IIMK/WPS/119/ FIN/2013/05

EARNOUTS A RISK MITIGATING STRATEGY FOR CROSS BORDER ACQUISITIONS IN INDIA

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An attempt has been made in this study to assess the impact of different modes of payment employed in cross border acquisitions, viz. cash, earnout and stock on the risk profile of the acquiring companies in India. The purpose is to discern which of the stated modes of payment enables an acquiring company in better hedging the risk of adverse selection that arises due to the information asymmetry on the part of the acquiring company regarding the true value of assets of the target company. It has been found that of the three modes of payment, earnouts provide best hedge to the acquiring companies for minimizing the risk of adverse selection in cross border acquisitions. The reason being earnouts enable an acquiring company resolve the problem of over-valuation and that of non-performance by making part payment contingent on the ex post performance of the target company as well as by retaining target company's managers respectively. The paper recommends earnouts as a valuable strategy for the acquiring companies from India as well as other emerging markets for their future global acquisitions as these companies usually end up overpaying the target companies due to lack of expertise in cross border acquisitions. The paper has tried to fill the void in the existing literature by explicitly analyzing the impact of the different modes of payment on the risk profile of acquiring companies in the post acquisition period.

Keywords: Mergers and acquisitions, Cash offers, Earnouts, Stock offers, Betas, Cross border acquisitions, India

INTRODUCTION

Literature related to cross border acquisitions highlights that such acquisitions, despite endowing advantages of international diversification (Cheng and Chan, 1995; Conn and Connell, 1990; Doukas and Travlos, 1988; Kiyamz and Mukherjee, 2000; Markides and Ittner, 1994) as a result of imperfections in financial markets and internalization of non-tradable assets (Conn, Cosh, Guest and Alan, 2005; Magee, 1981; Morck and Yeung 1991; Seth, Song and Pettit, 2002), are fraught with the prominent risk of adverse selection. This arises as a result of information disadvantage on the part of a foreign acquirer in assessing the true value of the target company's assets that in turn may leave an acquirer paying more than the real worth of the target company (Eckbo and Thorburn, 2000; Moeller and Schlingemann, 2005; Reeb, Kwok, and Baek, 1998).

However, Hansen (1987) states that the problem of information asymmetry that in turn creates the problem of mis-valuation leading to adverse selection can be hedged by

employing an appropriate mode of payment by an acquiring company. An acquirer may satisfy the target shareholder's claims by paying cash or by issuing shares depending upon the level of information relating to the true value of the target company's assets on its part and the consequent risk of mis-valuation.

Generally, stock financing is employed by the acquiring company to hedge the risk of mis-valuation arising on account of information asymmetry. The reason being stock financing has a contingent payment effect and enables the acquiring company to share the risk of mis-valuation of the target company with that of the target shareholders in the post acquisition period. Eckbo and Thorburn (2000) opine that the payment in bidder's shares forces the target company to share the overpayment cost ex post.

However, evidence suggests that use of stock as a mode of financing conveys a negative signal to the market that the acquirer is skeptic about the valuation of the target company and wants to share the risk of mis-valuation with the target company shareholders in the post acquisition period as otherwise it would have financed such an acquisition with cash and would have reaped the benefits of potential synergies alone (Hansen, 1987; Martin, 1996). This is the reason for the acquiring company getting a negative reaction from the stock market on the announcement of a stock financed acquisition that in turn leads to the negative valuation of its shares (Blackburn, Dark and Hanson, 1997; Brown and Ryngaert, 1991; Faccio and Masulis, 2004; Loughran and Vijh, 1997; Smith and Kim, 1994; Travlos, 1987).

Another mode of financing employed by the acquiring company is cash. Cash financing is generally employed when an acquirer is aware about the exact value of target's assets and hence does not face the risk of mis-valuation. Thus, cash acquisitions reflect an acquirer's confidence in a particular deal because otherwise it would have employed stock financing to share the risk with that of the target company in the post acquisition period. Stock market welcomes cash offers considering these as good news which in turn leads to a positive valuation of share prices of the acquiring companies (Emery and Switzer, 1999; Loughran and Vijh, 1997; Martynova and Renneboog, 2006).

However, in cross border acquisitions cash offers may not yield the desired positive impact because in these acquisitions target companies are often reluctant to accept the stock of the acquiring companies as a currency and may force an acquirer to make the payment in cash (Conn *et al.*, 2005; Moeller and Schlingemann, 2005). The probability

of stock financing in cross border acquisitions is even lesser when an acquiring company belongs to an emerging market**.** This may be for the reasons like concentration of ownership in hands of promoters' of the acquiring company which may indicate to the target company that there is a lesser chance of the acquiring company being managed professionally. Another reason may be the vagaries of the stock market in emerging markets like India that make it difficult for the foreign target to accept acquirers stock as a mode of consideration. Lastly, the regulatory hassles like mandatory approvals for issue of shares to a foreign target company and the requirement of lock-in period on new shares issued to the target company may make the stock of the acquiring companies an unattractive proposition in foreign acquisitions (Mathew and Jain, 2006).

Thus, acquirers may finance a cross border acquisition through cash not because they are confident about the exact value of the target but because of the reluctance on part of the target to accept stock of the acquiring company as a currency. Hence, a cross border acquisition financed through cash may or may not create positive value, which cash offer is generally expected to create on the announcement.

As a result, an acquiring company may find itself in a situation where it is not able to employ stock financing due to unwillingness of the target company to accept its stock and is being made to forcibly employ cash financing to successfully conclude the transaction. In such a precarious situation, the quintessential question is how the acquirer can hedge the risk of wrong valuation resulting from information disadvantage on its part.

An alternative mode of payment suggested by the researchers (Cain, Denis and Denis, 2006; Datar, Frankel and Wolfson, 2001; Kohers and Ang, 2000; Reuer, Shenkar and Ragozzino, 2004) for managing the problem of adverse selection as a result of information asymmetry on the part of the acquirer is to enter into two part payment contract which is known as an earnout offer. An earnout is a contractual agreement in which the acquiring company makes payment to the target in two or more parts, that is, an up front payment which is made at the time of entering into the contract and a deferred payment or an earnout that is linked to the attainment of pre-specified performance targets within a pre-specified time period by the target company. The amount of up front payment reflects the mutually agreed upon portion of transaction

value while the earnout reflects the extent of disagreement between the target company and the acquiring company (Kohers and Ang, 2000).

An earnout offer enables an acquiring company to share the risk of overpayment ex post with the target company by making the part payment contingent upon future performance benchmarks. By linking the part payment to the future performance targets it also reflects the inherent strengths of the target company because only that target company which believes in its potential to create value in the post acquisition period would accept such an offer where part payment is premised on its ex post performance.

Another reason for employing earnout offer is that it serves as a tool to retain the managers of the target company who may possess the expertise and the specific knowledge in relation to the operations of the company that can otherwise not be duplicated (Kohers and Ang, 2000). By retaining the target managers and linking their earnings to their future performance, earnouts try to align the managerial objectives with organisational objectives. This in turn resolves the agency problem as highlighted by Reeb *et al.* (1998) that arises due to the difficulty faced by an acquiring company in overseeing the actions of overseas managers.

Hence, earnout offers, by resolving the problem of adverse selection on the one hand and by acting as a tool to retain the managers of the target company on the other hand enable the acquiring company in attaining the pre-specified performance targets through the target company itself and consequently help in mitigating the probable risks involved in realising the expected synergies in the post acquisition period.

From the above discussion it is clear that different modes of payments are employed by an acquiring company to finance a cross border acquisition in order to hedge the risk of adverse selection arising from information asymmetry on its part. However, which of these modes of payment enables an acquiring company in better hedging the risk in the post acquisition period is the question worth considering.

NEED FOR THE STUDY

During the period 2005-2007, Indian companies, driven by the availability of excess liquidity[1] pursued large sized outbound acquisitions. As per the disclosure of World Investment Report on mergers and acquisitions by UNCTAD the value of outbound acquisitions by Indian companies rose from $2648.55 million in the year 2005 to

$30414 million in the year 2007 which is the highest value of outbound acquisitions amongst the emerging economies represented by BRIC countries[2]. Kumar (2009) opines that impetus of many acquisitions by Indian companies in 2006-07 was the availability of the easy liquidity and not the fact that Indian companies were particularly globally dominant in their industries. Thus, the major objective of Indian companies for going global was to use the available liquidity to create world class companies.

However, the acquiring companies from India lacked expertise with respect to cross border acquisitions and ended up overpaying for the target companies. Moreover, these companies did not account for the environmental uncertainties; raised huge short term debt to finance their overvalued deals and got stuck in a debt spiral. To retire their debts these acquiring companies resorted to selling their stakes in some of their best companies at lower prices due to liquidity squeeze in the global markets as a result of economic downturn.

Hence, it is interesting to know that whether the acquiring companies from India who had overpaid the target companies due to lack of expertise in valuing the same, would have mitigated the risk of overvaluation by employing an appropriate mode of payment.

Moreover, plethora of studies has been conducted to evaluate the impact of different modes of payment on the acquiring companies' shareholders wealth (Blackburn *et al.,* 1997; Brown and Ryngaert, 1991; Emery and Switzer, 1999; Faccio and Masulis, 2004; Loughran and Vijh, 1997; Smith and Kim, 1994). However, there is hardly any study that has explicitly analyzed the impact of different modes of payment on the risk profile of the acquiring companies in the post acquisition period.

Thus, objectives of the present research are firstly, to evaluate the impact of different modes of payment (stock, cash and earnout offers) employed in cross border acquisitions on the risk profile of the acquiring companies. And secondly, to compare the risk alteration across the modes of payment and over different event periods to discern which of these have enabled the acquiring companies in better hedging the risk in cross border acquisitions.

METHODOLOGY

For attaining the above objectives, instead of measuring the risk adjusted abnormal returns, betas, which measure the systematic risk of a company, have been analysed. Ruefli, Collins and Lacugna (1999) who study the usage of various ex post measures of risk, opine that out of various measures of risk, beta is possibly the relevant and most widely used measure. Moreover, Breen and Lerner (1973) and Joehnk and Nielsen (1974) also suggest that beta is an appropriate measure of risk as it truly reflects the shift in market perception about the prospects of a company as a result of changes in its operating and financial decisions (viz. mergers and acquisitions). Besides, betas unlike announcement returns are not affected by problems of partial anticipation because these are estimated from a clean period that is exclusive of the immediate acquisition announcement period.

For computing the betas of the acquiring companies the market model as propounded by Fama and Macbeth (1973) and Fama (1976) has been employed. Further, the betas have been estimated for three different estimation periods that is, the pre acquisition estimation period, the post acquisition estimation period and the pooled estimation period. The pre estimation period measures the beta of the acquiring companies engaged in cross border acquisition for a period of -180 days to -31 days from the first public announcement date[3] of an acquisition. Similarly, the post acquisition estimation period ranges from +31 days to +180 days while the pooled estimation period combines both the periods and extends from -180 days to +180 days excluding 61 days around the first public announcement date of merger.

The market model employed for the estimation of betas over different event periods is explained as follows:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

Where α_i presents the normal return of the security i when R_{mt} is zero, β_i measures the risk of the security i that is, the sensitivity of R_{it} to the market wide factors. R_{mt} is the return on market index (Bombay Stock Exchange, Sensex in this case) while ε_{it} captures the effect of variables more specific to the prospects of a security i.

To appraise the impact of different modes of payment on the risk of the acquiring companies, a three step procedure has been adopted. Firstly, the average betas have been calculated for the acquiring companies for pre estimation period, post estimation period and pooled estimation period for the overall sample of cross border acquisitions without making any distinction regarding the mode of payment being employed. This is done to have a general view on how the risk of the acquiring companies undergoes a change as a result of outbound acquisitions. Moreover, ANOVA has been employed to test the significance in the difference among the average betas of pre, post and pooled estimation periods. Secondly, in order to assess the impact of different modes of payment on the risk of the company, average betas have been calculated for cash offers, earnouts and stock financed offers for pre estimation, post estimation and pooled estimation period separately. Further, to decipher whether the differences in average betas across different modes of payment are significant and whether these differences are sustained across the estimation periods, ANOVA has been employed separately, on the average betas of cash, earnout and stock offers across all event periods. Finally, in order to study the variation in average risk as a result of a particular mode of payment employed, average betas of post acquisition estimation period have been compared with those of the pre acquisition estimation period. Further, to assess whether the risk alteration in post estimation has been significant as compared to pre estimation, paired sample t-test has been employed on average betas of the individual samples of earnout, cash and stock offers.

As regards the definition of the mode of payment, an acquisition is defined as cash financed if it is financed with internal accruals or with the proceeds of either an initial public offering or foreign currency convertible bonds or via raising debt. An acquisition has been categorised as an earnout offer where part of the mutually agreed upon price is paid upfront by the acquiring company while another part of the payment is linked to future performance benchmarks. Further, an acquisition that is financed by exchanging the shares of the acquiring company with that of the target company or where mixed financing (both cash and stock) is employed is classified as stock offer.

DATABASE

For evaluating the impact of different modes of payment on the risk of the acquiring companies engaged in cross border acquisitions in India, the acquisitions announced

during the period 1st January, 1997 till 31st March, 2008 are considered. Information regarding announcement date, outcome date and the mode of financing has been obtained by scanning two leading financial dailies namely, The Economic Times and The Financial Express/ World for the above stated period. Moreover, official website of the Bombay Stock Exchange (BSE) has been consulted to cross check the announcement and outcome dates for different sets of offers. For the purpose of computing betas, data regarding the daily returns of individual stock of companies and that of Sensex are obtained from PROWESS, the database software developed by Centre for Monitoring Indian Economy. Deletions are made for those acquisitions where the mode of financing the acquisition is not clear. Further, deletions are made for the companies where data regarding daily returns of the acquiring companies are not available. Furthermore, deletions are made for those companies that have entered into more than one acquisition within a gap of 30 days to remove the impact of clustered acquisitions. After making the above deletions we got a final sample of 153 acquisitions out of which 103 acquisitions are cash financed acquisitions, 15 acquisitions are financed with stock while 35 acquisitions are the ones where earnout financing has been employed. The sector–wise distribution of the cross border acquisitions segregated according to mode of payment has been summarized in Table 1.

Table 1: Sector–wise distribution of the acquisitions segregated according to mode of payment

Sector	Cash financed acquisition	Earnout acquisition	Stock financed acquisition	Total
Information technology	35	29	8	**60**
Pharma & healthcare	21	2	1	**21**
Automotive	13	-	2	**11**
Chemicals & fertilizers	11	-	-	**9**
FMCG	6	-	-	**5**
Telecom	3	-	-	**3**

Textiles	3	-	-	**2**
Engineering & energy	3	-	1	**5**
Agro products	2	1	-	**3**
Media & entertainment	-	-	1	**1**
Logistics	1	-	-	**1**
Paper & pulp	-	1	-	**1**
Gems & jewellery	2	-	1	**2**
Metals	3	1	1	**4**
Financial services	-	1	-	**1**
Total	**103**	**35**	**15**	**153**

From Table 1 it is clear that majority of the cross border acquisitions are financed by employing cash followed by earn out offers and least number of such acquisitions are financed by stock of acquiring companies. The trend of financing is consistent with the suggestion of Moeller and Schlingemann (2005) who state that the probability of cross border acquisitions being financed with stock of the acquiring companies is lesser due to the reasons discussed earlier in this article. Moreover, across different modes of payment, cross border acquisitions are concentrated in hi-tech and service sector comprising of IT and Pharma & healthcare coupled with a good number of acquisitions in Automotive, Chemical & fertilizers, FMCG and Engineering & energy sectors.

RESULTS

The results of ANOVA depicting shift in the average betas of the acquiring companies pursuing cross border acquisitions for the overall sample are given in Table 2.

Table 2: Results of ANOVA for shift in the average betas of the acquiring companies for the overall sample

Estimation period	Betas
Pre-Acquisition	0.84
Post-Acquisition	0.82
Pooled	0.81
F-Ratio (p- value)	0.20 (0.82)
No of companies	153

From the above table it is clear that the acquiring companies that pursue cross border acquisitions face a slight reduction in the systematic risk in the post acquisition estimation period as well as in the pooled estimation period. This is evident in the betas of the three event periods which are 0.84, 0.82 and 0.81 for the pre acquisition estimation period, post acquisition estimation period and pooled estimation period respectively. However, according to the results of ANOVA the difference among the betas of these three estimation periods is not statistically significant.

As no clear picture regarding the alteration in systematic risk emerges from the results for the overall sample, therefore we segregate the sample of cross border acquisitions according to the mode of payment employed and again apply ANOVA to test whether any significant difference exist in the average betas on the basis of mode of payment and whether it is visible within different event periods. The results are summarized in Table 3.

Table 3: Results of ANOVA for shift in the average beta of the acquiring companies for the sample segregated according to the mode of payment

Mode of acquisition	Average Betas of Pre estimation period	Average Betas of Post estimation period	Average Betas of Pooled estimation period
Cash financed acquisitions	0.77	0.71	**0.73**
Earnout acquisitions	1.02	0.86	**0.89**
Stock financed acquisitions	0.92	1.42	**1.19**
F-Ratio (p-value)	**4.43 (0.01)**	**15.61 (0.00)**	**10.42 (0.00)**

The above table depicts that there are significant differences in the average betas of the acquiring companies across the different modes of payment and these differences are visible within each event period. During pre estimation period, the average beta is highest (1.02) for acquisitions financed via earnout mechanism, followed by beta for stock financed acquisitions (0.92) while it is least in case of cash financed acquisitions (0.77) and the difference among these betas is statistically significant as per the results of ANOVA. In the post estimation period again the differences among the average betas of cash, earnout and stock offers are significant but the trend of the average betas has undergone a change. For instance, in the post estimation period, the average betas have shown a reduction from 1.02 to 0.86 for earnout offers while cash offers have shown a minuscule decline from 0.77 to 0.71. As opposed to earnouts and cash offers, the average betas have increased from 0.92 to 1.42 in case of stock offers.

Similar trend is visible when the results of pooled estimation period are considered. The differences in average betas across the modes of payment are significant in case of pooled estimation period also. Further, the average betas have again shown a decline in

case of earnout acquisitions from 1.02 to 0.89 coupled with a meagre decline for cash acquisitions from 0.77 to 0.73 while stock offers have shown an increase in the average betas from 0.92 to 1.19.

From the above discussion it can be deduced that the average betas vary significantly across the different modes of payment and these differences are evident within different event periods. However, there is a shift in the trend of the average betas across different modes of payment over different event periods. For example, in the post estimation period and the pooled estimation period, both earnouts and cash offers have shown a decline in the average betas compared to those of the pre estimation period. On the contrary, stock offers have shown an increase in the average betas for the same event periods. But here we have not been able to analyze whether the change in beta in the post estimation period over the pre estimation period is significant or not as we have only tried to analyze the difference in the average betas across the mode of payment not across the estimation periods.

Hence, to analyse whether betas of the acquiring companies have altered significantly in the post estimation period vis-à-vis the pre estimation period, we compare the betas of these two estimation periods by employing paired sample t-test separately on the sample comprising cash financed acquisitions, earnout acquisitions and stock financed acquisitions.

Table 4: Result of paired sample t-test measuring the difference between average post and pre estimation betas of acquiring companies for the sample segregated according to the mode of payment

	Difference between average post and pre estimation betas	**No. of companies**	**t-test**	**p-ratio**
Cash financed acquisitions	-0.06	103	-1.42	**0.16**
Earnout acquisitions	-0.16	35	-1.97	**0.05**
Stock financed acquisitions	0.50	15	2.76	**0.02**
All acquisitions	**-0.03**	**153**	**0.70**	**0.49**

The results of paired sample t-test as summarized in Table 4 clearly depict that the average betas have shown a significant decline in case of earnout acquisitions (-0.16, -1.97) while the decline in case of cash offers has been insignificant (-0.06, -1.42). In contrast, the average betas have increased significantly (0.50, 2.76) in case of stock offers in the post acquisition estimation period[4].

Thus, from the above discussion it is evident that risk has declined in case of both cash offers and earnouts in the post estimation period. However, earnouts have produced a statistically significant reduction in betas as compared to the insignificant decline in the risk for cash offers. Contrarily, stock offers have shown a statistically significant increase in the risk of the acquiring companies in the post acquisition period.

FINDINGS

As an upshot of the above discussion, the following key findings have emerged from the study:

First, the risk of the acquiring companies has altered over different event periods as a result of cross border acquisitions for the overall sample. However, segregation of the overall sample according to the mode of payment employed has enabled us in better understanding the alteration in risk profile of such companies as a result of cross border acquisitions.

Second, cash acquisitions are accompanied by only a minor and statistically insignificant reduction in the betas. The reason being in cross border acquisitions, target companies are unwilling to accept the foreign acquirers stock as currency due to the reasons specified earlier and forces it to pay cash. Hence, positive signal accompanying cash payment may not be perceptible in the cross border transactions (Moeller and Schlingemann, 2005).

Third, the risk has reduced substantially in case of acquisitions financed with the earnout mechanism. An earnout offer enables the acquirer to concurrently handle two prominent risks in cross border acquisitions. Firstly, the risk of mis-valuation is minimized by including deferred payment clause and secondly the risk of non-performance is minimized by retaining target's managers.

Finally, the risk has increased significantly in case of stock offers. The results are in consonance with the common belief that stock offers are viewed skeptically and convey

a negative signal to the stock market about the confidence of the acquirer in value creating potential of the deal.

Hence, comparing the results across the different modes of payment and over different event periods, it is evident that companies employing earnout offers have been able to hedge the risk better than those companies that have employed either cash or stock financing. By employing earnouts an acquirer may be able to avoid the problem of negative signalling as well as the problem of reluctance of the target company which is more pronounced in stock offers. Our results are consistent with those of Reuer *et al.* (2004) who suggest that the probability of earnouts is higher in cross border acquisitions as these act as an effective tool of transferring the risk from the bidder to a more informed target company.

CONCLUSION AND IMPLICATIONS

From the above discussion it has emerged that mode of financing is an important tool to mitigate the risk of adverse selection in cross border acquisitions. Out of the three modes of payment, risk reduction is the maximum in case of earnout offers as compared to cash and stock offers. Hence, earnouts are the optimal way of hedging the risk of adverse selection by an acquirer who lacks information regarding the true worth of the target company in cross border acquisitions.

The findings of the study offer valuable implications for the companies from other emerging markets in general and for the Indian companies in particular in their pursuit for cross border acquisitions. Kumar (2009) confers that Indian companies usually pursue cross border acquisitions to obtain competencies, technology, brands and knowledge (that are difficult to value) and also prefer to retain the target company managers in order to learn deploying these assets so that these can be combined with their low cost manufacturing base in order to create world class companies. Under these circumstances, earnouts are advocated as a prudent strategy for the Indian companies for their future global acquisitions as it would enable these companies in hedging the risk of over valuation arising out of the lack of expertise on their part in cross border acquisitions as well as help them in retaining target's valuable human resources.

Raman (2009) opines that as the liquidity crunch in global economy eases, the emerging markets led by China, Brazil and Russia would be more actively pursuing

outbound acquisitions. It is suggested that the companies from emerging markets that are planning to adopt cross border acquisitions as a route for inorganic growth, may take a lesson from the Indian companies and may explore earnouts as an alternative mode of payment to bridge the valuation gap in outbound acquisitions. This mode of payment becomes even more attractive as the bargaining power of the target companies has been substantially reduced in the changed economic scenario. Even the mid sized Indian companies, in order not to lose this opportunity, can adopt earnouts as a strategy to finance their future global acquisition ambitions.

Thus, it can be concluded that the risk of the acquiring companies as a result of cross border acquisitions is a function of the mode of payment employed to finance these acquisitions. A diligently selected mode of payment may be a determining factor for the success of a cross border acquisition as it may guard an acquirer from the prominent risk of adverse selection arising out of information asymmetry on its part.

NOTES

1. It was due to two prime reasons. One was the removal of restrictions on overseas investment on Indian companies by the Government of India in the year 2005 which enabled these companies to raise overseas debt. While, the other factor was the flow of excess liquidity in the Indian capital market in form of funds from Foreign Institutional Investors because since 2004 India has been one of the most attractive investment destination for the global investors due to its robust growth rate.

2. World Investment Report on mergers and acquisitions by UNCTAD for the years 2005, 2006 and 2007.

3. The date on which the information regarding M&A first appeared in the newspaper

4. Similar results are obtained when the average betas of pooled estimation period are compared with those of pre acquisition estimation period. However, for the sake of simplicity we are not disclosing these results over here. The results are available from the authors on request.

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Indian Institute of Management Kozhikode

*Type of Document: (***Working Paper/Case/ Teaching Note, etc.)**	*Ref. No.:*
WORKING PAPER	***IIMK/WPS/119/ FIN/2013/05***

Title:

EARNOUTS A RISK MITIGATING STRATEGY FOR CROSS BORDER ACQUISITIONS IN INDIA

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Subject Areas: **Finance, Accounting and Control**	*Subject Classification Codes, if any:*
Supporting Agencies, if any:	*Research Grant/Project No.(s):*
Supplementary Information, if any:	*Date of Issue:* **February 2013**
	Number of Pages: ***17***

Abstract:

An attempt has been made in this study to assess the impact of different modes of payment employed in cross border acquisitions, viz. cash, earnout and stock on the risk profile of the acquiring companies in India. The purpose is to discern which of the stated modes of payment enables an acquiring company in better hedging the risk of adverse selection that arises due to the information asymmetry on the part of the acquiring company regarding the true value of assets of the target company. It has been found that of the three modes of payment, earnouts provide best hedge to the acquiring companies for minimizing the risk of adverse selection in cross border acquisitions. The reason being earnouts enable an acquiring company resolve the problem of over-valuation and that of non-performance by making part payment contingent on the ex post performance of the target company as well as by retaining target company's managers respectively. The paper recommends earnouts as a valuable strategy for the acquiring companies from India as well as other emerging markets for their future global acquisitions as these companies usually end up overpaying the target companies due to lack of expertise in cross border acquisitions. The paper has tried to fill the void in the existing literature by explicitly analyzing the impact of the different modes of payment on the risk profile of acquiring companies in the post acquisition period.

Key Words/Phrases: Mergers and acquisitions, Cash offers, Earnouts, Stock offers, Betas, Cross acquisitions, India

Referencing Style Followed: American Psychological Association