

CROSS-BORDER ACQUISITIONS OF EMERGING MARKET FIRMS: A REVIEW OF THEORETICAL PERSPECTIVES AND EMPIRICAL ISSUES

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***Abstract:** Cross-border mergers and acquisitions have gained in popularity over the last few years. Emerging market multinationals embarking upon acquiring cross-border companies to take advantage of regional and global business opportunities is a phenomenon which is intensified during early nineties. We look at the theoretical perspectives, motivations and research findings on cross-border mergers and acquisitions by emerging market firms in this paper. We present a survey and review the theoretical foundations, hypotheses and empirical findings on cross-border mergers and acquisitions by emerging market firms. We identify gaps in the literature and suggest six important research issues that provide directions for future research in emerging markets especially in Indian context.*

Key words: Synergy, Emerging Markets, Developed Markets, Mergers and Acquisitions, Cross-border Acquisitions, Shareholders Wealth.

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Introduction:

The proportion of cross-border mergers and acquisitions to total merger activity has increased significantly during the last decade. Cross-border mergers and acquisitions (M&As) are an important corporate strategy that enables firms to extend their current businesses to new markets, leverage their current capabilities, and diversify in to related markets. Technological development, globalization, increased economic integration and international trade, favourable regulation and policy changes, firm restructuring, , target firm undervaluation, and the strong global financial market to finance mergers and acquisitions has possibly led an unprecedented wave of cross-border mergers and acquisitions worldwide during the last few years (Kiyamaz, 2004). Cross-border M&As have been adopted as a strategic initiative by a large number of firms in multiple regions across the globe. While cross-border M&As have a number of factors in common with domestic M&As, they also have unique characteristics and important differences. Figure 1 presents few motivations for domestic and cross-border mergers and acquisitions. The motivations of cross-border M&As are largely similar to those of domestic M&As. However, due to their international nature, there are some specific factors which govern cross-border transactions such as favorable changes in economic and regulatory environment in foreign countries, low foreign tax rates, exchange rates and client base abroad. In addition, some other factors potentially affect cross-border mergers but are not present to the same extent in domestic mergers, such as cultural differences, geographic differences, and country-level governance differences. Cultural or geographic differences can increase the costs of combining two firms. Governance-related differences across countries can motivate mergers if the combined firm has better protection for target firm shareholders because of higher governance standards in the country of the acquiring one. Taxes are potentially important in motivating cross-border mergers, since if the acquirer has a lower rate or if the companies' countries have a tax treaty, combining the firms can potentially lower the firms' total tax liability.

Although firms from the developed world dominate the landscape of cross-border acquisitions, firms from the developing and emerging economies too have emerged recently in this market in a big way. Cross-border M&As have become a major mode-of-entry for these emerging multinational firms. Surprisingly, there seems little research on cross-border M&As made by developing-and emerging market firms The objective of the paper is to present a survey of extant latest literature and research findings on cross-border M&As in

context of emerging markets from three theoretical perspectives: (1) Studies of emerging markets either as a target or as an acquirer (2) Studies investigating acquisitions in multi-countries (3) India as a special case of emerging market. Extant empirical research has been grouped thematically stream to summarize major findings. For a better exposition, the paper is organized into 5 sections including this section. Section II reviews the previous empirical research work related to cross-border mergers and acquisitions in context of emerging economies. Section III explains the major hypotheses developed and investigated in previous research work related to cross-border mergers and acquisitions. IV describes the future directions and areas proposed for research. The concluding observations are contained in section V.

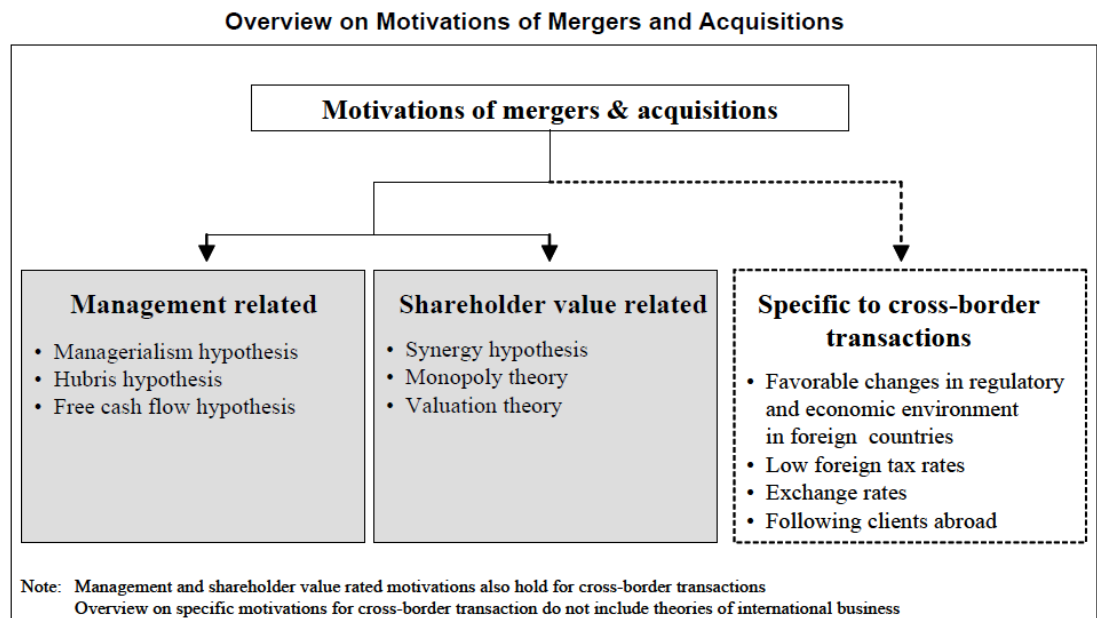


Figure 1: Motivations of Mergers and Acquisitions

Source: Adapted from *Mangold and Lippok (2008)*.

2. LITERATURE SURVEY:

Emerging market multinationals embarking upon acquiring cross-border companies to take advantage of regional and global business opportunities is a phenomenon which is intensified during early nineties. The purpose of this paper is predominantly assessed from the point of view of cross-border acquisitions in emerging markets. Accordingly, the review of extant

research work is primarily focused on studies measuring the implications of cross-border acquisitions particularly in emerging markets⁴. The review is arranged in three categories;

- Studies of emerging markets either as a target or as an acquirer.
- Studies investigating acquisitions in multi-countries.
- India as a special case of emerging market acquirer.

2.1 STUDIES OF EMERGING MARKETS EITHER AS A TARGET OR AS AN ACQUIRER.

Chari, Chen and Dominguez (2009) examine the foreign acquisitions of U.S. firms, specifically focusing on acquisitions made by firms located in emerging markets. By using transaction-specific acquisition data and firm-level accounting data they evaluate the post-acquisition performance of 214 publicly traded U.S. firms that have been acquired by firms from emerging markets over the period 1980-2007. They examine both stock market and accounting measures to evaluate the impact of emerging-country acquisitions on U.S. firm performance. The study use a difference-in-differences approach combined with propensity score matching to create an appropriate control group of non-acquired firms. Their findings suggest that emerging country acquirers tend to choose U.S. targets that are larger in size (measured as sales, total assets and employment), relative to matched non-acquired U.S. firms before the acquisition year. They have reported that post-acquisition sales and employment decline while profitability rises suggesting significant restructuring of the target firms.

In a recent study *Bhagat, Malhotra and Zhu (2011)* investigate market response to the announcement of 698 Cross-border acquisitions made by firms from eight emerging countries – Brazil, China, India, Malaysia, Mexico, Philippines, Russia, and South Africa during the period January 1991 through December 2008. Their empirical findings reveal that emerging country acquirers experience a positive and a significant market response of 1.09% on the announcement day. They also observe that targets tend to be small (by U.S. transaction value measures) — the median ranging between \$10 million and \$40 million (in 2008 dollars). However, from 2000 to 2008, 24 acquisitions were worth more than a billion dollars

⁴ For detailed review of cross-border acquisitions see , Shimizu, Hitt, Vaidyanath, and Pisano (2004).

each. The study also reports a positive correlation of acquirer returns are with (better) corporate governance measures in the target country.

Zhu, Jog and Otchere (2011) examine the partial acquisitions of sample of 3939 domestic partial acquisitions and 2372 cross-border partial acquisitions of publicly listed firms in 20 emerging markets during the period 1990 and 2007 to test two competing hypotheses: the market for corporate control hypothesis and the market entry hypothesis. They observe that targets of cross-border acquisitions outperform targets of domestic acquisitions in the pre-acquisition period. While cross-border acquisitions have no significant impact on target firms' operating performance, targets of domestic acquisitions experience significant improvements in operating performance and substantial changes in ownership structure after the acquisition. Their findings suggests that domestic partial acquisitions in emerging markets serve as a market for corporate control, while cross-border partial acquisitions are motivated by the strategic market entry rationale.

Burns and Liebenberg (2009) examine and compare the impact of foreign acquisitions on emerging and developed markets. They observe firm, acquisition, industry and country characteristics that may explain the reaction of individual firms to the acquisition. They investigate a sample of 971 US acquirer acquiring targets in 26 developed countries and 20 emerging countries during 1988–2004 and report positive return for acquisitions of private targets. The study estimate the impact of foreign acquisitions on the target's rivals and by studying the ways in which rival, acquisition, industry and country characteristics affect both the average and individual rivals' reaction. They observe that the acquirer's reaction is greater in acquisitions of emerging targets than developed and difference is statistically significant.

Bris and Cabolis (2008) investigate a sample of 506 during 1989–2002 consisting acquirer from developed and emerging countries and target from developed and emerging countries. The study reports negative wealth for acquirers.

Aybar and Ficici (2009) examine the value implications of cross-border acquisitions of emerging-market multinationals. They examine a sample of 433 mergers and acquisitions announcements associated with 58 emerging-market multinationals during period 1991–2004. They have used event study methodology to explore the impact of the announcements on the value of acquiring firms. They observe that cross-border expansions of emerging-

market multinationals through acquisitions do not create value, but point to value destruction for more than half of the transactions analyzed. They analyze a cross-sectional sample of firms to further explore the factors influencing the direction and magnitude of market reaction. Their empirical results reveal that target size, ownership structure of the target (private vs public), and structure of the bidder (diversified vs non-diversified) positively affect the acquirer value, high-tech nature of the bidder and pursuit of targets in related industries negatively affect the acquirer value. The study also provide some support for the positive impact of the stake pursued in the target firm and cultural distance, but not for the international experience and enhanced corporate governance.

2.2 STUDIES INVESTIGATING ACQUISITIONS IN MULTI-COUNTRIES.

Zhu (2011) examines the short-term wealth impact of sequential cross-border mergers and acquisitions (M&As) by acquiring companies in 70 countries during the period 1978 and 2008. Their findings suggest the persistent stock performance in sequential cross-border transactions. He conclude that acquiring firms that gained positive (negative) abnormal returns in previous cross-border acquisitions are more likely to experience positive (negative) abnormal returns in subsequent cross-border acquisitions. They investigated that persistency of the stock performance is stronger in situations when the elapsed time between the sequential acquisitions is shorter. He also suggests that the persistent stock performance is affected by investor sentiment as well as the choice of cash payments in the sequential cross border M&As. The study doesn't find any support for the acquiring firms' operating performance impact on the persistency of the stock performance.

Kose, Freund, Nguyen and Vasudevan (2010) examine the announcement-period acquirer returns and target values for a large sample of 1525 cross-border acquisitions by U.S. firms from 67 countries. The study differentiates between private and public targets and examined the legal protection of minority shareholders in the target country. They report that for high-protection target countries, acquirer announcement-period returns are significantly negative for public targets and significantly positive for private targets. In case of low protection target countries, the acquirer returns are significantly positive for public targets and insignificantly different from zero for private targets. For public targets, acquirer returns are decreasing and target-firm values and acquisition premia are increasing with the level of investor protection. For private targets, investor protection does not affect acquirer returns or target-firm values. They observe that acquirer returns decrease with the level of creditor protection in the target

country and increase with the quality of accounting standards. The findings also reveal that in low- protection countries firm-level corporate governance mechanisms substitute for the lower level of investor protection.

Chari, Ouimet and Tesar (2010) examine the returns to shareholders of developed country firms

that undertook acquisitions in emerging markets. They investigate a sample of 594 developed-market acquisitions of firms in emerging markets and 1624 acquisitions of firms in developed markets during the period 1986 to 2006. They document that when developed-market acquirers gain control of emerging market targets, they experience positive and significant abnormal returns of 1.16%, on average, over a three-day event window. They also observe that while emerging-market acquirers also realize positive returns in transactions involving control of emerging-market targets, the magnitude of the gain realized by developed-market acquirers is significantly higher.

2.3 INDIA AS A SPECIAL CASE OF EMERGING MARKET ACQUIRER.

Zhu and Malhotra (2008) examine the short-term stock performance of a sample of 74 Indian firms acquiring U.S. firms in the period 1999-2005. Their study shows that Indian stock market reacts positively to the acquisition announcement. However, They observe that the positive abnormal return lasts for only three days, after which, the returns become negative. They conclude that the announcement returns in the Indian cross-border mergers and acquisitions are mainly driven by the price pressure effect rather than the informational effect.

Gubbi, Aulakh, Ray, Sarkar and Chittoor (2010) conduct an event study of 425 cross-border acquisitions by Indian firms during 2000–2007. They observe positive abnormal returns for the acquiring firm shareholders. They also suggest that Indian firms use cross-border acquisitions for strategic assets-seeking in order to facilitate strategic and organizational transformation of the firms.

Karels, Lawrence and Yu (2011) study the cross border mergers and acquisition between US and Indian firms. They examine cross-border acquisitions between the US and India announced during the period January 1995 to August 2007. Their findings suggest that US firms realize significant losses on the announcement of acquisitions of Indian targets while

Indian targets realize significant gains on the announcement of mergers with acquirers. Publicly traded Indian firms realize insignificant returns on their announcement of acquisitions of publicly traded US firms but realize significant positive returns on announcements of acquisitions of privately held firms and subsidiary firm targets. Publicly traded targets realize insignificant gains when acquired by Indian firms.

Barai and Mohanty (2011) study the short term announcement period abnormal returns of sample of 1177 Indian acquirers during the period April 1996 to March 2008. They analyze three determinants of acquirer performance – cash or stock as mode of payment, industry relatedness between target and acquirer, and whether the target is a domestic listed, or domestic unlisted, or a foreign firm. They observe that cash financed acquisitions outperform stock paid ones, presumably because of beneficiary role of debt. The study also document that industry relatedness is a robust determinant of significantly positive abnormal returns, indicating higher value placed on synergistic combinations in India. They also investigated that within domestic targets, acquisition of listed targets are more valuable than that of unlisted targets, a fallout of lack of takeover competition in the former case and fears of misappropriation amidst information unavailability in the latter. Their findings also reveal that cross-border acquisitions generate larger gains than domestic firms.

Although there has been an exponential increase in the number and size of cross-border mergers by emerging market firms during the past decade, there is little research that examines whether such deals are value-enhancing activities for shareholders of acquirers in emerging markets.

3. HYPOTHESIS

The present section briefly describes the major hypotheses developed and investigated in previous research work related to cross-border mergers and acquisitions; however these are not the exhaustive set of hypotheses.

3.1 MULTINATIONAL NETWORK HYPOTHESIS:

The multinational network hypothesis favors the contention that firms extract above normal returns from cross-border investments by internalizing host-country market imperfections when their firm-specific assets cannot find comparable value elsewhere Cross-border

acquisitions may also increase the operational flexibility of the firm by giving it the opportunity to exploit market conditions (Kogut, 1983).

3.2 MARKET FOR CORPORATE CONTROL HYPOTHESIS:

The market for corporate control hypothesis states that poorly performing companies become takeover targets in a competitive takeover market. The market for corporate control hypothesis has been extensively examined within the context of domestic acquisitions in developed markets.

3.3 MARKET ENTRY HYPOTHESIS:

There is a voluminous literature on cross-border M&As as a potential mode of entry into a foreign market, perhaps this is the widely investigated hypothesis. Previous empirical work group the factors which influence choice of a cross-border M&A as a mode of entry into a foreign market into (1) firm-level factors

(2) industry-level factors and (3) country-level factors. Firm-level factors which influence the firms strategy to adopt cross-border acquisitions as a mode of entry are identified as multinational experience, local experience, product diversity, and international strategy; industry-level factors such as technological intensity, advertising intensity, and sales force intensity; country-level factors such as market growth in the host country, cultural idiosyncrasies between the home and host countries, and the specific culture of the acquiring firm's home country particularly in terms of uncertainty avoidance and risk propensity ().

3.2 REGIONAL DOMICILE HYPOTHESIS:

Regional domicile hypothesis consider geographic influence on the performance of acquiring firms. Regional domicile hypothesis and market reaction to their strategic activities have been examined by (*Brouthers and Brouthers, 2000; Shrivastava, 1986; Krugman, 1991*).

3.2 INVESTMENT OPPORTUNITY HYPOTHESIS:

The hypothesis states that firms with excellent future investment opportunities should not pay in cash for acquisitions. Cash transactions often have to be financed with new debt. Cash

flows, however, should not be used for debt service payments since this reduces the amount of discretionary cash flows available in the future.

3.2 RISK SHARING HYPOTHESIS:

The hypothesis states that, particularly for high-risk transactions, it could be advantageous to pay in stock because in this case, the target company will have an incentive to make a success of the takeover transaction as mentioned by *Martin (1996)*.

3.2 BOOTSTRAPPING HYPOTHESIS:

The bootstrapping hypothesis argues that poor governance acquirers voluntarily bootstrap to the better-governance regime of the target (*Martynova and Renneboog 2008; Khanna and Palepu's, 2004*). The hypothesis suggests that poorly governed firms acquire well governed firms to credibly bootstrap themselves to better corporate governance standards. They bootstrap the quality of their corporate governance standards by (voluntary) adhering to the higher shareholder protection of the target firm. Given that the nationality of the target firm does not change, and that part of the equity of the target firm is still held by its (old) shareholders, the acquirer may feel pressurized by the target minority shareholders or voluntarily decide to emulate the high corporate standards in the country of the target firm. This is reflected in the acquirers' returns.

4. FUTURE DIRECTIONS AND AREAS SUGGESTED:

4.1 SEQUENTIAL AND EXPERIENCE IN CROSS-BORDER MERGERS AND ACQUISITIONS:

A few studies document persistent announcement returns (Rosen, 2006; Croci and Petmezas 2009) for domestic M&A in US; Antoniou, Gao and Petmezas (2008) in UK. They find that the acquiring firm's cumulative abnormal return (CAR) during the current acquisition announcement is positively correlated with its announcement return in the previous acquisition. The previous experience in cross-border mergers and acquisitions has not received adequate attention in this research stream in context of emerging markets. It is important to study the sequential cross-border M&As as what causes the positive serial

correlation in the acquisition announcement returns as documented in previous literature is still not clear.

4.1 METHOD OF FINANCING IN CROSS-BORDER MERGERS AND ACQUISITIONS:

In cross-border acquisitions, the targets are frequently unwilling to accept foreign equity, which forces the acquirer to pay with cash (Gaughan, 2002). Conn et al. (2005) suggest that the signalling effect of cash transactions may not have the same force in the case of cross-border mergers and acquisitions in that, other factors may have influence on the means of payment. The positive signal from paying with cash might therefore be diminished or non-existent for cross-border transactions. In the light of these arguments, it remains unclear whether cash acquisitions will outperform stock acquisitions in the case of cross-border acquisitions in emerging markets. Future research work in this context will be a valuable contribution to the understanding of method of payment as a success factor in cross-border acquisitions.

4.1 THE ROLE OF PROFESSIONAL ADVISORS IN CROSS-BORDER MERGERS AND ACQUISITIONS:

Empirical work is required towards understanding valuation of assets of target and how to decide payment of those assets for acquisitions the role of consultants, investment bankers in these transactions. *Ferreira, Massa and Matos (2010)* observe that foreign institutional investors build bridges between firms and reduce transaction costs and information asymmetry between bidder and target. *Lowinski, Schiereck and Thomas (2004)* argue that the expenses for professional advice might outweigh the potential benefits. The importance of professional advisors in cross-border M&As is obvious, yet, the actual value added by the services of such advisors is debatable. More empirical work in this direction will be valuable in understanding the role of these services in success of cross-border acquisitions by emerging countries.

4.1 LEVEL OF CONTROL, OWNERSHIP STRUCTURE AND GOVERNANCE ISSUES IN CROSS-BORDER MERGERS AND ACQUISITIONS:

Another strand of literature examines the relationship between corporate governance and cross-border acquisitions (*Bris and Cabolis, 2008; Rossi and Volpin, 2004*). Cross-border acquisitions can be an important mechanism for corporate governance convergence as argued by (*Martynova and Renneboog, 2008; Wang and Xie, 2009*). More empirical work is required in context of India to test the control, spillover, bootstrapping hypotheses. Which factors affect cross-border acquisitions of the majority stake (51% or more) of a target firm, compared with when it holds a minority stake (e.g., 30%)?. It would be interesting to examine these hypotheses and acquisitions performance when the target is from other developing and emerging markets versus when the acquisition is from developed market.

4.1 INTEGRATION CHALLENGES IN CROSS-BORDER MERGERS AND ACQUISITIONS:

The problem of integrating different cultures has been examined in the literature. But previous research presumed that cross-border M&As is a strategic initiatives by firms from developed countries entering less developed countries. During the past decade a trend of emerging market multinationals acquiring business in developed countries has been observed. *Aybar and Ficici (2009)* examined acquisitions by these emerging markets multinationals. Developed countries differ in their institutional contexts A fundamental question arise in this context can we apply the existing perspectives to this new development. It would be highly valuable to direct more research efforts in this context.

4.1 THE LEVEL OF DEVELOPMENT OF MARKETS IN CROSS-BORDER MERGERS AND ACQUISITIONS:

The level of development of the markets is another factor that could affect cross-border mergers as many influencing factors in international acquisitions by emerging market firms are substantially different from those in the developed countries. Compared with firms from developed market, emerging market firms tend to be younger and smaller; they lack international experience and exposure; domestic capital market is less developed and investors are less sophisticated; their government regulation, corporate governance, and cultural background are more distant from the developed target country. Therefore, cross-

border M&As may be a more risky challenge to the emerging market firms than developed-market firms.

5. CONCLUSIONS:

Previous research and extant literature has made significant contribution to the theoretical and empirical development, but increasing globalization has created many new challenges for emerging market to use cross-border M&As as a strategic initiative to be a success in the global economy. Many success factors in cross-border acquisitions by firms from emerging countries would be substantially different from those in the developed country, such as international experience and exposure, corporate governance, cultural background, government regulation, and maturity of the domestic capital market. We believe that further research on cross-border mergers and acquisitions in proposed areas will make valuable contributions both to the understanding of scholars as well as practitioners.

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