INTI INTERNATIONAL UNIVERSITY

MASTER OF BUSINESS ADMINISTRATION

THE EFFECTS OF FREE CASH FLOW ON CHINESE LISTED COMPANIES' CROSS-BORDER MERGERS AND ACQUISITIONS PERFORMANCE

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Submission Date: August 27, 2014
Ethics Number: N/A
Final World Count: 12474

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Acknowledgement

It would not have been possible to finish this thesis without the help and support of the people around me, to some of whom it is possible to give particular mentions here.

Above all, I would like to express sincere appreciation to my supervisor Dr. Ng Sin Huei. He has put a lot of focus on helping me finish this thesis and given me necessary guidance. His good advices and supports have been invaluable on an academic level, for which I am extremely grateful.

Secondly, I would like to thank my parents for supporting my study at all times. They have given me their unequivocal support throughout, as always, for which my mere expression of thanks likewise does not suffice.

Last but not least I would like to thank my close friends Pan QiQi and Kang Kai for their words of encouragement when times become challenging.

Thank you.

Declaration

The work presented in this thesis is the fruition of my own work and effort, never has this work been submitted for any other award but for the partial fulfillment of my MBA studies at INTI International University, Malaysia.

Any information used within this study from other sources has been acknowledged to their respective authors.

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Table of Contents

List of Tables

Abstract

There are more and more Chinese listed companies take the cross-border mergers and acquisitions (M&A) in recent year, but the M&A performance are not well in generally. Jensen's free cash flow (FCF) hypothesis was introduced in 1986. According to the FCF hypothesis, FCF has a negative relationship with M&A performance. This study is to examine the effect of FCF influence on Chinese listed companies' cross-border M&A performance. In addition, this study also examine the relationship between FCF and corporate ownership structure, and examine the relationship between FCF and type of M&A. The data consist of 39 cross-border M&A deals from 2000 to 2008 and 36 Chinese A-share listed companies from Shanghai Stock Exchange and Shenzhen Stock Exchange. The windows period is 5 years. Data are collected from CSMAR database of Shenzhen GuoTaiAn Information Technology (GTA) and Chinese official websites of security.

Accounting research methods and Principal component analysis are used to evaluate the M&A performance of every sample deals in this study. Descriptive Analysis and multiple liner regression analysis are used to test the research questions of this study. The results the research present that the FCF has a positive effect on Chinese listed companies cross-border M&A performance. The listed state-owned companies have higher FCF rate than private-owned companies before take cross-border M&A. Companies with higher FCF rate prefer choose horizontal M&A to vertical M&A in cross-border M&A. Private-owned companies' cross-border M&A performance are better than state-owned companies'. The cross-border vertical M&A performance are better than the cross-border horizontal M&A performance.

Keywords: free cash flow hypothesis, cross-border M&A, Chinese listed company

Chapter 1: Introduction

1.1 Research Background

Mergers and Acquisitions (M&A) are common financial news. In fact, M&A activities can be traced back to the 19th century. So far, we have experienced five Mergers and Acquisitions Waves. The 1st M&A wave began from 1880 and lasted 24 years; the strategic background is the realization of monopoly rents by horizontal takeovers. The 2nd M&A wave appeared from 1916 to 1929, and the strategic background is the vertical integration to gain control of the complete value chain. The 3rd M&A wave appeared from 1965 to 1969; the strategic background is the 3rd technological revolution which stimulated the conglomerate M&A, and the scale and speed was far large than the past two M&A waves. From 1981, the 4th M&A wave appeared because companies want back to core business through divestures and carve-outs; the Leveraged Buy Out was the major role of this M&A wave. Following the 4th M&A wave, and because the occurrence of the globalization, the 5th M&A wave appeared from 1993, and it is continuing so far (Gaughan, 2003). The main form of these M&A is cross-border M&A. Cross-border M&A is a form of foreign direct investment (FDI); it is replacing multinational creation gradually and become the dominant way of transnational direct investment. In 1987, the value of total cross-border M&A in the world was only \$7.4 billion; in 1990, it rose to \$151 billion; in 1995, the value of American enterprise M&A is \$450 billion; in the first half of 1996, it rose to \$279.8 billion. The value of total cross-border M&A in the world rose to \$1.1438 trillion in 2000 (UNITED NATIONS, 2013). In 2001, due to the stagnation and decline of the European and American countries' economic growth as well as the influence of "9.11" incident, the wave of global cross-border M&A showed sign of slowing. But looking at the trends of long-term development, cross-border M&A will continue to develop. It is interesting that when the cross-border M&A wave is receding in developed countries, it is spring up in developing countries. More and more companies in developing countries are joining the global cross-border M&A wave, especially the companies in emerging markets. It is more interesting to note that in previous cross-border M&A cases, the role of the companies of developed countries are bidder companies and the companies of developing countries are target companies, but now, this situation is shifting into reverse (CAPITAL GROUP, 2014).

In recent years, many Chinese companies have ventured overseas to extend their businesses. In the long run, globalization can help enterprises purchase raw material, research and develop new technology, sell products and attract talents in a larger scope. These are very important for growth of companies. (Liu, et al., 2011)

According to the data of China's Ministry of Commerce, Chinese companies' foreign direct investment grew 16.8% year-on –year, and their investment performance is better than the word's average level. Under globalization, Chinese companies' foreign investment has accelerated. As the.same time, the foreign exchange reserves of four trillion dollars and the internationalization of Renminbi (RMB) has sped up capital output. Mergers and Acquisitions is one of the main ways of company expansion. George. J. Stigler (1950) said, "Almost all of American companies expand themselves by means of mergers and acquisitions." There is no exception for Chinese companies which want to play important roles in global economy. China's Ministry of Commerce also declared that cross-border mergers and acquisitions activities in China in 2013 were also active, and showed a sharp rise in amount and scale. In 2013, Chinese companies completed 138 cross-border M&A with an average transaction of $51.463 billions, rising 53.7% compared to the amount of $33.483 billion in 2012. Cross-border M&A becomes the main avenue for Chinese companies to extend their businesses.

Compare with direct investment for developing businesses, cross-border M&A has two advantages as a way of expansion: cost efficiency and increase in market share. On one hand, cross-border M&A can help enterprises to realize the international expansion strategy within a short time, build their positions in new market and improve sales; on the other hand, cross-border M&A can assemble the resources and managerial experience in each related aspect, especially in occupying foreign target companies' brand resources, customers resources, distribution channels and technologies (Caiazza, et al., 2013). For Chinese companies, the significance of cross-border M&A is becoming more and more obvious, because the cross-border M&A is a quick and easy path for Chinese companies to continually extend. It can help companies quickly get the tangible and intangible assets which could not be found in China. It can cater to Chinese companies' ambition of they hope to have international operation; it can improve Chinese companies' technologies, management, products, brands and corporate structure. It can also help Chinese companies to gain competitive advantage, and improve their global influence. In a nutshell, cross-border M&A can let companies acquire assets of different regions quickly, and these assets are the important factors to strengthen the companies in the global economy (Yang, 2009).

However, it is not easy to gain the advantage of cross-border M&A. When comparing with domestic M&A, there are many hidden risks in cross-border M&A, and any improper handling can lead to negative effects. Many reports and news, have indicated that many Chinese companies' cross-border M&A are not going smoothly. A series of studies (Liu, Low and Niu, 2011; Kling and Weitzel, 2012) presented that the success rate of Chinese listed companies' cross-border M&A is smaller than its failure rate, and the M&A performance lacks sustainability. So, this phenomenal arouses researcher's interest to figure out what factors undermine Chinese listed companies' performance not well in cross-border M&A.

There is a variety of factors influencing the M&A performance. And it is important to figure out these factors and take effective measures to regulate the behavior of listed companies engaging in M&A activities. The mature theory of M&A is the Agency Cost Theory, introduced by Michael Jensen and William Meckling in 1976. The Agency Cost Theory defines that there is a commissioned – agent relationship between the owners and operators of modern enterprises, and the enterprises are not only pursuing profit maximization; enterprises take the M&A activity in order to reduce the agency cost (Fama and Jensen, 1983). Jensen's Free Cash Flow Hypothesis is one of three important hypotheses to explain the failure of M&A in Financial Economics, which is introduced by Jensen in 1986. Jensen thought that M&A reduce the companies' free cash flow and agency cost, but moderate creditor's right can reduce more agency cost and add the value of companies. It is necessary to know whether M&A can bring growth to the company, and whether the management undertake unreasonable expansion in order to pursue their own interests. This study base on the free cash flow and through research the relationship between the free cash flow and the performance of M&A to judge whether the agency problem is one of factors that impacts Chinese listed companies' cross-border M&A performance.

1.2 Problem Statement

The M&A performance is an issue which has been researched by many researchers, especially in the west. Mergers and Acquisitions in Western countries has a history of more than 100 years, and the research on M&A has been very active since the 1960. This research is mainly related to M&A motivation and M&A performance. The research on

M&A is relatively mature, and it has formed a consensus on systemic M&A theory and practical motivation. However, in the research on M&A performance, the measurement methods are different, but their research results are similar. The Business Week had a detailed research for the giant M&A activities in United State, and the result showed that almost all M&A had not achieved the Synergistic effects which was expected. On the other hand, many M&A activities ultimately harm the shareholders' value (Bruner, 2003). In recent years, western scholars focus mainly around three aspects; the theory of M&A performance, the evaluation method of M&A performance and the empirical research. They carry out extensive and in-depth research on the problems of M&A performance. Many researchers have done research on the M&A performance based on the Agency Cost Theory and Free Cash Flow Hypothesis, Gregory and Wang (2013), and Uddin and Boateng (2009), got quite different results. Many results support the FCF Hypothesis while some didn't support (Gregory & Wang, 2013). Steven B. Perfect(1995) found that the FCF Hypothesis is supported in the short-term, but there is no evidence to support the FCF Hypothesis in the long-term.

Due to the development of the economy and the increasing number of M&A events, more and more Chinese researchers are interested in researching the M&A performance of Chinese companies. In China, empirical research on Chinese companies' M&A performance were done by means of foreign evaluation of M&A performance. Most of the studies are based on Chinese companies' domestic mergers and acquisitions, and produced the different research results. The results of studies show that the corporate ownership structure has significant influence on the M&A performance in China. The state-owned companies' M&A performances are better than private companies' M&A performance (Chi, et al., 2011). The reason of this result may be due to Chinese government support for the state-owned companies. Some results of studies also show that the vertical M&A or horizontal M&A has significant influence on the performance