

THE IMPACT OF CORPORATE GOVERNANCE ON CHANGING FINANCIAL PERFORMANCES OF MERGERS AND ACQUISITIONS



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ABSTRACT

In the present paper, we construct a corporate governance index for a sample of 93 Indian companies listed on Bombay Stock Exchange and National Stock Exchange. The index is based on a comprehensive set of 64 governance attributes for these sample companies, the companies, then, have been classified into four governance portfolios using their corporate governance ranking. Furthermore, we have calculated average of 3 years post - mergers and acquisitions (M&A) financial performance and valuation ratios for each governance portfolio. Our findings suggest good governance appears to be of much value as we found significant higher post mergers and acquisitions rate of return ratios for companies in top quartiles. We also report significant higher valuation ratios for companies in top governance portfolio. The present study concludes that companies with higher rank for corporate governance score are good performers which

are revealed from better financial ratios. Their post M&A better financial performance and valuation shows that good governed companies bring positive synergies from their M& A activities which is recognized by market reflected in higher valuation ratios.

Keywords: Merger, Acquisition, Agency Problems, Synergy, Corporate Governance, Hubris, Managerialism, Abnormal Returns

Introduction

The motives for acquirers engaging in merger and acquisitions are well documented in the literature with the synergy motive associated with positive wealth effects for acquirers while zero/negative wealth effects said to be driven by hubris and/or managerialism (Berkovitch and Narayanan, 1993). Synergy results when the value of the combined firm is greater than the sum of the acquirer and target as individual firms and can be achieved from combining firms in the same industry sector (operational synergy), when firms have different financial resources (financial synergy) or different managerial resources (managerial synergy). Hubris occurs when management in the acquiring firm makes a mistake in over-estimating the value of the target leading it to overpay and a wealth transfer from acquiring to target shareholders as a result. Managerialism arises when managers use acquisitions for their own motives of empire building at the cost of their own shareholders wealth. Managers can be viewed as agents for the shareholders of public corporations.

Corporate governance has evolved as a response to the agency problems that arise from the separation of ownership and control in a corporation. A firm's governance structure can be used to reduce the total agency costs of a

firm through the monitoring of management of action by aligning the managers' self-interests with those of shareholders. In much of finance and strategic management literature, the

definition of corporate governance has been viewed through the lens of an “agency problem” arising out of separation of ownership and control between firm and its providers. (Jensen and Meckling, 1976) An agency relationship exists when one or more persons (the principal or principals) hire another person (the agent or agents) as decision -making specialists to perform a service.

The agency problems arise when agent makes decision that result in the pursuit of goals that conflict with those of principals, or because shareholders lack direct control of largely publicly traded corporations. Thus, principals establish governance and control mechanisms to prevent agents from acting opportunistically. Agency problems exist any time when managers serve their own interests at the expense of their shareholders (Williamson, 1984). Agency problems create need for effective corporate governance to align the interest of managers and shareholders (Baysinger and Hoskisson, 1990).

Ever since Manne (1965) and Marris (1964) framed the phrase “the market for corporate control”, the phenomenon of mergers and acquisitions has been closely associated

Literature Review

The present section presents review of select major empirical works that focus on the relationship between corporate governance rating and firm performance.

Carline, Linn and Yadav (2009) examine associations between corporate governance characteristics of acquiring firms and operating performance effects of 81 domestic corporate mergers in the United Kingdom during 1985-94. They find that board ownership, board size and block-holder have an economically and statistically significant impact on post-merger operating performance changes. They have also investigated the relations between the initial market revaluation of the merger partners, operating performance changes and post-mergers returns of the merged firm.

Gompers, Ishii and Metrick (2003) examine the relationship between corporate governance and firm value in large sample of 1500 U.S. companies for a period 1990-1999. They have constructed a “Governance Index” to serve as proxy for the level of shareholder rights using the incidence of 24 governance factors provided by Investor Responsibility Research Center (IRRC). The index is based on the factors that influence shareholders right by adding one point for each corporate governance. Market for capital control is external mechanism to control agency problems. If the managers are inefficient at

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every provision that restricts shareholders’ rights. Their contention is that every provision that restricts shareholders’ maximizing shareholder wealth and the board fails to replace them, then an outside group may be able to takeover the company and replace the firm’s management. The primary purpose of takeovers is in disciplining inefficient management and the threat of takeover helps to align the managers’ interests with shareholders. A great deal of theory and evidence supports that takeovers address the governance problems. In view of the above, Mergers and acquisitions are well suited events to conduct an empirical study of the effects of corporate governance on financial performance and valuation.

The present paper has several objectives. Firstly, it constructs a corporate governance index based on the scores to a questionnaire scheduled with a personal interview of the directors and executive directors, chief finance officers, company secretaries of Indian companies who have undertaken mergers and acquisitions from 2003-2007. Secondly, it investigates the difference between the post mergers and acquisitions financial performance and valuation of companies ranked on the basis of the corporate governance score. For better exposition, the remainder of the paper has been organized in 4 sections. Section II reviews some of the relevant existing empirical work. Section III reviews the corporate governance initiatives in India.

Section IV delineates with the sources of data and research methodology; section V presents the empirical results. Finally section VI presents concluding observations.

right increases managerial power. They found a positive relationship between corporate governance and stock returns; empirical evidence has also been observed between performance and corporate governance. They measured performance through Tobin's Q. They have concluded that an investment strategy which focused on buying a portfolio of shares with strong shareholders rights which represents strong governance structure and selling shares with weak shareholder rights a proxy for weak governance structure would have realized annualized abnormal returns of 8.5 per cent from 1990 to 1999.

Bebchuk, Cohen, and Ferrell (2009) extended the work of Gompers, Ishii and Metrick (2003) by investigating the relative importance of 24 governance provisions included in the index. They constructed an Entrenchment Index (E Index) based on the six provisions and found that the index based on these provisions is negatively correlated with the abnormal return and firm's value, as measured by Tobin's Q during the period 1990-2003.

Cremers and Nair (2005) examined the relationship between abnormal return and governance proxies for a period from 1999 to 2001. They have considered the percentage of share ownership by institutional block- holders, and the percentage of share of ownership by pension funds as proxies for internal governance. For proxy of external governance they have constructed a Takeover Protection Index based on presence of staggered boards, presence of poison pill and restriction on shareholder voting right to call special meetings.

They demonstrated an investment strategy that focused on buying a portfolio of shares of firms with high takeover vulnerability and high public pension fund (block- holder) ownership and selling shares of firms with low takeover vulnerability and high public pension fund (block- holder) ownership generates an annualized abnormal return of 10-15 per cent, depending on which proxy is used for internal governance.

Aggarwal and Williamson (2006) constructed a comprehensive corporate governance index based on 64 corporate governance attributes provided by Institutional Shareholder Services (ISS). They studied a composite set of governance provisions that specifically focus on the ones targeted by new regulations of Sarbanes Oxley Legislation (SOX 2002). They examined the relationship between governance and valuation for the period 2001-2005 using a sample of 5,259 firms. They find a positive and significant relation between governance and firm value after controlling for size and industry. They find that new regulations are associated with higher firm value in firms that adopted the regulations prior to these regulations being mandated.

Durnev and Kim (2005) have developed a model which identifies investment opportunities, external financing and ownership structure are related to quality of governance and disclosure practices. The on corporate governance has been focused on corporate accounting scandals and their prevention. Corporate governance and merger strategy, however, has not been the focus. Literature survey indicates that there is very little empirical work, if any, on the relationship between mergers and acquisition and a comprehensive framework of corporate governance as far as India is concerned. The present research work is an attempt to fill this gap by conducting an empirical research by investigating the impact of corporate governance in a comprehensive framework by constructing a corporate governance Index for the companies undertaking mergers and acquisitions in India.

Review of the Corporate Governance Initiatives in India

Corporate Governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance, a voluntary code of corporate governance for listed companies published by the Confederation of Indian Industry. In February 2000, SEBI introduced the first formal regulatory framework on Corporate Governance for listed companies with a new Clause 49 in the Listing Agreement of the stock exchanges following

the recommendations of the Kumar Mangalam Birla Committee Report. Corporate governance formally became a part of the regulatory framework for Indian listed companies with the introduction of clause 49 in February used the Credit Securities Lyonnais Agency (CSLA) corporate governance ratings to test the model. The CLSA

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The Indian Code of Corporate Governance, approved by the Securities and Exchange Board of ratings cover 24 emerging countries and newly-emerging countries for 2000 and provide ratings for 494 companies. They have also used Standards and Poor (S&P) disclosures data as robust checks. They demonstrated that firm with higher governance and transparency rankings are valued higher in stock market. The study also reveals that the relations are stronger in weaker legal regimes/ less investor friendly legal environment. Klapper and Love (2003) also document a positive relationship between market valuation and corporate governance by using similar CLSA data. They also find that better corporate governance is highly correlated with better operating performance.

Dahya, Dimitrov, and McConnell (2006) complemented Durnev and Kim (2005) Klapper and Love (2003) by focusing on the board composition as a central building block of a firm's corporate governance structure. They investigate the relation between corporate value and the proportion of the board made up of independent directors in 799 firms with a dominant shareholder across 22 countries. The study presents evidence that firm value is positively related to board independence for a sample of firms (with a controlling shareholder) in countries with weak legal protection for shareholders.

While corporate governance has received more attention in recent years, the role that such governance plays in merger and acquisition strategy has not attracted such attention particularly

in India. Much of the recent academic attention India (SEBI) in early 2000, was implemented in stages over the following two years and led to changes in stock exchange listing rules, notably the new Clause 49 in the Listing Agreement. Further reforms have been made over the past decade to modernize both company law and securities regulations. The Companies Act, 1956 has been amended several times, in areas such as postal ballots and audit committees, while Naresh Chandra committee (2002), N. R. Narayana Murthee Committee (2003), J.J. Irani Committee (2005) were appointed to recommend improvements. In the area of securities regulation, SEBI has made numerous changes in recent years including: revising and strengthening Clause 49 in relation to independent directors and audit committees; revising Clause 41 of the Listing Agreement on interim and annual financial results; and amending other listing rules to protect the interests of minority shareholders, for example in mergers and acquisitions.

Research Methodology

Research Design: The study is based on a sample of 93 companies having completed mergers and acquisitions deals announced between January 2008 to December 2011. The rationale of the period of study emanates from the fact the major development and changes in SEBI clause 49 has been incorporated in year 2003 itself. The sample consists of 58 manufacturing and 35 service companies.

Data Collection: The present study is based on the primary as well as secondary data. The secondary data is collected in two parts. In first part, acquisitions of Indian companies are identified from Center for Monitoring Indian Economy (CMIE) data base related to Monthly Review on Mergers and Acquisitions, Deal Tracker in Business World and NEWS Papers.

The data collection in second part mainly focuses on data pertaining to financial performance

and valuation as a measure of corporate governance. To collect data related to corporate governance measures, annual reports of the acquirers are examined from website of companies.

CGS has been assigned a value of 1 to governance attribute if the company meets minimally acceptable standard on that attribute and 0 otherwise. The answers to these questions are also cross-checked from the information available in public domain. Primary data is used to prepare a Corporate Governance Index (CGI). Corporate Governance Index (CGI) is constructed on the basis of total scores obtained for these qualities.

Primary data is used to prepare a Corporate Governance Index (CGI). Primary data is collected through a questionnaire supplemented with interviews of senior management, directors, CFOs, company secretaries, compliance officers, investor relation officers and board members. The questionnaire is designed on the basis of major standard qualities relevant to measure the corporate governance

Respondents Designation Number

responses of the 64 issues included in the questionnaire.

1. Management Discipline (MDIS)
2. Transparency (TRA)
3. Independence (IND)
4. Accountability (ACC)
5. Responsibility (RES)
6. Fairness (FAI)
7. Social Responsibility & Recognition (SRR)

Concluding Observations

The present study concludes that companies with higher rank for corporate governance score are good performers which are revealed from better financial ratios. Their post M& A better financial performance and valuation shows that good governed companies bring positive synergies from their M& A activities which is recognized by market as evidenced by higher valuation ratios.

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