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EMPIRICAL RESEARCH AB OUT THE MARKET FOR CORPORATE CONTROL IN REPUBLIC OF CROATIA

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Abstract

The market for corporate control can be viewed as an exogenous organizational variable that puts pressure on managers to behave and make investment decisions that are coherent with the interests of shareholders. With the respect to the fact that there is a lack of researches in the Republic of Croatia regarding the impact of the market for corporate control on the performance of the target companies and taking into consideration that poor effectiveness of the management for a longer period of time results in poor company performance, this paper will test the hypothesis the hypothesis according to which companies that have a below average profitability in its industry, over a longer period of time, are more likely to become takeover targets as compared to other companies in the industry. This paper also examines the impact of the market for corporate control on the performance of target companies after the takeover.

Key words: market for corporate control, takeover, empirical research, Republic of Croatia

1. INTRODUCTION

Integration processes are prominent phenomenon of the modern capitalist world. In order to implement the growth strategies, companies often decide to expand operations through mergers, acquisitions or through a strategic alliance. The decision on the participation in horizontal integration, meaning mergers and acquisitions in the same industry, can be viewed through the prism of increasing profitability through joining or purchasing assets and other resources (human capital, know-how, etc.) of previous competitors (Hill & Jones, 2008). The decision on the participation in vertical integration (meaning mergers and acquisitions in other industries in order to gain partial or total control over value chain) can be reasoned by construction of barriers to entry of competitors into the industry, facilitating investment in specialized assets with aim at increasing the efficiency of operations and protection of product quality (Gamble & Thompson, 2009).

Form of enterprise where the owners are no longer personally liable for the obligations of the company as well as separation of ownership functions from management functions are the fundamental postulates of the modern corporation. The foundations of the modern corporation and the theory of corporate governance were introduced by Adolf Berle and Gardiner Means. Separation of ownership from management roles has created the conditions for the different symmetry of power compared with conventional entrepreneurial organizations. Owners of many businesses owned a small share in the ownership structure of companies and had relatively less influence on managerial decisions (Berle & Means, 1932). In this situation a number of issues related to the behavior of managers were raised. In fact, according to agency theory managers often make decisions that are in their best interest, and not in the interest of owners (Eisenhardt, 1989). Relying on the postulates of agency theory, independently of each other, an economist Robin Marris and lawyer Henry Manne shaped model of the market for corporate control (Blair, 1995).

Jensen and Ruback define the market for corporate control, often referred to as the takeover market, as a market in which alternative managerial teams compete for the rights to manage corporate resources (Jensen & Ruback, 1983). The basic premise of the model of the market for corporate control is that managers have the right to manage the corporation so long until its market value can be significantly improved by the alternative group of managers with a better business strategy. The main driver for change in the model is poor effectiveness of management in terms of value creation for shareholders (Tipurić et. al., 2008).

Relying on the basic postulates of the market for corporate control, the hypothesis according to which companies that have a below average profitability in its industry, over a longer period of time, are more likely to become takeover targets as compared to other companies in the industry, will be tested in this paper. Following the conceptualization of the market for corporate control and the overview of recent researches, research methodology as well as the interpretation of the results will be presented in this paper.

2. MARKET FOR CORPORATE CONTROL

The market for corporate control can be viewed as an exogenous organizational variable that puts pressure on managers to behave and make investment decisions that are coherent with the interests of shareholders. If managers make decisions in order to increase their own wealth at the expense of the company's owners, the market will ensure that there is a change of current managers with better managers. Behavior of managers that is in conflict with the interests of shareholders will reflect trough the reduction in value of corporation shares. Lower share prices will enable the participants of the capital market to buy shares in order to achieve control over the corporation, and also to increase the value of the corporation after the takeover resulting in their own earnings. Planned increase in corporation shares can be achieved through replacement of inefficient management with better and efficient management (Tipurić, 2006).

Many researchers have emphasized the growth of the company as the dominant goal of most managers, so managers' discretionary behavior is mostly manifested when making decisions on mergers and acquisitions. Manne, unlike others who see mergers and acquisitions as managers act in order to meet their own needs and interests, scrutinized mergers and acquisitions as an effective mechanism by which the harmful behavior of managers can be control. Manne points out that the market for corporate control is a permanent threat to managers who do not work in order to maximize shareholder wealth, and capital market is one that sends a signal to assess the managers' work throughout the company's stock price (Manne, 1965).

For Jensen market for corporate control is best seen as a major component of the managerial labor market. According to him, it is the arena in which alternative management teams compete for the rights to manage corporate resources. Managers often have trouble abandoning strategies they have spent years devising and implementing, even when those strategies no longer contribute to the organization's survival. Such changes can require abandonment of major projects, relocation of facilities, changes in managerial assignments, and closure or sale of facilities or divisions. Takeovers generally occur because changing technology or market conditions require a major restructuring of corporate assets, and it is easier for new top-level managers with a fresh view of the business and no ties with current employees or communities to make such changes. Moreover, normal organizational resistance to change is commonly significantly lower early in the reign of new top-level managers (Jensen, 1988). Jensen also posits that managers do not always consciously to increase their own wealth at the expense of shareholders but that their behavior is simply a reflection of an erroneous choice of strategy. In such situations capital market by reducing the market price of shares of companies suggests that managers make mistakes and that the strategy should change. If managers are not accepting signals from the market, their change is desirable for the benefit of all shareholders and the entire economy (Jensen, 1988).

Internal monitoring mechanisms in corporations, acting through the board of directors, should encourage managers to restructure. When the internal processes directed to changes are too slow and costly to influence the decisions on restructuring and improving the efficiency of managers, that job does the capital market through the effect of the market for corporate control. The market for takeover in such situations serves as an important source of protection of shareholders, especially small ones. Other groups of managers often recognize an opportunity in which the reorganization of corporate resources can create value and then compete for the rights of corporate governance. In order to succeed to take over the management rights of corporate resources group of managers who is competing has to pay premium price. In that way, shareholders have the opportunity to earn a premium as a consequence of takeover (Jensen, 1988).

Manne also points out that the market for corporate control gives shareholders the power and protection that is proportional to their shares in the corporation. The fundamental premise of the market for corporate control is based on the existence of a positive correlation between management's efficiency and corporation's share price. If managers poorly manage corporations in terms of achieving lower returns than more efficient management would realize for shareholders, the market price is reduced compared to the price of the shares of other corporations in the industry. Lower market price increases the option for takeover and thus the possibility that inefficient management is replaced with more efficient management. The market price also reflects the possibility of potential earnings for those who think that corporate resources can be managed better than existing management does it. Potential returns from a successful takeover can be enormous (Manne, 1965).

In the theory of free cash flows Jensen noted that managers realize large personal benefits by building a business empire, and stressed that managers of firms with large free cash flows, and small opportunities for profitable investment, sooner decide on mergers or takeovers that destroy value rather than to payout the dividends to shareholders. Lang et al. in their study tested Jensen's hypothesis was the results obtained support the Jensen's reasoning (Lang et al., 1991). Mork et al. have also tested the same hypothesis. The results of their study suggest that there are several types of takeovers, with emphasis on takeovers that relate to the targets with high-growth rates, in which managers can realize substantial personal gains at the expense of shareholders (Mork et al., 1990). Jensen emphasized that the takeovers are at the same time evidence of conflict of interest between owners and managers, and solution of the same problems. Some scholars think that market for corporate control can be regarded as a control mechanism that reduces the conflict of interest between managers and owners

(Choi, 1991). A study of Mitchell and Lehn stressed that the market for corporate control discourages managers in the process of empire building science bidders whose takeovers result in reduced shareholder wealth have a greater ability to become targets and be taken over (Mitchell & Lehn, 1990).

Masulis et al. in the recent survey of 3.333 takeovers in the period 1990. – 2003. analyzed the impact of the market for corporate control on the behavior of managers. Research results suggest that the market for corporate control has strong influence on managers to make investment decisions that increase shareholder wealth, particularly when those decisions relate to acquisitions of other companies. In addition, the authors of the study point out that disciplining management by the market for corporate control varies depending on the number of takeover defense techniques that are available to managers (Masulis et al., 2007). In the study on the sample of nearly 8.000 takeovers, in the period 1980. – 1999. Offenberg came to the results that the market for corporate control and the board of directors in more cases discipline managers of larger companies than managers of smaller companies (Offenberg, 2009).

With the respect to the fact that there is a lack of researches in the Republic of Croatia regarding the impact of the market for corporate control on the performance of the target companies, this paper examines the impact of the market for corporate control on the performance of target companies after the takeover.[1] The impact of the market for corporate control will be analyzed through the performance of a target company before the takeover. Taking into consideration that poor effectiveness of the management for a longer period of time results in poor company performance, this paper will test the hypothesis that firms with ineffective management and poor performance will be taken over.

3. METODOLOGY AND RESEARCH RESULTS

Measuring instrument (questionnaire) for testing the hypotheses of this research consisted of a set of questions that the respondents (board members and company managers) answered and expressed their agreement/disagreement with proposed statements whereat a Likert measurement scale of five degrees was used. Propositions used in different measurement scales are either originally developed for research purposes, or processed and adapted from existing measurement scales that can be found in the relevant scientific literature.

Empirical research was conducted in Croatian companies, which have been taken over. In Bloomberg and Mergermarket databases 233 transactions in the period 1998. - 2010. were recorded. With the detailed investigation of the

[1] When testing the impact of the market for corporate control shareholder wealth will not be taken into account because the capital market in the Republic of Croatia is shallow, and as such does not reflect the real price of the shares. Accounting information will be taken into account when measuring company's performance.

information library of the Croatian Agency for Supervision of Financial Services another 401 transaction during this period was recorded, which combined with the transactions from Bloomberg and Mergermarket databases comes to a total of 634 transactions. Since this paper analyses transactions in non-financial sector, the sample on which the empirical research was conducted comprised of 598 companies. In order to analyze the impact of the market for corporate control on performance of companies that were taken over, it is important that at least three years have passed since takeover. For this reason, the companies that were taken over were analyzed in the period since 1998. - 2006.

In the period of sixty days after the beginning of the primary research 43 completed questionnaires were returned representing a return rate of 7.19%. Considering the sensitivity of the analyzed phenomena and complexity of analysis, the rate of return of questionnaires was acceptable. The complexity of the analysis is reflected in the fact that the study included only companies in which at last three years passed after the acquisition. Additional criteria were related to the fact that the respondent (the president or board member or senior manager) should be included in the acquisition process and familiar with the acquisition activities, and also working in the company that was taken over at least 5 years in order to identify and assess the changes that have occurred after the takeover. Of the total number of received questionnaires 30 companies that performed better after the takeover was identified (69.8%) and 13 that performed poorer after the transaction (30.2%).

In the analysis of empirical data collected in this study large number of statistical techniques was used. Overall data analysis was conducted using statistical software package SPSS 17.0. Empirical research begins by testing the hypothesis:

1. **H1** - Companies that have a below average profitability in its industry, over a longer period of time, are more likely to become takeover targets as compared to other companies in the industry.

In order to test the hypothesis research participants were asked about their company's performance before and after the takeover. Performance indicators of acquired companies are presented in Table 1.

Table 1.

Analysis of the profitability of acquired companies

Performance of the target before the acquisition		**Performance after the acquisition**		**Total**
		Worse	*Better*	
Loss	Number of companies	4	10	14
	%	28,6%	71,4%	100,0%
Below average profitability compared to competition	Number of companies	0	5	5
	%	,0%	100,0%	100,0%
Average profitability compared to competition	Number of companies	0	12	12
	%	,0%	100,0%	100,0%
Above average profitability compared to competition	Number of companies	9	3	12
	%	75,0%	25,0%	100,0%
Total	Number of companies	13	30	43
	%	100,0%	100,0%	100,0%

The table shows that out of the total number of analyzed companies 14 or 32.55% operated with losses in the period of three years prior the acquisition, 5 companies or 11.63% had below-average profitability compared to competitors, and 12 companies respectively 27.91% of them were operating with an average profitability relative to competitors. Only 12 companies or 27,91% had above-average profitability compared to competitors. Most of the companies was operating with losses or had a below average or average profitability before the takeover.

Of the total number of companies that have operated with a loss, 71.4% of them operated better (successful) after the takeover, while the remaining 28.6% continued with poor performance. It is interesting that all analyzed companies that had below-average and average profitability when compared to the industry before the takeover operated better after the takeover. According to Table 1 out of 12 companies that have previously had above-average profitability compared to the competition, all 3 companies or 25% of them continued with better performance, while 9 companies or 75% operated worse compared to the period before the acquisition.

When companies are grouped into two categories as shown in Table 2 it is evident that the 31 company or 72.09% of them in the period prior to the acquisition had losses, below average or average profitability of the business.

Table 2.

Analysis of acquired companies according to their profitability before and after the acquisition (grouped)

Performance of the target before the acquisition		**Performance after the acquisition**		**Total**
		Worse	*Better*	
Losses, Below average and average profitability compared to competition	Number of companies	4	27	31
	%	12,9%	87,1%	100,0%
Above average profitability compared to competition	Number of companies	9	3	12
	%	75,0%	25,0%	100,0%
Total	Number of companies	13	30	43
	%	100,0%	100,0%	100,0%

The above conclusions which were drawn from descriptive statistics, initiated statistical testing of the correlation of profitability before and after the acquisition. Chi-square test showed a statistically significant correlation between profitability before and after the acquisition ($p < 0.001$). Fisher's exact test for small frequencies was aslo applied because of the small frequencies in some areas. Test results of the test are shown in Table 3 and in Table 4 symmetric measures of Chi-square test are also shown.

Table 3.

Chi-square test

Chi-Square Test	**Value**	**df**	**Asymp. Sig. (2-sided)**	**Exact Sig. (2-sided)**
Pearson Chi-Square	18,787[a]	3	,000	,000
Likelihood Ratio	22,455	3	,000	,000
Fisher's Exact Test	17,739			,000

Table 4.

Chi-square symmetric measures

Symmetric Measures	Value	Approx. Sig.	Exact Sig.
Phi	,661	,000	,000
Cramer's V	,661	,000	,000
Contingency Coefficient	,551	,000	,000

Descriptive statistics showed that 72.09% of the analyzed companies operated with losses, below average or average profitability and become a takeover target, which confirms the hypothesis:

1. **H1** - according to which companies that have a below average profitability in its industry, over a longer period of time, are more likely to become takeover targets then other companies in the industry.

In addition, the correlation between profitability before and after the acquisition was statistically tested and confirmed.

4. CONCLUSION

Research conducted in this paper was based on the premise that the market for corporate control represents a constant threat to managers who manage companies inefficiently and make business decisions to maximize their own benefit at the expense of company's owners, i.e. shareholders. Taking into the account that such managers' behavior over a longer period of time results in a lower company's performance, in this paper the hypothesis according to which companies have a below average profitability in its industry, over a longer period of time, are more likely to become takeover targets then other companies in the industry, was tested. Descriptive statistics, which was used to test this hypothesis, showed that 72.09% of the analyzed companies operated with losses, below average or average profitability became a takeover target, which confirmed the hypotheses. In addition, the correlation between profitability before and after the acquisition was statistically tested using Chi-square test and confirmed.

The results of this study are coherent with Jensen and Manne postulates as well with the results of recent research of Masulis et al. Managers who make investment decisions that are in conflict with the interests of shareholders can work that way until that way of conducting business is not reflected in the decrease of company's profitability. Reduced profitability of the company leads to the decrease of the company's value, which opens the possibility for alternative groups of managers to take over the company and to allocate company's resources appropriately achieving benefits for themselves and the owners of the company.

The research results suggest a correlation between profitability before and after the acquisition of target company and therefore, it can be concluded that managers are aware that the market for corporate control will punish bad investment decisions and that the market for corporate control is a permanent threat to managers which forces them to work in the interest of the company.

5. BIOGRAPHY

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EMPIRIJSKO ISTRAŽIVANJE TRŽIŠTA ZA KORPORATIVNU KONTROLU U REPUBLICI HRVATSKOJ

Sažetak

Tržište za korporativnu kontrolu može se promatrati kao egzogena organizacijska varijabla koja vrši pritisak na ponašanje menadžera i na njihovo odlučivanje o investicijama koje je u skladu s interesima dioničara. U Republici Hrvatskoj nema dovoljno istraživanja glede utjecaja tržišta za korporativnu kontrolu na rad ciljnih tvrtki, stoga ovaj rad istražuje utjecaj tržišta za korporativnu kontrolu na rad ciljnih tvrtki nakon preuzimanja. Uzevši u obzir da loša učinkovitost upravljanja tijekom duljeg razdoblja rezultira lošim radom tvrtke, u ovom radu će se testirati pretpostavka da će tvrtke čija je profitabilnost dulje vrijeme ispod prosjeka vjerojatno postati mete preuzimanja u usporedbi s drugim tvrtkama iz istog sektora.

Ključne riječi: tržište za korporativnu kontrolu, preuzimanje, empirijsko istraživanje, Republika Hrvatska.

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