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Comparative Analysis of Cross-Border M&AS in EU and Republic of Croatia in Period 2013 – 2017

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Abstract

Cross-border mergers and acquisitions are crucial for the competitiveness of corporations as well as for the global economy and their intensity is affected by the availability of funding sources, capital market development, regulatory restrictions and technological shocks. Only in April 2017, 1,026 transactions totaled \$ 229.9 billion which represents an increase of 3.8% in the total transaction value (although the absolute number of transactions was lower by 530 compared to April 2016). The key objective of this paper is a comparative analysis of activities of cross-border mergers and acquisitions in the Republic of Croatia with the EU countries in the period from 2013 when the Republic of Croatia became a member of the EU until the end of 2017. Analyzed transactions are precisely cross-border acquisitions since they account more than 95% of all cross-border transactions in EU countries. The paper focuses on identification of number and value of cross-border merger and acquisitions in the Republic of Croatia in relation to other EU countries with detailed description of the largest cross-border transactions in the Republic of Croatia and EU in the observed period. The structure of the modalities of mergers and acquisitions in the Republic of Croatia will be compared with other EU countries. The expected contribution is related to the description, analysis and synthesis of European and Croatian experiences in cross-border mergers and acquisitions in order to identify trends and to address the challenges.

Keywords: Croatia, cross-border mergers and acquisitions, EU, 2013-2017

Track: *Management & Leadership*

Word count: 3.915

1. Introduction

For more than two decades economic liberalization and accelerated development of technology have been the drivers of increasing business globalization. One of the most important results of globalization is a hyper-competition and competitive dynamics around many industries in global economy. These contemporary business environments force corporations to use different strategies in order to successfully position with respect to competition and to preserve and increase their profit margins. Mergers and acquisitions are crucial for the competitiveness of corporations as well as for the global economy. Their

intensity is affected by the availability of funding sources, capital market development, regulatory restrictions and technological shocks.

The focal interests of the paper are cross-border transactions and we provide relevant literature review. The theoretical framework based primarily on managerial approaches to mergers and acquisitions, is followed by empirical research. Empirical part of the paper is based on comparative analysis of activities of cross-border mergers and acquisitions in the Republic of Croatia with the EU countries in the period from 2013 when the Republic of Croatia became a member of the EU until the end of 2017. Analyzed transactions are precisely cross-border acquisitions since they account more than 95% of all cross-border transactions in EU countries.

The scientific contribution of the paper is related to the description, analysis and synthesis of European and Croatian experiences in cross-border mergers and acquisitions in order to identify trends and to address the challenges. In conclusion we stress the importance of cross-border M&A for competitiveness in EU countries.

2. Theoretical framework

Cross-border M&As as those involving an acquirer firm and a target firm whose headquarters are located in different home countries. Cross-border M&A activities due to their international nature, have unique challenges as countries have different economic, institutional and cultural structure (Hofstede, 2001). Cross-border M&A activities pose tremendous challenges, in particular in the post-acquisition stage (Child et al., 2001). Recent evidence suggests that they are not highly successful. For example, a study by KPMG found approximately that only 17% of cross-border M&As create shareholder value, while 53% destroyed it (Economist, 1999).

Cross-border mergers and acquisitions process should be seen as a series of largely independent events, culminating in the transfer of ownership from the seller to the buyer rather than just an independent event (Filipović, 2012). In theory, thinking of a process as discrete events facilitates the communication and understanding of numerous activities required to complete the transaction. Thinking of M&As in the context of transaction-tested process, while not ensuring success, increases the probability of meeting or exceeding expectations (DePhampilis, 2010). When pursuing cross-border M&As, firms consider various conditions, including country-industry-and firm-level factors, which relate both to the acquiring and to the target firm. At national and industry level, factors such as capital, labor and national resource endowments, in addition to institutional variables such as legal, political and cultural environment, are highly significant. At the firm level, organizations pursuing an international strategy need to identify and evaluate potential targets to acquire in the host countries (Shimizu et al., 2004).

Cross-border mergers and acquisitions have, historically, been analyzed from economic perspectives like transaction cost economics (Williamson, 1975) and ownership-location-internalization framework (Dunning, 1993). A major focus in these researches has been the

uncertainty and risk associated with different national cultures and institutional settings. These frameworks provide limited insights for M&As implementation processes. Recent research has examined the value of international expansion and cross-border M&As from resource-based perspective and organizational learning perspective (Vermeulen, Barkema, 2001). Given the increasing strategic importance of cross-border M&As, both from practitioner and research perspective, Shimizu et al. suggest that additional theoretical insights and broader focus of research are required (Shimizu et al., 2004). Therefore, the consequent segment of the theoretical framework is managerial approach to cross-border mergers and acquisitions.

Managerial approach to cross-border mergers and acquisitions focuses on the study of widespread evidences that most of the mergers and acquisitions do not create value for shareholders and other influential groups. For example, KPMG (1999) conducted a research which included 700 cross-border transactions of the highest value in the period from 1996 to 1998. Out of the total number of transactions, only 17% created a value, 30% had "zero" effect, and 53% of transactions had negative effects from the point of view of creating value for shareholders.

Based on the postulates of Berle and Means (1932), over the time, a numerous versions of managerial theories have been developed, of which the most important are those of Penrose (2009) and Marris (1963). Although each of these theories emphasizes different things, one thing is common to both. Namely, all the authors came to the conclusion that the shareholders of the company and competitive market forces cannot discipline managers in full range and because of that managers can work for themselves in order to increase their own wealth at the expense of the shareholders. Manager's personal interests manifests through many different forms including empire building, growth and diversification. Mergers and acquisitions, which are motivated by personal interests of managers, do not create value but just the opposite – they are destroying the value by an ineffective use of assets (Carline, Linn, Yadav, 2009).

Of the many theories that have been developed over the time, Marris's theory (1963) is considered to be the most elaborated. According to Marris, managers can put their own wealth in the first plan and on the expense of shareholders until the moment in which company's value decreases significantly. Decrease in value is a signal to other managers or companies to take advantage of situation and to discipline management by takeover activities (Manne, 1965).

In analysis of managerial approach to mergers and acquisitions, it is necessary to take Gort's theory of an economic disturbance of mergers in consideration. According to Michael Gort (1969), waves of mergers and acquisitions arise in periods of economic expansion. In these situations, some investors have higher expectations of future demand and therefore, for them, target companies are worth more. Mergers and acquisitions are the result of investors' attempts to take advantage of discrepancies in the value of the target company. At the moment when leading companies decide to acquire, their competitors follow them out of fear that they

will found themselves in unfavorable situation after the new constellation of forces in the industry. In this way, the waves of mergers and acquisitions begin. Gort's theory is consistent with the waves of mergers and acquisitions during the periods of strong economic growth in the United States, the United Kingdom and the rest of the European Union (Sudarsanam, 2005).

According to the theory of economic disturbance, Gort states that discrepancies in the value of the company arise in situations, not when stock prices are low, but rather just the opposite – when stock prices are high. His opinion is based on assumption that managers and shareholders of the target company would not accept takeover bid if the price of shares of the target company is low because, at that point, they believe that the value of their company is undervalued. In the same situation neither acquirer would decide to acquire by offering a significantly higher price than the one that currently reflects the market. Such thesis is supported by numerous empirical researches (Crook, 1995; Golbe, White, 1993).

Contrary to Gort, Mueller (1969) points out that growth, as a company's objective, is the main motive for which managers decide to merger and acquire. Separation of ownership and management functions enable managers to work in their own personal interest and acquire other companies in order to achieve growth.

Also, an indispensable part of the managerial perspective on mergers and acquisitions is a contribution given by Richard Roll. Roll developed the hubris hypothesis of corporate takeovers based on empirical studies done by Jensen and Ruback (1983) who concluded that acquisitions have positive effect on the wealth of shareholders and that target's shareholders have benefits from these transactions, while shareholders of the acquirer do not lose. In their opinion the positive effects of acquisitions are not a consequence of strengthening the company's market position and they point out that it is difficult to detect destructive behavior of managers during the process of mergers and acquisitions.

Roll (1986) explains that the positive effects of acquisitions are often overrated, if they even exist. The mechanism which initiates acquisition suggests that at least one part of the increase in the target stock's price can represent a transfer of the value of acquirer's stocks, i.e., the part that refers to a premium. For Roll, the process of valuation of a company is of great importance. In this process, after the identification of a target company, the acquirer approaches to valuation of the target company in which he incorporates potential synergies and opportunities for more efficient business operations with new management. The resulting value of the target company is compared with the current market value and if it is higher than the current market value, the acquirer decides to make an acquisition. Starting from a hypothetical situation in which synergies and other positive effects cannot be achieved during acquisition, and the management of acquirer believes otherwise, Roll observes the valuation process of the company as a random variable whose average is the current market value of the target company. When a random variable exceeds average value, acquirer makes a takeover bid, as otherwise there is no bid. Acquirer is considering the bid only in situations when his

valuation of the target company is high and he does not consider values which are located on the left side of the distributions curve. The premium is, in this case, actually a random acquirer's error.

Empirical researches of numerous psychologists suggest that, in the process of making a decision to acquire a company, all managers do not behave rationally. Acquisitions are a reflection of individual manager's decisions and it is difficult to expect that the manager will refrain from acquiring a target company which is based on previous experiences (Filipović, 2012). Although some companies are often faced with mergers or acquisitions, a manager, at the average, in his career has a chance to participate only in a few transactions. The manager can be convinced that his valuation of the target company is accurate, and that the current market value of the target company does not reflect its full economic value. For that reason, Roll (1986) explains the phenomenon of acquiring through the manager's arrogance and sets so called the hubris hypothesis. If there are actually no aggregate positive effects of acquisition (increase of the wealth of an acquirer and of a target company) then acquisition depends on the arrogance of managers who believe their valuations are accurate. Even if positive effects exist in some acquisitions, the height of a premium which is paid for the target company can be a result of a mistake in valuation and arrogance of the manager.

In a situation where several acquirers are competing for a target company, the acquirer who succeeds to take over the target company is often characterized by the winner's curse. The winner's curse is a reflection of a manager's mistake in estimating the value that can result in overpayment of the target company, which will minimize area for the value creation after acquisition (Damodaran, 2002).

Along with the Roll's hypothesis of managerial arrogance, Amihud and Lev (1981) have given an essential contribution to managerial perspective of mergers and acquisitions. They began from the assumption that managers invest their own resources in the company, i.e., knowledge and skills as well as financial resources. In that way, the assets of a manager are not diversified, unlike stockholders assets, and are subject to specific corporate risk such as bankruptcy. Managers decide on acquisition to minimize volatility of a company's earnings, thus reducing the risk of bankruptcy, job losses and losing their investment in the company.

Hayward and Hambrick (1997) were researching high premiums payouts in the process of acquisition associated with managerial arrogance. In their research, which included 106 large acquisitions, they measured the arrogance of CEO with: the recent company success, media glory, and relative power (measured by the ratio of CEO compensation with the following best paid manager). The conclusion of their research suggests that arrogant and wealthy CEOs were constantly overpaying the companies that they have acquired. Malmeinder and Tate (2008) also researched the impact of managerial arrogance on mergers and acquisitions on the sample of 394 large companies in the United States in the period from 1980 to 1994. The results obtained by their research are consistent with the Roll's assumptions and apostrophize how arrogant managers overestimate their ability to create value for shareholders. As a

repercussion of overestimating their capabilities and erroneous valuation of the target company, acquisitions result in destruction and not in creating value. Malmeinder and Tate also pointed out that market's reaction on transaction, in which participate arrogant managers, is negative. Fung, Jo and Tsai (2009) emphasized that managers, who do not have significant amount of shares in companies and whose compensation packages are related to the share options, often opt for acquisition that result in destruction of value.¹

3. Empirical research

The comparative analysis of activities of cross-border mergers and acquisitions in the Republic of Croatia with the EU countries is executed for the period from 2013 when the Republic of Croatia became a member of the EU until the end of 2017. Data was obtained from Mergermarket database covering transactions of 5 million USD and more and cross-border M&A are reported at the time when the deal was announced.

Dynamics and volume of M&A activities reflect the economic growth intensity as well as economic recession and periods of recovery. Table 1. presents M&A activities in Croatia, EU and world from 2013 until 2017. Constant growth of transaction is marked at EU and global level. Meanwhile, dynamics and volume of M&A activities in Republic of Croatia were relatively stable from 2013 when the Republic of Croatia became a member of the EU until the end of 2016. Minor decrease is evident in 2017 in Republic of Croatia, therefore it will be interesting to analyze future dynamics and trends.

Table 1. M&A transactions in Croatia, EU and worldwide in period 2013 - 2017

Year	M&A Croatia	M&A EU	M&A world
2013	26	5.800	7.124
2014	25	6.746	8.233
2015	28	6.813	8.075
2016	24	7.620	8.970
2017	18	7.967	9.383
Total	121	34.946	41.785

Source: www.mergermarket.com

Domestic transaction is a transaction concluded within a nationally boundary i.e. a deal involving two or more increment nationals, while cross-border is transaction that is conducted across national boundaries i.e. a deal that involves companies from at least two different nationalities. It is evident from Table 2 and Figure 3 that 71,9% of M&A transactions in Republic of Croatia are cross-border transaction.

¹ Fung, S., Jo, H., Tsai, S. C. (2009) Agency problems in stock market-driven acquisitions. *Review of Accounting and Finance*, Vol. 8, No. 4, pp. 421-425.

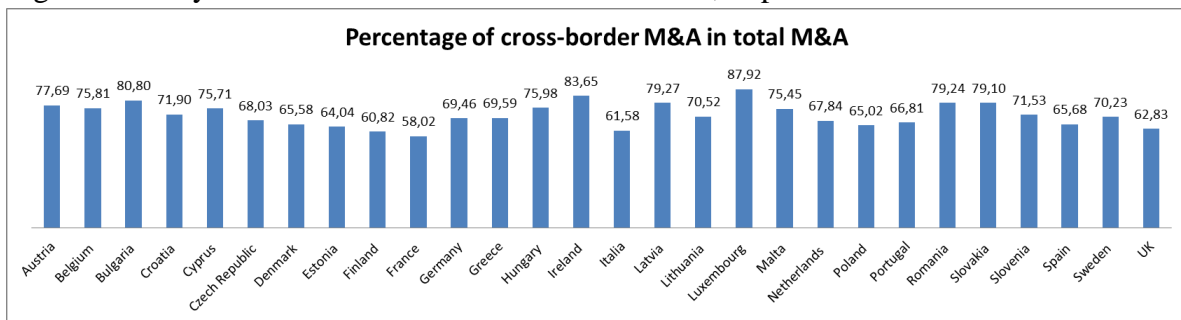
Filipović (2011) analyzed cross-border transactions for the period 1998 until June 2010, value of 5 million USD and more, and proportion of cross-border activities in Republic of Croatia were 84%. Decrease of proportion of cross-border transaction from 84% in period 1998 – 2010 to 71,9% in period 2013 -2017 incontestably may be related to the domestic economic situation which resulted in increase of domestic transactions.

Table 2. M&A and cross-border M&A in EU, in period 2013 - 2017

Country	TOTAL M&A	CROSS-BORDER M&A	Country	M&A	CROSS-BORDER M&A
Austria	883	686	Italia	2.905	1.789
Belgium	1.484	1.125	Latvia	164	130
Bulgaria	125	101	Lithuania	173	122
Croatia	121	87	Luxembourg	753	662
Cyprus	177	134	Malta	110	83
Czech Republic	610	415	Netherlands	3.383	2.295
Denmark	1.714	1.124	Poland	929	604
Estonia	228	146	Portugal	476	318
Finland	1.067	649	Romania	289	229
France	6.234	3.617	Slovakia	177	140
Germany	6.304	4.379	Slovenia	137	98
Greece	171	119	Spain	2.500	1.642
Hungary	254	193	Sweden	2.761	1.939
Ireland	1.217	1.018	United Kingdom	10.640	6.685

Source: www.mergermarket.com

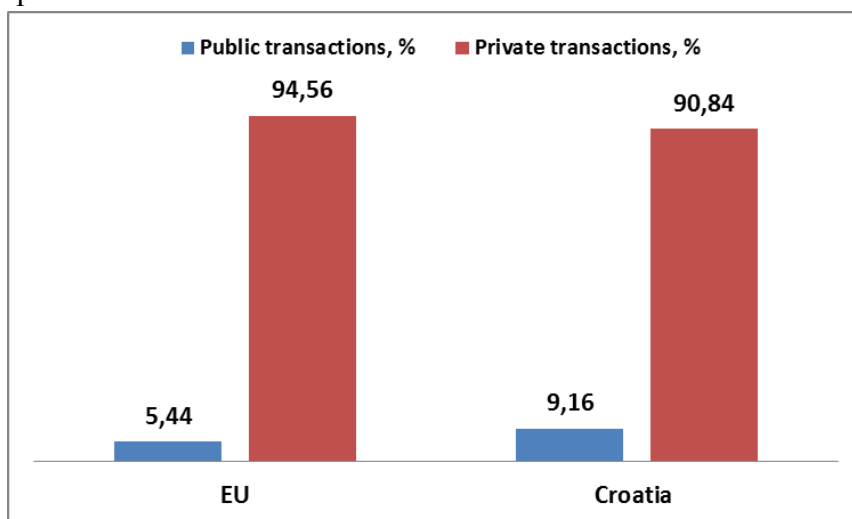
Figure 1. Analysis of cross-border M&A in total M&A, in period 2013 - 2017



Source: www.mergermarket.com

Private M&A is transaction that does not require shareholder approval in a public forum either from the bidder, target or vendor shareholder while public transaction requires one. Figure 2 indicates that 9,16% of all Croatian M&A activities and 5,44% of all M&A activities in EU from 2013 until 2017 are public. Partial explanations for proportion of private and public transactions for EU countries are characteristics of continental corporate governance system which is present in most EU countries.

Figure 2. Comparison of M&As' arena



Source: www.mergermarket.com

In analyzed countries all of the largest transactions in terms of value are cross-border transactions which confirm their role for economic development.

The leading transaction in EU in period 2013 - 2017 was public, cross-border acquisition announced in 2015 and completed in 2016. Anheuser-Busch InBev (Belgium based and listed beverage producer) reached an agreement on the terms of a recommended acquisition of SABMiller Plc. (London and Johannesburg listed, UK based, beverage producer). Second largest transaction was also public, cross-border acquisition announced in 2015 and completed in 2016. Royal Dutch Shell Plc. (UK listed and incorporated and Netherlands tax-resident energy company) acquired BG Group Plc. (UK listed and based energy company).

The leading transaction in Republic of Croatia in period 2013 - 2017 was public, cross-border acquisition announced in 2013. Agrokor d.d. (Croatia based company headquartered in Zagreb, engaged in production, distribution and retail sale of food products and drinks) acquired Poslovni sistem Mercator d.d. (Slovenia based company headquartered in Ljubljana, operates as a food retailer). Second largest transaction was private, cross-border acquisition announced and completed in 2015. British American Tobacco Plc. (listed UK-based company, headquartered in London, manufacturer and distributor of cigarettes, cigars and other tobacco products) acquired TDR d.o.o. and other tobacco and retail assets from Adris Grupa.

4. Conclusion

With increased external pressures companies have increasingly searched outside their internal boundaries and national borders to build or reinforce their competitive capabilities. The relevance of cross-border M&A activities in hyper-competition environments has been identified and analyzed. Empirical research ratifies the relevance of cross-border M&A activities for companies from Republic of Croatia and EU. Moreover, many similarities among EU countries are identified regarding cross-border M&As that are verified as significant segment in total M&A activities.

Mergers and acquisitions are prevalent choice for growth and expansion, and companies from EU countries will engage in these transactions even more in the future, therefore it is imperative to highlight the importance of cross-border M&A success in terms of creation of value for shareholders and all relevant stakeholders. As a origin of unsuccessful mergers and acquisitions, the literature often lists poorly designed or inadequate implementation of business strategy after the transaction, therefore these would be the suggestions regarding future researches. Case study analysis regarding post-transaction activities could be the most beneficial contributions to the cross-border M&As' success.

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