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Cross-Border Acquisitions and Labor Regulations

BY ROSS LEVINE, UNIVERSITY OF CALIFORNIA–BERKELEY, THE MILKEN INSTITUTE, AND THE NATIONAL BUREAU OF ECONOMIC RESEARCH; CHEN LIN, UNIVERSITY OF HONG KONG; AND BEIBEI SHEN, CHINESE UNIVERSITY OF HONG KONG

Cross-border acquisitions account for a large and growing proportion of all acquisitions. The dollar value of cross-border acquisitions rose from an average of \$300 billion per annum during the 1990s to an average of almost \$800 billion per annum since 2000. Furthermore, the proportion of all acquisitions accounted for by cross-border deals rose from 24 percent to 39 percent.

Previous research has focused on the financial and corporate governance determinants of cross-border acquisitions (exchange rates, relative stock market valuations, the strength of corporate governance, and the nationalities of owners and directors). But researchers have not yet studied how labor market regulations and policies influence cross-border acquisitions. Researchers have evaluated the impact of offshoring and multinational firms on wages and employment, but not whether differences in protections for the employed and assistance to the unemployed influence cross-border acquisitions.

This is surprising. Besides affecting wages and benefits, labor regulations shape the costs of hiring, firing, and adjusting worker hours. Labor market flexibility could be especially important for the success of acquisitions since acquiring firms often restructure targets to minimize labor costs and maximize synergies.

We provide the first assessment of the relationship between cross-country differences in labor regulations and cross-border mergers and acquisitions. We use a sample of cross-border transactions in the Securities Data Company database across 50 countries over the period 1991–2012. We examine individual deals and assess the cumulative abnormal stock returns (CARs) and the abnormal return on assets (ROAs) of acquiring firms following cross-border acquisitions.

We use three measures of labor regulations: the degree to which laws impede employers from firing workers, increasing work hours, or using part-time workers; measures of the strictness of regulations on dismissals constructed by the Organization for Economic Cooperation and Development; and the proportion of the unemployed covered by unemployment benefits. For brevity, we use the phrases “stronger” and “weaker” labor regulations to describe the degree to which laws and policies protect the employed and aid the unemployed.

With these data, we evaluate how an acquiring firm’s CAR and abnormal ROAs respond to a cross-border acquisition. The key explanatory variable is the difference in labor regulations between the countries of the target and acquirer; we also control for characteristics of the acquirer country, the target country, the time period, deal-

specific traits, geographic distance between the acquirer and target, and time-varying country characteristics such as gross domestic product per capita.

We find a strong empirical connection between labor regulations and both abnormal stock returns and profits. An acquirer's CAR and abnormal ROA respond more positively when the target is in a country with weaker labor regulations than those of the acquiring firm. The abnormal ROA results are robust across the different measures of labor regulations and specifications. The results on the relationship between CARs and the labor protection law index are more fragile. This fragility reflects weakness in identifying those target firms within a country that are likely to be influenced by labor regulations.

We extend these analyses by recognizing that labor regulations might differentially affect firms. In this case, the stock market's reaction to a firm acquiring a target will be more sensitive to labor regulations when the target is in an industry that relies heavily on labor market flexibility.

We therefore examine the relation between labor regulations and changes in an acquiring firm's CAR and abnormal ROAs while differentiating by the degree to which the target is in an industry where firm performance depends heavily on labor markets. We use U.S. data to create two measures of labor dependent industries. "Labor intensity" equals labor and pension expenses relative to sales, while "labor volatility" equals the volatility of employment relative to assets. We then redo the analyses of how an acquiring firm's stock returns and profits respond to a cross-border acquisition.

We find that the CARs and abnormal ROAs of acquiring firms respond most positively to cross-border acquisitions of targets in countries with comparatively weak labor regulations when the target is in a labor-dependent industry. In turn, when the target is in an industry in which labor regulations are unlikely to influence firm profitability, the stock market and profits do not respond much to cross-border differences in labor regulations. The relationship between cross-border differences in regulation and acquirer CARs and abnormal ROAs is especially large when the performance of the target industry depends heavily on labor market flexibility.

We also extend these analyses by assessing the relationship between differences in labor regulations and the number and value of cross-border acquisitions. If labor regulations shape the stock price reaction to cross-border acquisitions and profitability of such deals, this should be reflected in the incidence and size of cross-border acquisitions when differentiating by country pairs.

We find that a country's firms acquire more firms and spend more on each acquisition in a country if that target country has weaker labor regulations than the regulations in the acquirer country. That is, firms find targets in countries with weaker labor regulations more appealing than similar targets in countries with comparatively strong labor regulations. China, for example, has labor protections that are average in our sample. About 67 percent of its cross-border acquisitions flow to countries with weak labor protection laws, while only 9 percent flow to countries with strong labor protection laws. These results are consistent with our core findings: acquiring firms enjoy larger CARs and abnormal ROAs after a cross-border acquisition if the target is in a country with weaker labor regulations than the acquirer's country.

Our results do not, and do not seek to, evaluate the impact of a random firm acquiring another random firm in a different country in a random year on the CARs and abnormal ROAs of the acquiring firm. These acquisition choices are anything but random. Rather, we evaluate what happens to CARs and abnormal ROAs when a firm chooses to acquire another firm and whether this relationship differs by the comparative labor regulations in the two countries and by the degree to which the target firm is in an industry that requires flexible labor markets. We find that labor regulations are powerfully associated with stock price reactions to cross-border acquisitions, the abnormal ROAs of such deals, and the degree to which firms in one country acquire firms in other countries.

NOTE

This research brief is based on "Cross-Border Acquisitions and Labor Regulations," Ross Levine, Chen Lin, and Beibei Shen, National Bureau of Economic Research Working Paper no. 21245, June 2015, <http://www.nber.org/papers/w21245>.