groups in the corporate world and the media. However, while empire building might be beneficial to the group as a whole and the promoter in particular, it might not be beneficial to the acquiring and target companies within the group. The reasons can be varied, and we elucidate some of the dynamics here. It is known that family firms depend on internal sources of finance rather than external sources of finance like banks or stock markets (Munoz-Bullón & Sánchez-Bueno, 2012). This is done to keep external investors at bay, and ensure that family power and control over their firms are not restricted or diluted (Gomez-Mejia, Makri, & Larraza-Kintana, 2010). This raises the spectre of capital misallocation—the promoter might not take rational decisions that truly increase value of his group. This need not be because he has malafide intentions but because he may not possess the significant managerial expertise and talent required in undertaking and managing an acquisition (Gomez-Mejia et al., 2010). Unfortunately, family firms are known to be reluctant in installing non-family members in top management positions as that may lead to handing over control to outsiders. Even if such personnel are hired, the final decision is always retained in the hands of the promoter. A rational manager also obeys accepted rules about decision making in order to safeguard his own interests in the company. As a result, these firms may lack the ability to carry out the entire acquisition process, beginning from target selection and evaluation, negotiation, to integration. This is even more pronounced when new products and new markets are to be evaluated (Gomez-Mejia et al., 2010). There may be additional problems in integration. Typically, a new product market necessitates doing business in a new context and a different organizational culture. This means, firms might have to put in place different processes for planning, control, and operations. Family firms are generally resistant to change, and hence might find it difficult to adapt to the new working order leading to a policy paralysis (Munoz-Bullón & Sánchez-Bueno, 2012). Thus, it becomes quite probable that family firms are unable to manage the additional intricacies that non-related target firm entails, thereby destroying value. Thus, there could be a diversification discount, which is quite different from that envisaged in the context of developed markets.

On the other hand, the applicability of the diversification benefit hypothesis is suspect. First, we have explained earlier that income tax and other rules do not allow acquisitions to take advantage of various financial benefits. Benefit of internal capital markets do apply, but in a negative sense, since we argue above that promoters may not have the expertise in detecting a good opportunity over bad, and so might misuse the internal finances. While business groups do gain political clout from becoming large

(Khanna & Yafeh, 2005), the benefits might accrue to another group firm, and not necessarily to the acquirer. In view of these arguments, we suggest:

**Hypothesis 3** Non-related acquisitions would lead to negative abnormal returns, both in the announcement period and in the long run.

Mergers, on the other hand, present the likelihood of value enhancements from financial synergy. We argue that financial synergies that can be exploited through mergers stem from reduction in excise duties, savings in sales tax if the companies are located in different states, change in credit rating (improvement) after a merger, taking advantage of accumulated losses in case of a sick unit merger and all these may lead to increase in value. These synergies would also be equally applicable in the case of non-related mergers. In addition, co-insurance effects, risk reduction from uncorrelated cash flows, and other financial benefits can be exploited by non-related mergers, leading to value enhancements.

As we already stated earlier, we also see many subsidiaries getting merged in the parent company. In a few cases, the subsidiaries are finance companies which operate as holding companies in India.<sup>14</sup> Since the holding companies are finance companies, we treat this merger as non-related merger. If the holding company is a profit making company, then the merger leads to an increase in the earnings per share (EPS) of the parent company after the merger.<sup>15</sup> An accretive merger will create some excitement in the market and hence we anticipate stock price increase in the short run.

Even in the absence of synergy, mergers in India are unlikely to be value-destroying. Since both the acquiring and the target company belong to the same management, no value destruction happens because of the diversification discount hypothesis. Managerial ambitions are fulfilled anyway since management holds sway over both companies even without the merger. Alternately, if the motive is to tunnel out cash or other resources, there is no reason why a publicly listed acquirer will announce a merger and draw regulatory, corporate, and media attention to itself—such a motive can be fulfilled by the management quietly. Further, our arguments in the context of non-related acquisitions need not hold true in the case of non-related mergers. Since the target firm is already a group firm or a subsidiary, promoters and management already know its potential and value proposition. Thus capital misallocation or hubris does not apply. To summarize, we find limited applicability of the diversification discount hypothesis while evaluating non-related mergers in India. Hence, we propose the following hypothesis:

**Hypothesis 4** Non-related mergers, generate positive abnormal returns, both in the announcement period and in the long run.

Before moving to the methodology, we would like to show how the predictions of our hypotheses compare with those found in Western literature. We follow an approach similar to Lubatkin (1983) to show the predicted benefits from different types of mergers both in India and in Western countries. In Table 2

<sup>14</sup> A holding company holds shares in other companies (primarily other group companies). Indian promoters often control different group companies through the holding companies.

<sup>15</sup> When holding company is 100 % subsidiary of the parent company, and is profitable, EPS would increase after merger.

**Table 2** Predicted synergy in mergers and acquisitions under the three hypotheses (India vs. Western countries)

	Strategic fit hypothesis	Diversification discount hypothesis	Diversification benefit hypothesis
Related mergers (India)	Less likely	Unlikely	Likely
Related acquisitions (India)	Possible	Unlikely	Unlikely
Unrelated mergers (India)	Unlikely	Less likely	Possible
Unrelated acquisitions (India)	Unlikely	Possible	Unlikely
Related M&A (Western countries)	Possible	Unlikely	Less likely
Unrelated M&A (Western countries)	Unlikely	Possible	Possible

we compare likely outcomes of related and non-related mergers and acquisitions in India and in Western countries.

## Methodology

### Sample and data

We collect data on completed mergers and acquisitions undertaken by publicly traded, Indian firms during the years April 1996 to March 2008. The source of our data are the Prowess and M&A Databases of Centre for Monitoring Indian Economy (CMIE) and the Takeovers Database of Securities and Exchange Board of India ([www.sebi.gov.in](http://www.sebi.gov.in)). From this initial list, we exclude deals where the acquirer is a privately-owned firm, or foreign firm. Also, while we include all mergers, we consider only those acquisitions where there is a change in management control. Therefore, partial acquisitions of minority stake, where there is no change in control, or substantial acquisitions leading to consolidation are not considered. From this intermediate list, we consider only those cases where required data on announcement date and acquirer share prices over a window of three months before and after announcement, are available. We obtain share price data of the acquirers from the website of Bombay Stock Exchange (BSE) and Prowess Database of CMIE. All deals are friendly. Finally, our sample consists of 1,177 mergers and acquisitions. On this sample, we conduct short run performance tests. Panel A of Table 3 provides some descriptive statistics of our dataset.

The average acquirer in our sample has a mean market capitalization of Rs. 32.33 billion at the beginning of the year of transaction. Based on industry relatedness of acquirers and targets, we divide our sample of takeovers into two groups—related and non-related. Fifty-seven percent of the takeovers are focus increasing, horizontal M&As and the average market capitalizations of these acquirers are higher than those who seek to diversify into other industries. For the long run performance tests, we screen our initial set of acquirers based on availability of stock price data 36 months before and after the M&A. In order to maintain a larger sample, we allow for a maximum of three monthly returns to be missing per year, for any acquirer. When

**Table 3** The dataset considered in this study

	All acquirers	Related	Non-related
Panel A: Dataset for short run performance test			
Avg. market cap of firms	32.33	33.79	30.88
Number of firms	1,177	662	508
Acqn: Avg. market cap of firms		38.99	43.27
Number of firms		372	57
Merger: Avg. market cap of firms		28.06	29.61
Number of firms		290	451
Panel B: Dataset for long run performance test			
Avg. market cap of firms	23.20	27.48	18.13
Number of firms	809	446	360
Acqn: Avg. market cap of firms		28.13	11.67
Number of firms		238	34
Merger: Avg. market cap of firms		26.71	18.82
Number of firms		208	326

Market cap in Rupees billion (1 US \$  $\approx$  Rs 55)

three or less number of monthly data are missing in any year for any acquirer, we include that year for that acquirer, by replacing the missing values with returns of a corresponding benchmark portfolio that we describe shortly. Further, when an acquirer has more than three missing data in any year, we drop that acquirer. Since stock returns data are not available for all the acquiring firms for the entire three years period, both before and after the event, the number of observations decline as the number of years of analysis increases. Finally, we have a sample of maximum 809 mergers and acquisitions,<sup>16</sup> whose descriptive statistics are exhibited in Panel B of Table 3. In this reduced set, the average market capitalizations of both the entire dataset as well as the subsets decline, although the broad trends largely remain the same

## Measures

*Relatedness measure* In this study, we use the 4-digit NIC codes to define relatedness<sup>17</sup> The Government of India prepares and publishes National Industrial Classification (NIC) codes, which is a list of industry codes based on economic activity ([http://www.mospi.gov.in/nic\\_2008\\_17apr09.pdf](http://www.mospi.gov.in/nic_2008_17apr09.pdf)). These codes are 4-digit codes, and are based on the United Nations International Standard Industrial Classification. All companies are

<sup>16</sup> While testing a hypothesis, power analysis is done to determine if the sample size is large enough to draw meaningful inferences at  $\alpha = .05$  and  $\beta = .2$  (the power of the test =  $1 - \beta = .8$ ). Cohen (1992) suggested a minimum sample size of 586, when  $\alpha = .05$  and the power of the test is 80 % for small effect size. Since our sample size exceeds 586, we believe our test results are pretty robust.

<sup>17</sup> Martin and Sayrak (2003) summarized the various measures that have been used to measure relatedness, along with the benefits and costs of each. SIC codes are generally used to define relatedness in the US context (Akbulut & Matsusaka, 2010).

accorded a NIC code, which reflect their primary economic activity. In this study, the NIC codes of target and acquiring firms are matched to ascertain relatedness. Four levels of relatedness can be obtained, by matching all four digits of NIC codes (tightest and most homogeneous) to just the first digit of NIC code (widest and most diverse). Obviously, the choice of the number of digits to be matched will have different implications on sources of value creations through mergers.

Matching all four digits of NIC codes would imply horizontal mergers between firms with exactly the same primary economic activities. These would necessarily be driven by operational synergies derived from economies of scale. However, mergers can also be deemed “related” when the acquirer firm intends to derive economies of scope, through synergies in purchasing or marketing or even R&D. Such forms of relatedness can only be captured by matching fewer than four digits of NIC codes. For example, when only the first three digits of NIC codes are matched, value can be derived not only from economies of scale but also from complementarities of assets, technical know-how, and markets. Obviously, when even the first digit of the NIC codes of target and acquirer does not match, we can reasonably claim that they are non-related (conglomerate). Accordingly, four levels of relatedness were used in this study, by matching the first 4, 3, 2, and 1 digits of NIC codes. However, since the results are not qualitatively different, those reported here correspond to relatedness measure obtained by matching all four digits of NIC codes.

Arguably, our measure of relatedness has a drawback, in that it does not capture what percentage of the revenues of the target or acquiring firm is contributed by the economic activity it refers to, although it is known that most firms would be active in multiple segments. We are aware that research papers from the US and other advanced markets use stricter definitions of relatedness based on segmental revenues. However, unfortunately in India, segmental reporting has been made mandatory since only 2008. So, Indian firms are only assigned a single NIC code, based on its primary economic activity that is registered with the Registrar of Companies. However, it may be mentioned here that most firms are indeed active primarily on a single activity. The few aberrations that do operate on multiple segments are treated as “diversified” firms.<sup>18</sup>

*Short run performance measure* We measure short run performance with announcement period abnormal return, which has been the most commonly used measure in extant literature. Following the market model method, we obtain cumulative average abnormal returns (CAAR) to ascertain the value created or destroyed by Indian acquiring firms. Designating the day of announcement as Day 0, we consider three event periods: -1 to +1 (3 day period), -5 to +5 (11 day period), -10 to +10 (21 day period). The estimation period used in each of these methods is a 120 day window over -130 to -11 days.<sup>19</sup>

<sup>18</sup> [www.eaber.org/intranet/documents/112/1444/IGIDR\\_Kali\\_2005.pdf](http://www.eaber.org/intranet/documents/112/1444/IGIDR_Kali_2005.pdf)

<sup>19</sup> There is also some merit in using a larger estimation period because of the likely presence of insider trading before the merger announcement. We test sensitivity of our results to longer estimation period (-260 to -11 days). We find that our results do not change when we use a longer estimation period.

As per the market model, abnormal returns  $AR_{it}^{MM}$  of firm  $i$  on any day  $t$  is given by:

$$AR_{it}^{MM} = R_{it} - (\alpha + \beta R_{mt}) \quad (1)$$

Here  $R_{it}$  is the actual return of firm  $i$  on day  $t$  of the event period and,  $\alpha$  and  $\beta$  are ordinary least squares (OLS) estimates of regressing the estimation period returns of the  $i^{\text{th}}$  firm against estimation period returns of the market portfolio,  $R_{mt}$ .

We use Sensex<sup>20</sup>—the benchmark index of BSE—as the market proxy.

*Long run performance measure* We measure the long run performance using the buy and hold abnormal return (BHAR). It is defined as the compounded return that an investor receives by holding an acquirer stock over a period minus the compounded return that she would receive by holding an equivalent risk portfolio over the same period. Following the method described in Mitchell and Stafford (2000), we calculate 1, 2, or 3 years BHAR, as follows:

For any firm  $i$ ,

$$BHAR_i = \prod_{t=1}^T (1 + R_{i,t}) - \prod_{t=1}^T (1 + R_{b,t}) \quad (2)$$

and

$$\overline{BHAR} = \sum_{i=1}^N w_i BHAR_i \quad (3)$$

Here,  $T$  equals 12, 24, or 36, depending on whether we are calculating BHARs for 1, 2, or 3 years after a takeover.  $R_{b,t}$  denotes the returns of a benchmark portfolio to which the  $i^{\text{th}}$  acquirer is assigned.  $w_i$  is the weighting factor for the  $i^{\text{th}}$  firm, and is taken as the ratio of the market capitalization of firm  $i$  in the month before the acquisition and the level of Sensex in the same month. We use only value weighted abnormal returns here since “bad model problem” seems to shrink and even disappear when event firms are value weighted. We use 25 value weighted, non-rebalanced, size-BTM portfolios for benchmarks. We exclude the acquiring and target firms from these portfolios, but otherwise include all BSE firms with data availability. In India, financial year begins from April, and we assume that all accounting data for the period ending 31<sup>st</sup> March of year  $t$  is available from October 1 of year  $t$  onwards. Hence, we take the market capitalizations of all firms listed in BSE at the end of September each year, rank them, and divide them into five quintiles. Within each of these quintiles, we further rank the firms based on their book to market (BTM) ratios,<sup>21</sup> and divide them into five quintiles.

<sup>20</sup> Sensex is calculated using the “free-float market capitalization-weighted” methodology with 30 component stocks representing large, well-established and financially sound companies across key sectors.

<sup>21</sup> Book value of equity = Total assets – Miscellaneous assets (specifically, capital expenses and amortization not written off) – Current liabilities – Borrowings – Revaluation reserves – Preferred stock. This is calculated at the end of March each year. Then, BTM = Book value of equity at March end/Market capitalization at September end.



Thus we obtain 25 portfolios. Now, we calculate the returns for each of these portfolios for the year, defined as October of year  $t$  through September of year  $t + 1$ , as the value weighted average of the returns of each of the constituent firms. We make new portfolio assignments at the end of September each year, based on the new size-BTM values of the firms.

For statistical inference, we undertake bootstrapping procedure described by Mitchell and Stafford (2000).

In the results, we report both  $p$  values and  $t$  values. Also, we deem a BHAR to be indicative of value creation if  $t$ -value is positive, and value destroying if  $t$ -value is negative. Further, there can be a situation when BHAR is negative but  $t$ -value is positive, which we deem as value creating.

*Independent variable* To find whether relatedness affects performance of acquiring firms, we run a cross-sectional regression. The dependent variables are the performance measures described above. We introduce the independent variable, *Rel*, which is a dummy equal to 1 if the acquisition is related and 0 if it is non-related.

*Control variables* We include other factors that have been shown to impact acquirer performance as control variables, and define below:

*Mode of M&A* To differentiate the effect of mode of takeover, we introduce a dummy variable, *Mode*, which is equal to 1 for acquisition and 0 for merger.

*Status of target* Studies based on developed economies, mainly the US and UK, largely demonstrate that acquisitions of private targets generate positive abnormal returns while those of public targets yield negative effects (Moeller, Schingemann, & Stulz, 2004). However lately, studies based on developing economies that do not have strong regulatory environments report the opposite results (Alexandridis, Petmezas, & Travlos, 2010, Asia, East Europe, South Africa, South America, and Oceania). Besides, premiums for unlisted targets are significantly lower than listed ones (Officer, 2007). To capture this effect, we introduce a dummy variable, *Pvt*, which is equal to 1 if target is unlisted in the Bombay Stock Exchange (BSE) and equal to 0 if target is listed in BSE. In our sample, there are 97 non-Indian target firms. In order to know if the geographical location of the target (Indian versus foreign) has any effect on the return to the acquirer, we use a second dummy variable, *Foreign*, which is equal to 1, if the target is a foreign company and 0 if it is an Indian company.

*Size of acquirer* Moeller et al. (2004) demonstrated that, irrespective of other variables, the announcement return for small acquirers is greater than that for larger acquirers. They examined possible explanations for this size effect and suggested that managers of smaller firms are more aligned to shareholder interests. Gorton, Kahl, and Rosen (2009) also reported that acquisition profitability depends on firm size. Accordingly, we introduce the variable *MCAP*, and define it as the market capitalization of the acquirer at the most recent October prior to the acquisition.

*Capital structure* Jensen and Meckling (1976) proposed that capital structure affects corporate governance which in turn disciplines managerial actions and mitigates agency problems. The opposite view proposes that high leverage compels managers to pass up promising investment opportunities and so conservative leverage imparts financial flexibility to managers and enables them to invest in value enhancing acquisitions. Gao (2011) reported that announcement returns are lower for acquirers having higher

excess cash reserve. Hence, we map this aspect with the variable *Lev*, defined as the ratio of debt to equity of the acquirer, averaged over the previous three years.

*Free cash flow hypothesis* Jensen (1986) argued that when agent-managers have free cash resources, they might tend to use them in “low benefit or even value-destroying mergers” rather than disbursing it to the principal-shareholders. This is captured through the variable *FCF*, defined as follows:

$$FCF = \frac{CF0 - \Delta WC - \Delta NFA}{\text{Total Assets}},$$

where *CF0* is cash flow from operations, *WC* is working capital, and *NFA* is net fixed assets of the acquirer. This value is averaged over the past three years.

*Tobin's Q* Acquirers with high Tobin's Q have been shown to achieve significantly positive abnormal returns while those with low Tobin's Q obtain significantly negative abnormal return (Servaes, 1991). Hence, we include this characteristic with the variable *Tobin's Q*, which we define as:

$$\text{Tobin's Q} = \frac{BV(\text{Assets}) + MV(\text{Equity}) - BV(\text{Equity})}{BV(\text{Assets})}$$

We calculate this value by taking market values in the most recent October and book values in the most recent fiscal year end (Mitchell & Stafford, 2000).

*Extrapolation hypothesis* Rau and Vermaelen (1998) documented that long time stock price performance is negatively related to market to book (MTB) ratio, implying that value acquirers with low MTB ratio outperform glamour acquirers with high MTB ratios. Accordingly, we use the variable *MTB* to incorporate this effect. *MTB* is defined as the market capitalization of common equity in October divided by most recent fiscal year end book equity (Mitchell & Stafford, 2000)

*Relative size of the target* Jansen, Sanning, and Stewart (2013) discussed the various linkages between relative size and acquirer performance. We also use the relative size of the target vis-à-vis the acquiring company as an additional explanatory variable. If the target is a smaller company, as compared to the acquiring company, then the synergy benefits will also be smaller in size. However, with a smaller target firm, the agency costs associated with tunneling, entrenchment, and so on, will also be smaller in magnitude. Since most of the target companies are private companies (352 in our sample), we use the book value of assets (rather than the market capitalization) as a proxy for size. We define *Relative* as the ratio of the book value of the target divided by the book value of the acquiring company.

## Results

### Impact of industry relatedness on M&A performance

We first plot the short run, abnormal returns against the days of event period in Fig. 1. We observe that CAARs of related deals increase up to the fourth day after

announcement, after which it reverses, whereas the CAARs of non-related deals increase up to the first day after announcement, after which it starts reversing. If we assume that increasing CAARs are indicative of market euphoria following the announcement of an acquisition or a merger, we can conclude that the effect of market euphoria seems to last longer in the case of related transactions, and reverses only from day +4. In the case of non-related deals, reversal of market sentiments occurs from day +1 itself. Thus, here we have some indications of market applying heuristics or established notions while evaluating mergers. Since it is widely held that horizontal combinations have a greater likelihood of exploiting synergistic benefits than non-related ones, it probably takes longer time to proliferate investors' mindsets and build a collective market belief that the combination might not be as profitable as thought earlier. Oler, Harrison, and Allen (2008:174) demonstrated this cognitive bias specifically for horizontal acquisitions and concluded: "The market is unable to anticipate fully the performance implications of horizontal acquisitions at the time of their announcement." While we value ex-ante market perceptions of announcements of an event, and examine the widely reported short run abnormal results, we also derive warning signals of market inefficiencies from Fig. 1 and augment our results with long run abnormal returns, which are arguably more indicative of ex-post actual performance.

Table 4 reports the short run CAARs of acquirers making related and non-related acquisitions. Table 5 reports the long run BHARs of the acquirers over 1, 2, and 3 years.

From both short run and long run performance metrics, we find strong support for Hypothesis 1, which posits that related acquisitions create value. CAARs obtained over the event periods of -1 to +1 days and -5 to +5 days are significantly positive, implying that capital markets do place greater confidence on the value-creating potential of related acquisitions. From Table 5, we observe that post acquisition, 1 year BHAR is negative and insignificant, which might be attributed to delayed realization of synergies, for various reasons like sticky prices, protracted resource consolidations or implementation issues. However, the 2 year BHAR is positive and significant at .025 %. The

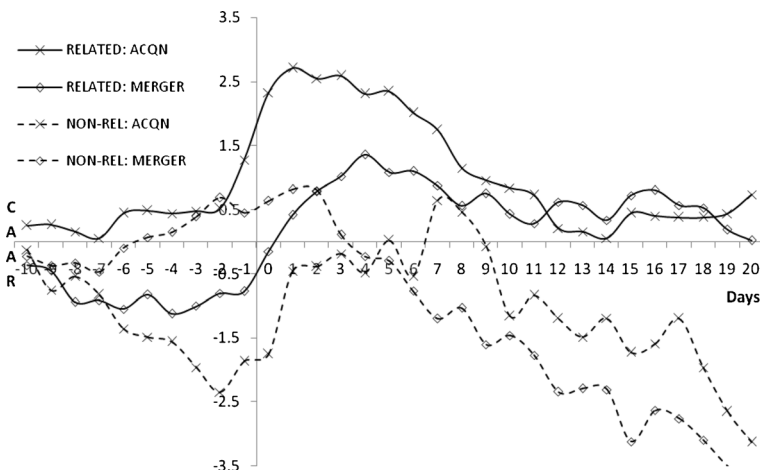


Fig. 1 CAAR of acquirers

**Table 4** Cumulative average abnormal returns (CAARs) to acquirers

Event period	-10 to +10	-5 to +5	-1 to +1
Related acquisition	.839 (1.01)[.32]	1.906 (3.17)[.00]	2.181 (6.95)[.02]
Related merger	.434 (.28)[.53]	2.129 (1.94)[.05]	1.229 (2.15)[.13]
Non-related acquisition	-1.161 (-.41)[.69]	1.382 (.67)[.52]	1.892 (1.77)[.22]
Non-related merger	-1.464 (-.21)[.84]	-.203 (-.04)[.95]	.130 (.05)[.92]

Figures in parentheses are *t* values, and figures in brackets are equivalent *p* values

upward trend continues with the 3 year BHAR which is also positive and significant at .072 %. Thus, these acquirers generate significantly positive abnormal returns post acquisition, vindicating the trust placed by markets. This would suggest that related acquisitions exploited true synergies and maximized shareholder value over the long run, possibly endorsing the strategic fit hypothesis.

Hypothesis 2, which states that related mergers create value, also finds good support from short run performance metric and from the 1 year metric. Like related acquisitions, related mergers also exhibit significantly positive CAARs obtained over the event periods of -1 to +1 days and -5 to +5 days. That is, capital markets seem to welcome announcements of related mergers. Table 5 shows that related mergers generate a significantly positive abnormal return of .019 % only in the first year after merger, and thereafter have insignificant abnormal returns. This might be indicative of the transitory nature of superior performance, suggesting that there were only short term benefits like tax savings or other financial synergies to be exploited from these mergers.

Hypothesis 3, which states that non-related acquisitions destroy value, finds weak support. The CAARs obtained for non-related acquisitions over all event periods are insignificant, that is, markets were indifferent to announcements of these events. From Table 5, we note that BHAR over 1 year is significantly negative, implying that

**Table 5** Long run abnormal returns of acquirers

	+1 year	+2 years	+3 years
Related acquisitions	-.073 [.71](.77)	.025 [2.32](.0)	.072 [2.73](.0)
Related mergers	.019 [1.41](.08)	-.077 [-.24](.31)	-.085 [-.36](.20)
Non-related acquisitions	-.319 [-1.03](.09)	-.215 [-.41](.15)	-.247 [-.29](.16)
Non-related mergers	.076 [3.20](.01)	.037 [1.89](.02)	-.201 [-1.67](.06)

Figures in square brackets are *t* values and those in parentheses are *p* values

shareholder value was eroded over 1 year by these acquirers. This implies that diversification to non-related industries led to temporary, but significant underperformance. That is, non-related acquisitions destroyed value vis-à-vis non-event firms in the same industry.

Finally, our conjecture in Hypothesis 4, that non-related mergers would create value, is not defended by short run metrics of performance, and partially defended by long run metrics of performance. The CAARs over all event periods are insignificant, implying that upon announcement, markets were neither optimistic nor pessimistic about their future implications. That is, no value was created in the short run. Observing the BHARs in Table 5, we note that 1 year BHAR is significant and positive at .08 % that reduces to a significant .04 % over 2 years, and finally to becoming significantly negative at  $-.2$  % over 3 years. This suggests that there were probably short term benefits as envisaged by the diversification benefit hypothesis, which led to higher performance over the first 2 years. So, value was created in the initial phase after merging. However, 3 years down the line, value seems to have been destroyed, which could be because of difficulties in managing a large organization, like developing operational inefficiencies or capital misallocation (Seo, Lee, & Wang, 2010). We have proposed that mergers in India are between parent subsidiary firms, or firms under the same management, and hence there is no fresh possibility of either exploiting strategic advantages, or agency problems. However, inefficiencies can creep into the merged entity, simply because till 2007, there was no requirement of segment reporting in India, and hence monitoring a large firm, with non-related businesses might become difficult. Prior to the merger, the two firms were separate entities, enabling better monitoring. That is why, in Table 2, we mention that diversification discount hypothesis might not be completely unlikely in the case of non-related mergers.

### Multivariate regression analysis

As we discussed earlier, mergers in India give certain tax benefits to the acquiring firm. There are also other financial synergies in a merger that are unlikely to be realized in an acquisition. So, it is possible that our sample has “selection bias” in the sense that only companies that perceive higher financial synergies go for mergers. In this case, our estimates will be biased, even asymptotically (Kennedy, 2009). We test for this possible endogeneity in our sample by using Heckman’s (1979) two-step method. However, we find that inverse Mills ratio was significant in only three of the 15 regressions (both short and long run) and hence we do not report these results here.

*Dependent variable: Short run performance metrics* For the regression analysis with short term returns, we have three dependent variables, corresponding to three time periods used to calculate CAARs. However, for regressions on CAAR calculated over the time period  $[-10, +10]$ , we do not obtain any significant coefficient, and hence we do not report the results. Regressions on the CAARs calculated over  $[-1, +1]$  and  $[-5, +5]$  are reported in Table 6.

We observe that for the event period  $[-1, +1]$ , *Rel* is positive and significant, implying that the performance from related acquisitions is significantly greater than

that of non-related acquisitions, even after controlling for other effects known to influence performance. However, for the event period  $[-5, +5]$ , *Rel* becomes insignificant. Thus we obtain only partial evidence that industry relatedness is a significant indicator of good performance.

Among the control variables, we note that Leverage and Tobin's Q have significantly positive influences on performance. Thus the beneficiary role played by debt providers and the effect of a good managerial team in improving short run acquisition

**Table 6** Multivariate analysis of acquirers' short run abnormal returns

Dep. Var.	CAAR <sup>MM</sup> [-1, +1]		CAAR <sup>MM</sup> [-5, +5]			
Constant	-.631 (.59)	-.649 (.59)	.359 (.77)	-.886 (.70)	-.846 (.72)	.024 (.99)
Rel	1.454 (.07)	1.453 (.09)	1.353 (.11)	1.548 (.33)	1.527 (.36)	.877 (.59)
Tgt	.184 (.81)	.308 (.70)	.206 (.80)	.029 (.99)	.168 (.92)	-.508 (.75)
Mode	1.063 (.28)	1.118 (.27)	1.293 (.21)	.940 (.63)	.874 (.67)	1.185 (.55)
Lev	1.006 (.01)	.974 (.01)	.779 (.05)	1.733 (.02)	1.643 (.04)	1.180 (.12)
FCF	.443 (.76)	.172 (.91)	-.588 (.71)	3.000 (.30)	3.464 (.26)	.076 (.98)
Tobin's Q	.334 (.02)	.334 (.02)	.307 (.03)	.528 (.06)	.546 (.06)	.488 (.08)
MTB	-.087 (.27)	-.081 (.33)	-.067 (.42)	-.200 (.21)	-.202 (.22)	-.177 (.27)
MCAP	-.158 (.39)	-.141 (.45)	-.144 (.45)	-.179 (.62)	-.139 (.71)	-.111 (.77)
BHAR12	-16.196 (.52)			3.023 (.95)		
BHAR24		-14.073 (.26)			-10.710 (.66)	
BHAR36			-9.489 (.22)			-5.513 (.71)
R <sup>2</sup>	3.5 %	3.7 %	3.4 %	1.8 %	1.8 %	1.2 %

*Dep. Var.* Dependent variable is CAAR<sup>MM</sup> (CAAR calculated by Market Model). Figures in brackets denote the days over which the cumulating of abnormal returns were carried out

Independent variables: *Rel* (Dummy) Equals 1 if acquirer and target belong to same industry, else 0. *Tgt* (Dummy) Equals 1 if target is listed, 2 if it is unlisted, and 3 if it is foreign. *Mode* (Dummy) Equals 1 for acquisition, 0 for merger. *Lev* Previous 3 years' average of acquirer debt to equity ratio. *FCF* Previous 3 years' average of acquirer free cash flow, defined as (Cash flow from operations - Change in working capital - Change in net fixed assets) / Total assets. *Tobin's Q* Previous year acquirer Tobin's Q, defined as [BV(Total assets) + MV(Equity) - BV(Equity)] / BV(Total assets). *MTB* Most recent market to book ratio

Figures in parentheses are *p* values

performance is upheld. Also, *MTB* is found to be significantly negative, upholding the extrapolation hypothesis.

*Dependent variable: Long run performance metric* We conduct another regression analysis on acquirer's long run performance. We have three dependent variables—the *BHAR* over 1/2/3 year post acquisition. We build three models based on different sets of independent variables. In all models, the common control variables included are the three dummies for mode of transaction (*Mode*) and status of target (*Tgt*), Market capitalization (*MCAP*), Leverage (*Lev*), Free cash flow (*FCF*) and Tobin's *Q* ratio (*Tobin's Q*). The distinguishing independent variables are as follows:

- a) Model 1 includes past performance with pre-acquisition *BHAR* (*BHAR-k*) but not *MTB*,
- b) Model 2 with both *MTB* and pre-acquisition *BHAR* (*BHAR-k*),
- c) Model 3 with *MTB* but no pre-acquisition *BHAR* (*BHAR-k*)

Table 7 presents the regression results. We observe that in all models, for all dependent variables, *Rel* is insignificant. Thus, we do not find evidence to suggest that over the long run, relatedness leads to enhanced performance.

Among the consistent controlling variables, when dependent variable is *BHAR3*, *MCAP* is negative and significant, corroborating the conjecture of Moeller et al. (2004) that size is an important factor that mediates acquirer performance. Further, in Model 1 and Model 2, pre-acquisition abnormal returns are significant when the dependent variable is *BHAR2* (compounded over the first 12 months after acquisition).

## Discussion and conclusion

### Contribution

The vast literature on takeover performance in general and the effect of relatedness in particular has been conceptualized in developed economies. The conjectures proposed therein reflect the capital and regulatory contexts of those economies. However, many emerging economies have very different settings, especially with respect to control issues of dominant shareholder. Single dominant controlling shareholders are quite common in these economies (Hu, Tam, & Tan, 2010). In addition, there are regulatory differences, as highlighted in this paper. For example, there are benefits that accrue to a merger and not to an acquisition because of specific Indian regulations. Other regulations imply that mergers take place between companies under the same management, in order to ensure that there is no loss in control. Because of these control issues, we mostly find inter-group mergers and intra-group acquisitions. Given that there is no real change in control in mergers, we argue that many of the benefits as well as evils suggested in the M&A literature do not hold true in the case of mergers, simply because those in control could exploit both, even without the merger. India thus provides a unique market for corporate control. It becomes obvious then, that such a vastly

**Table 7** Multivariate analysis of acquirers' long run abnormal returns

Model	Model 1			Model 2			Model 3		
	BHAR1	BHAR2	BHAR3	BHAR1	BHAR2	BHAR3	BHAR1	BHAR2	BHAR3
Constant	.018 (.43)	.110 (.01)	.066 (.26)	.014 (.54)	.080 (.08)	.034 (.57)	.011 (.64)	.132 (.00)	.137 (.03)
Rel	-.011 (.49)	-.038 (.21)	.004 (.93)	-.010 (.52)	-.037 (.22)	.009 (.82)	-.019 (.27)	-.052 (.10)	.015 (.73)
Tgt	-.001 (.95)	-.022 (.44)	-.038 (.31)	.000 (.99)	-.011 (.70)	-.029 (.45)	.004 (.80)	-.010 (.74)	-.016 (.68)
Mode	.032 (.11)	.016 (.66)	-.034 (.46)	.031 (.12)	.012 (.74)	-.040 (.39)	.029 (.16)	.007 (.85)	-.016 (.74)
MCAP	-.008 (.06)	-.026 (.00)	-.023 (.03)	-.007 (.09)	-.021 (.01)	-.018 (.10)	-.010 (.02)	-.041 (.00)	-.045 (.00)
Lev	.010 (.21)	.005 (.72)	.023 (.23)	.010 (.19)	.010 (.50)	.024 (.20)	.015 (.07)	.008 (.59)	.021 (.30)
FCF	-.031 (.26)	-.004 (.94)	-.039 (.69)	-.029 (.30)	.022 (.68)	-.031 (.75)	-.008 (.78)	.022 (.69)	.009 (.92)
Tobin's Q	-.010 (.03)	-.017 (.04)	-.016 (.11)	-.007 (.25)	.008 (.58)	.021 (.36)	.003 (.51)	.007 (.34)	.011 (.62)
MTB				-.002 (.62)	-.022 (.03)	-.031 (.07)	-.001 (.16)	.000 (.65)	-.028 (.09)
BHAR-k	7.901 (.02)	-19.800 (.00)	-24.000 (.00)	8.061 (.02)	-18.000 (.00)	-22.005 (.00)			
R <sup>2</sup>	3.7 %	13.7 %	15.3 %	3.7 %	14.6 %	16.1 %	2.5 %	6.3 %	9.1 %

Dependent variables are Buy and hold abnormal returns compounded over 1, 2, and 3 years.

Independent variables: *Rel* (Dummy) Equals 1 if acquirer and target belong to same industry, else 0; *Tgt* (Dummy) Equals 1 if target is listed, 2 if it is unlisted, and 3 if it is foreign; *Mode* (Dummy) Equals 1 for cash, 0 for stock; *MCAP* Acquirer market capitalization in the most recent October; *Lev* Previous 3 years' average of acquirer debt to equity ratio; *FCF* Previous 3 years' average of acquirer free cash flow, defined as (Cash flow from operations - Change in working capital - Change in net fixed assets) / Total assets; *Tobin's Q* Previous year acquirer Tobin's Q, defined as [BV(Total assets) + MV(Equity) - BV(Equity)] / BV(Total assets); *MTB* Market to book ratio taken as ratio of market capitalization of common equity in the most recent October divided by most recent fiscal year end book equity; *BHAR-k* Buy and hold abnormal returns of acquirer, compounded over  $k$  months before the event, where  $k = 12$  for dependent variable BHAR1,  $k = 24$  for dependent variable BHAR2, and  $k = 36$  for dependent variable BHAR3

Figures in parentheses are  $p$  values

different setting would necessitate alternative frameworks to assess mergers and acquisitions, and their effects on shareholder wealth (Yang et al., 2011). In this paper, we suggest that mergers and acquisitions cannot be construed as a homogenous group, since they are transacted differently, and offer different benefits and opportunities to the investee firm, and hence should be analyzed separately. We propose that, because of the distinctiveness of Indian regulations, there is a higher chance of realizing financial synergy in mergers and realizing operating synergy in acquisitions in India. Since



realization of synergies is also linked to the similarities or dissimilarities of industry of target and acquirer firm, we examine the effect of industry relatedness on the performance of Indian acquirers in this study, using both long run and short run performance metrics. We also consider mergers and acquisitions separately, to get hints of sources of synergies exploited by these combinations. Our results uphold our view—mergers and acquisitions display different performances over both short and long term, even when considered under the same settings of relatedness or non-relatedness of the target industry. While acquisitions, which are structured almost similar to M&A deals in developed economies, exhibit performances that are analogous to those reported in literature based on those economies, Indian mergers have unique configurations that affect its sources of synergies and are found to exhibit divergent results. Further research is necessary to contribute more to this framework of sources of synergies in the distinctive institutional context that dominates emerging economy firms.

Second, this article uses both short term announcement period returns as well as long term buy and hold abnormal returns to assess takeovers. Again, an examination of the results reveals that these results can provide different interpretations of the same event. In fact, we find that all short term abnormal returns reverse within a few days after the announcement; although reversal for related transactions take place about three days later than reversal for non-related transactions. This provides some hint of market applying heuristics to evaluate these events immediately after announcement. Hence, it is advisable to use both kinds of performance metrics, and then combine the implications of the results to arrive at a holistic and rational conclusion.

For announcement period performance, we consider three event periods—a 3 day period spanning 1 day before to 1 day after the announcement day, an 11 day period extending from 5 days before to 5 days after the announcement day, and a 21 day period over  $-11$  to  $+11$  days.

For long run performance study, we employ the buy and hold abnormal returns. Keeping in mind the various drawbacks of this method, we take care to apply the necessary correction, and make the methodology robust to those drawbacks. Using these metrics, we find that related acquisitions, which we conjecture are undertaken to exploit operational or marketing or financial synergies, create value both in the short run and long run. But non-related acquisitions, where diversification discount can come into play, exhibit insignificant announcement period abnormal returns and negative long run returns, indicating they destroy value. These results are similar to what has been reported in literature based on developed economies. This is not unsurprising, since acquisitions are structured on similar lines as M&As are structured elsewhere in the world. Performance results diverge from these established findings when we consider mergers. In India, mergers are generally between firms which are under the same business groups or are parent-subsidiary firms. Hence we argue that all the benefits of strategic fit or the damages of diversification discount can be exploited by the common management, even without any merger. That is, a merger need not be undertaken for these purposes. Of course, Income Tax Laws allow some financial synergies only to mergers and not to acquisitions, and the exploitation of those synergies can be the sole aim of a merger. Under this situation, mergers should always create value for its shareholders, irrespective of business relatedness or not with the target. Consequently, we find related mergers create value both in the announcement period, and also over the long term. Non-related mergers also create value, but over the

first two years post merger; value however, is destroyed over the three years post merger. This could be because of increased monitoring complexities of a large diversified firm over that of smaller individual firm.

Thus, this study contributes to the literature in two ways. First, we draw focus to the fact that, in economies where family controlled firms are common, considerations of loss of control is an important factor in deciding whether firms opt for a merger or an acquisition. This finds resonance with the M&A literature that focus on unlisted targets, and suggest that entrenched managers avoid private targets to preserve their control and avoid monitoring (Harford, Humphrey-Jenner, & Powell, 2012). A similar concern exists in India, and other economies where business groups, organized around a family, flourish. Thus a merger, where target firm shareholders become acquiring firm shareholders, is undertaken when both target and acquiring firms belong to the same group. But an acquisition is undertaken when target and acquiring firms belong to different groups, since in an acquisition only controlling stake is acquired and target firm continues as a separate legal identity.

Our second contribution lies in identifying different sources of value creation or destruction for inter-group mergers and intra-group acquisitions. While we draw from documented M&A theories of synergy and agency, we note that their relevance in the Indian context is varied. So, we also adopt concepts from business group literature to identify other sources of value creation or destruction. Thus, through our attempt to integrate the Indian story into known theoretical frameworks, we also draw attention to the need for developing a modified framework that discusses value creation in economies dominated by family firms. We hope our study would spawn further research in this direction.

In spite of the above contributions, this work is also not without limitations. Some of the synergy stories developed here are rooted in Indian regulations and laws that govern mergers and acquisitions. We are not aware whether similar laws are applicable in other countries. This limits the generalisability of our findings. So, further investigations into the uniqueness and similarities of other economies organized around business groups, are of great importance before a truly robust framework can be developed for such economies.

Notwithstanding the above limitation, we can still draw some practical implications of our study. At the very least, our study informs market participants to take into account regulatory and institutional diversities before evaluating major corporate decisions. This will further promote capital markets to be more efficient and less heuristic.

#### Implications for the Asia Pacific market

As opposed to diffused shareholding with strong legal protection in developed economies, or government as the dominant shareholder in China, or *keiretsu* in Japan, firms in most Asia Pacific economies including India, are known to be dominated by family ownerships. These owner-families are generally reluctant to use equity to finance mergers to ensure they do not dilute control (Jiang & Peng, 2011). In such situations, our argument that there would be more inter-group acquisitions and intra-group mergers, should be more pertinent. Like in India, therefore, mergers and acquisitions between firms in the Asia Pacific economies cannot be deemed equivalent; these are separate firm strategies. Further, it is well known that greater control rights over cash

flow rights lead to control over multiple companies, each of whom share resources and relationships (Zhou & Peng, 2010). Our contention on sources of synergies from mergers would be relevant in such relational and resource sharing environments too, and can be empirically verified. In fact, we believe that present theories on drivers of M&As do not consider *loss of control* as an important issue, although this is one of the most important realities as well as the most stark differentiators. We hope our article will stimulate more research in this direction, within similar institutional contexts.

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