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**Impact of earnout offers on the acquiring company  
wealth gains in cross border acquisitions**

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## **Impact of earnout offers on the acquiring company wealth gains in cross border acquisitions**

*The present study seeks to assess and compare the acquiring company shareholders announcement gains in earnout, cash and stock offers. For this purpose a sample of 202 cross border acquisitions comprise the sample set. Out of the total sample of 202 acquisitions, 103 are financed via cash (cash offers), 35 acquisitions are financed via earnout mechanism (earnout offers) while 15 offers are financed by exchanging shares of the acquiring companies with that of target companies' shares (stock offers). For computing the announcement returns, standard event study methodology has been employed. Further, one way analysis of variance (ANOVA) has been applied to compare the announcement returns of the acquiring companies across different modes of payment. For this the announcement returns of three day window (day -1 to day +1) are taken as dependent variable. The results of event study for various sub periods reveal that market has given positive reaction to all cross border acquisitions irrespective of the mode of payment employed. The results of ANOVA show that there is a significant difference in the three day returns of cash, earnouts and stock offers. However, the post hoc analysis makes it evident that earnout offers have produced significantly higher returns only in comparison to the cash offers and not in comparison to stock offers during the three day event window. Thus, from the entire analyses it can be deduced that earnouts, that are specially designed to elude the risk of adverse selection in cross border acquisitions, do not generate any superior returns to the acquiring company shareholders compared to other modes of payment.*

The fundamental requirement in any merger and acquisition transaction is that the acquirer must know the value of the resources at the target's disposal. However, in case of imperfect information market, the information gap on part of the acquirer regarding the true value of the target's resources pose the risk of adverse selection for the acquirer. This risk is more pronounced in case of cross border acquisitions (Datar *et al.*, 2001; Reuer *et al.*, 2004) and is defined as liability of foreignness by Zaheer (1995). The reason is the unfamiliarity of the foreign acquirer with the local industrial environment that makes it difficult for it to assess the true value of the assets at the target company's disposal. Donohoe (2006) also argues that information disadvantage on the part of a foreign acquiring company is the often cited reason for the losses of the firms engaged in international operations.

Generally an acquiring company uses mode of payment as a mechanism to manage the risk of adverse selection in case of imperfect information market. Accordingly, the market assesses the value creating potential of a deal on the basis of the mode of

payment employed. The use of stock financing conveys negative signal about the bleak prospects of the combined company to the market. Hence, it leads to negative valuation of the acquirer's shares on the announcement of such stock offers. On the other hand, the use of cash financing depicts the confidence of the acquirer in a particular deal and highlight better prospects of the combined company. This is the reason for markets welcoming cash offers by positively valuing the shares of the acquiring companies on the announcement of such offers.

In cross border acquisitions the acquirer may not be able to use the stock as a hedge to avoid the risk of adverse selection due to reluctance of the target company to accept the stock of the acquiring company as a currency especially in cases where the acquiring company belongs to an emerging market (Conn *et al.*, 2005; Moeller and Schlingemann, 2005; Wiegerinck and Eije, 2007). The reason for such reluctance is the vagaries of the stock market that make the stock of the acquiring company an unattractive proposition for the target shareholders (Mathew and Jain, 2006).

Thus, in a cross border acquisition, a situation may arise where the acquirer (who faces the risk of mis-valuation) is unwilling to offer cash and the target is not willing to accept stock (due to the skepticism regarding the valuation of the acquirer's shares) as a currency of exchange. In such cases, the risk of losing the deal due to valuation disagreement between the target and the acquiring company can be resolved by entering into two part payment contract that 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 upfront 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 upfront 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 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). Datar *et al.* (2001) state that in cross border acquisitions the acquirer may prefer to retain the target's owners/managers due to possession of the country specific expertise. By retaining the target managers and linking their earnings to their future performance, earnouts try to align the managerial objectives with organizational 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 realizing the expected synergies in the post acquisition period.

Limited research has been conducted on assessing the impact of earnout mergers on the announcement returns of an acquiring company. Kohers and Ang (2000) analyze the conditions wherein earnouts are prominent and also study the wealth effect of earnout mergers, comparing these with that of cash financed and stock financed mergers. They find that earnouts are more prevalent in case of hi-tech industries and service industries; in case of acquisitions in unrelated businesses; in case the acquired company is a subsidiary of a listed company or is a private company; and in case of cross border acquisitions. As regards the wealth effect of earnout mergers they conclude that earnout offers garner higher wealth gains for the shareholders of the acquirer company as compared to those of cash financed and stock financed mergers. However, Fabregat (2005) does not find any significant difference in wealth gains of

earnout mergers when compared with those of cash financed mergers and stock financed mergers. Reuer *et al.* (2004) also study the conditions for earnout mergers and state that the likelihood of an earnout increases when the acquirer lacks experience in domestic and international acquisitions; in case of unrelated acquisitions; when higher percentage of equity is acquired and when the acquirer is in hi-tech and service industry. Similarly, Datar *et al.* (2001) suggest that the probability of an earnout merger increases in case of targets with unrecorded assets, that is, in case of a private company and also in such cases where fewer acquisitions take place within an industry.

From the above discussion it is evident that an earnout is preferred by an acquirer to mitigate the risk of adverse selection in those acquisitions where the level of information asymmetry is very high due to high level of intangible assets with the target company; where the acquirer is not familiar with the business of the target company, that is, in case of unrelated acquisitions; when the acquirer is not able to track the true value of the target company's assets due to lack of disclosure on the part of the target company, that is, in case of unlisted and wholly owned subsidiaries; and in case of cross border acquisitions. Furthermore, earnouts are employed by the acquiring company as an inducement to retain human capital of the target company when the success of the target company is dependent on its human resource like in case of service industries.

Since the year 2003, Indian companies have also started employing earnouts as a mode of payment in the outbound acquisitions, besides cash (which is the commonly used mode of payment employed by the acquiring companies in outbound cross border acquisitions in India) and stock offers. However, there is hardly any study being conducted in India to evaluate the impact of earnout offers on acquiring company shareholders wealth. Thus, keeping in view the dearth in the extant literature and the role of earnout offers in evading the risk of adverse selection in acquisitions, the present study has been conducted with following two objectives:

1. To assess the impact of earnout offers on the acquiring company shareholders wealth.

2. To compare the wealth gains in earnout offers to those of cash and stock offers to discern which of the three modes of payment yield superior returns to the acquiring company shareholders in presence of information asymmetry.

## **Database and Sample Selection**

For achieving the aforementioned objectives, acquisitions announced during the period 1<sup>st</sup> January, 1997 till 31<sup>st</sup> March, 2008 are considered. Information regarding announcement date, outcome date and bid specific factors like mode of financing, relatedness and competition among acquirers has been obtained by scanning two leading Indian financial dailies namely, The Economic Times and The Financial Express/ World for the above stated period. Moreover to cross check the announcement and outcome dates of mergers and takeovers, official websites of the Securities Exchange Board of India (SEBI) and the Bombay Stock Exchange (BSE) have also been consulted. Further, data regarding the daily returns of individual stock of acquiring companies is obtained from PROWESS, the database software developed by Centre for Monitoring Indian Economy.

The sample is restricted to only those acquisitions that are successful and where the objective of the acquirer is to acquire a majority control of the target company. Such acquisitions have been deleted where the mode of payment is not clear. Deletions have also been made for those companies where data regarding daily returns of the acquiring company is not available. Yearly distribution of the sample acquisitions is detailed in Table 1.

**Table 1: Year Wise Distribution of the Outbound Cross Border Acquisitions Segregated According to Mode of Payment**

	<i>Cash offers</i>	<i>Earnouts</i>	<i>Stock offers</i>	<i>Total</i>
1997	1	0	0	1
1998	1	0	0	1
1999	2	1	0	3
2000	6	0	4	10
2001	3	0	2	5
2002	7	0	0	7
2003	14	2	1	17

2004	16	2	1	19
2005	30	7	2	39
2006	38	9	1	48
2007	40	1	2	43
2008 (till March 08)	7	2		9
Total	165	24	13	202

From the year-wise distribution of acquisitions from the Table 1 it is clear that the trend of earnout offers has picked up from the year 2003 with the maximum number of earnouts being pursued during the year 2006. Moreover, 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 skepticism on part of the target company regarding valuation of the acquirer's shares.

## **Methodology**

To assess the impact of earnout offers in hedging the problem of adverse selection in outbound cross border acquisitions, entire sample is segmented on the basis of mode of payment into three categories viz. cash offers, earnouts and stock offers. Firstly, announcement returns are assessed separately for the sample of cash, earnout and stock offers with the help of event study methodology. Secondly, a comparison of the announcement gains across the different modes of payment is made with the help of one way analysis of variance (ANOVA).

### ***Event Study***

Standard event study methodology as propounded by Fama and Macbeth (1973) and Fama (1976) has been employed for assessing the impact of cross border acquisition announcement on the wealth of the acquiring company shareholders. Further, the risk and market adjusted variant of standard event study methodology which is better known as the market model has been used. The rationale for applying event study is that it measures the impact of a specific unanticipated event related to a company on

the wealth of its shareholders by analyzing the abnormal returns around that event period (Brown and Warner, 1980 and 1985). The sign (either positive or negative) and the magnitude of the abnormal returns reflect the market's assessment of the impact of such a decision on the long term future prospects of the company.

To calculate the abnormal returns for examining the market reaction to the announcement of cross border acquisition, firstly, an estimation period is selected for computing the parameters ( $\alpha$  and  $\beta$ ) of the market model. The estimation period used here is  $t = -251$  to  $t = -51$ , relative to the first public announcement date of an acquisition ( $t = 0$ ). Daily abnormal return on a particular day  $t$  is the excess of the actual return on day  $t$  over the expected return on that day. The expected return for a particular day  $t$  is computed as follows:

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

Where  $\alpha_i$  presents the normal return of the security  $i$  when  $R_{mt}$  is zero,  $\beta_i$  measures the risk of security  $i$  that is, the sensitivity of  $R_{it}$  to the market wide factors.  $R_{mt}$  is the return on market index (BSE Sensex in this case). Thus,  $\beta_i R_{mt}$  collectively capture the effect of variables that affect the return on all securities or at least most of the securities while  $\varepsilon_{it}$  captures the effect of variables more specific to the prospects of a security  $i$ .

The abnormal return (AR) for a security  $i$  on day  $t$  is calculated as follows:

$$AR_{it} = R_{it} - \hat{R}_{it}$$

Where  $R_{it}$ , is the actual return of a particular company's security  $i$  on day  $t$  and  $\hat{R}_{it}$  is the expected return on the same day.

Daily abnormal returns for each company are calculated over the interval  $t = -50$  to  $t = +50$ .

Further, daily abnormal returns (ARs) have been averaged over  $N$  companies for each day  $t$  and are computed as follows:

$$AAR_t = \sum AR_{it} / N$$

Where,  $AAR_t$  is the average abnormal daily return on day  $t$  and  $N$  is the number of companies.

Further, cumulative average abnormal returns (CAARs) are derived by summing the AARs over various time intervals. For example, CAARs for a particular time interval  $t_1$  to  $t_n$  are derived as follows:



$$CAARs = \sum_{t_1}^{t_n} AAR$$

To comment upon the significance of CAARs the following test statistics has been employed:

$$\text{Test of significance of cumulative average abnormal returns} = \left( \sum_{t_1}^{t_n} AAR / \delta_{AAR_t} * \sqrt{N} \right),$$

where AAR is average abnormal return of all securities from day  $t_1$  to  $t_n$  and  $N$  is the number of days over which AARs are cumulated.  $\delta_{AAR_t}$  is the standard deviation of AAR over the estimation period ( $t = -251$  to  $t = -51$ ).

**One way analysis of analysis of variance (ANOVA):** The one-way analysis of variance (ANOVA) test is applied to test the differences in the means of more than two independent groups. In the present study, ANOVA has been applied to compare the announcement returns of cash, earnouts and stock offers. For the purpose of comparison the CAARs of three day window (day -1 to +1) are taken as it captures a major portion of the stock price effect on the announcement of an acquisition (Andrade *et al.*, 2001; Cheng and Chan, 1995).

## Analysis and Interpretation

### Analysis of announcement returns in cash, earnout and stock offers and comparisons thereof

This section firstly, details the announcement returns of the acquiring company shareholders in cross border acquisitions for different modes of payment viz. cash, earnouts and stock offers. Secondly, a comparison of three day announcement returns across these modes of payment is also presented.

**Table 2: The Announcement Returns of the Acquiring Company in Outbound Cross Border Acquisitions Segregated on The Basis of Mode of Payment**

Event Windows	CAARs Cash Offers	t-test	CAARs Earnouts	t-test	CAARs Stock Offers	t-test
-50 to -41	0.10	0.13	-0.94	-0.62	-6.96	-2.20**
-40 to -31	0.58	0.76	-0.26	-0.17	-2.70	-0.85
-30 to -21	0.86	1.13	-0.85	-0.56	-0.03	-0.01
-20 to -11	1.13	1.49	0.31	0.20	2.49	0.79

-10 to -1	0.43	0.57	0.62	0.41	-0.19	-0.06
-5 to 0	1.73	2.94***	2.57	2.18**	4.41	1.80*
Day -1	0.04	0.17	0.81	1.69*	1.98	1.98**
Day zero	1.28	5.33***	1.68	3.50***	2.18	2.18**
Day +1	0.58	2.42**	1.44	3.00***	-1.35	-1.35
-1 to +1	1.90	4.57***	3.93	4.72***	2.82	1.63
0 to +5	1.35	2.29**	2.37	2.02**	-0.01	-0.01
0 to +10	1.35	1.69*	0.98	0.61	4.19	1.26
0 to +20	0.78	0.71	2.15	0.98	-1.64	-0.36
0 to +30	0.05	0.04	0.51	0.19	-2.63	-0.47
0 to +40	2.03	1.32	2.08	0.68	-5.33	-0.83
0 to +50	1.63	0.95	-0.89	-0.26	-5.70	-0.80

\* p value < 0.10, \*\* p value < 0.05, \*\*\* p value < 0.01 respectively.

From the above table it is clear that in case of cash offers, the rising trend of CAARs has picked up from 40<sup>th</sup> day before the announcement. However, significant positive returns have been earned by the shareholders of the acquiring companies from the sub period -5 to 0 (1.73, 2.94). Besides, significant positive returns have been availed of on the day of actual announcement (1.28, 5.33) and one day after the announcement (0.58, 2.42). Maximum returns have been attained during the three day event window (1.90, 4.57). Moreover, the rising trend of CAARs have sustained till the sub period 0 to +5 (1.35, 2.29). Afterwards, the trend of CAARs has declined till the sub period 0 to +30 (0.05, 0.04) with some recovery visible during the sub period 0 to +40 (2.03, 1.32).

The trend of CAARs for earnout offers from Table 2 makes it evident that the announcement returns have been fluctuating till the sub period -30 to -21. The rising trend of CAARs has picked up from the sub period -20 to -11 (0.31, 0.20) however, statistically significant CAARs have started flowing from the sub period -5 to 0 (2.57, 2.18) and have continued till fifth day after the announcement. On the day of actual announcement (1.68, 3.50) and one day after the announcement (1.44, 3.00) substantial returns have accrued to the shareholders. Maximum returns have been earned during the three day window (3.93, 4.72). Moreover, the positive trend of the CAARs has continued till the sub period 0 to +5 (2.37, 2.02) beyond which the trend has become random.

Similarly, for the stock offers again the trend of significant positive returns has picked up from the sub period -5 to 0 (4.41, 1.80). The actual announcement day (2.18, 2.18) has again generated significant positive returns to the acquiring company shareholders. However, during the three day window (2.82, 1.63), insignificant positive returns are gained by the shareholders. The reason is that the returns have turned negative immediately after the actual announcement day. Further, the negative trend continues till the period 0 to +50 (-5.70, -0.80) though some recovery is visible during the sub period 0 to +10 (4.19, 1.26).

From the above discussion it is clear that the acquiring company shareholders have received positive market reaction in case of all offers but the magnitude and the sustainability in the rising trend varies across three modes of payment. In case of cash offers, the rising trend of CAARs has started from 5<sup>th</sup> day before announcement and has sustained till 5<sup>th</sup> day after the actual announcement day. However, the magnitude of CAARs is lesser than other modes of payment for various event periods viz. sub period -5 to 0, day -1 and day 0. For earnout offers the rising trend of CAARs has picked up from the 5<sup>th</sup> day before announcement and has sustained till 5<sup>th</sup> day after announcement. Moreover, the magnitude of CAARs for earnouts has been higher than those of cash offers for the above mentioned event windows. Observing the trend of CAARs for the stock offers, it is evident that the increasing trend of CAARs has picked up from the 5<sup>th</sup> day before the actual announcement but has sustained only till the announcement day. Thus, keeping in view the magnitude and the trend of CAARs no concrete result can be drawn regarding whether earnouts have created higher wealth gains in outbound cross border acquisitions.

Thus, to remove the ambiguity regarding wealth gains in outbound acquisitions to know whether the announcement gains in earnout offers are significantly different from those of cash and stock offers, the comparison of the announcement gains across modes of payment has been made by employing one way ANOVA test. The results are given in Table 3 and are explained as follows:

**Table 3: Results of ANOVA for Comparing the Three Day Announcement Returns across Earnouts, Cash and Stock Offers**

Mode of payment	Three day Average CAARs	No. of companies
Earnout	3.92	36
Cash Offers	2.81	153
Stock Offers	1.90	13
F test (p value)	2.32 (0.10)	202
Post hoc analysis		
	<i>Mean Difference</i>	<i>p value</i>
Earnout-cash offers	2.02	0.08
Earnout-stock offers	1.11	0.78
Cash-stock offers	-0.91	0.81

From the results of ANOVA as illustrated in Table 3, it is clear that there is a significant difference in the three day announcement returns across three modes of payment. Further, the post hoc analysis suggests that the difference in the three day announcement gains persists only in case of earnout and cash offers and not in case of earnouts and stock offers. It implies that earnout offers have produced significantly higher returns compared to the cash offers during the three day event window. However, the difference in the announcement gains of earnouts and stock offers is not significant for the corresponding event window. Moreover, cash offers have not only underperformed compared to those of earnouts but also in comparison to the stock offers though not significantly.

From the above discussion it is clear that market has given similar reaction to all the offers irrespective of the mode of payment employed. Hence, it can be deduced that though earnouts are specially designed to hedge the risk of adverse selection in case of imperfect information markets, these have not generated substantially superior returns to the shareholders of the acquiring company compared to other two modes of payment.

## **Conclusion**

Thus, from the above analyses, it is evident shareholders have given positive reaction to all cross border acquisitions irrespective of the mode of payment. Earnout offers have created higher returns compared to cash and stock offers, however, the difference is not statistically significant. It leads us to the conclusion that earnouts that are specially designed to elude the risk of adverse selection in cross border acquisitions do not generate any superior returns to the shareholders compared to other modes of payment. The probable reason for the subdued market reaction may be that earnout is a relatively newer phenomenon in India and is being exercised by mid-sized companies only in IT sector with lesser number of such acquisitions being initiated by other technology intensive and services sectors. Hence, the market participants seem to be relatively ignorant about the potential of earnout offers in hedging the risk of adverse selection in acquisitions especially the cross border ones. The findings are consistent with those of Fabregat (2005) who opine that market does not offer substantial returns to the acquiring company shareholders in earnout offers than other modes of payment just due to the ignorance on the part of the investors regarding the risk hedging capacity of these offers.

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