

The Long-Term Performance of UK Mergers & Acquisitions: Separation by Bidder Motivation

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Abstract

Prior studies have basically reported that acquirers significantly under-perform in the long-term post-merger period. Many theories exist regarding the motivation towards the initiation of a takeover. This study intends to study three major merger motivations separately and examine the performance of the firm over a long-horizon period. Bidders and targets are identified from a sample of completed UK takeovers between the period 1990 and 1998 that accurately reflect a specific merger motive. The findings show that the performance in the post-merger period is not necessarily negative as generally found in prior studies but depends on the main driving force behind the takeover. The conclusions presented in this paper add new evidence to the post-merger dilemma by postulating that the underlying motives behind the takeover is related to the performance of the bidder over the long-horizon.

I. Introduction

Many studies have examined the long-term post-acquisition performance of acquirers. Such studies have related returns to factors such as the method of payment, bid premium, size and industry while also applying different methodologies. Yet in the area of corporate control, several theories explain the rationale behind mergers and acquisitions. However, it is often difficult to isolate any one motive for a merger probably due to the simultaneous existence of many motives in a single takeover. Even though the empirical research in studying the wealth effects of mergers and acquisitions is extensive, few studies have tested specific management motives and their impact on shareholder wealth (Berkovitch and Narayanan (1993).

This forms the basis of our paper. Our paper separates and examines three specific takeover motives and measures the long-run performance linked to each. The three main motives relate to synergy, hubris and hostile takeover. The main contribution of this study is that it does not examine a general sample, but assembles samples of bidder firms with characteristics that are associated with the underlying theories of each motive studied. Moreover, this study is one of the first to measure long-horizon bidder returns, concentrating on separating the sample in terms of the main motive behind the bid. The following management motives are examined: hostile (disciplinary), synergistic, and hubris. This study identifies three underlying motives behind takeovers, and examines whether wealth differences exist. This paper also examines a general bidder sample that is not linked to the three motives mentioned above and so is likely to reflect past studies that have analysed long-term bidder performance without sub-sampling by motive. Furthermore the performance of the three motive samples is compared against matching samples constructed by size and industry. The findings do not conform to the reports of bidders underperforming in the post-acquisition period and significant differences are found depending on the motive of the bid.

II. Evidence surrounding Long-Run Bidder Performance

Franks, Harris and Titman (1991) find that under-performance is not due to wealth-deterioration from the merger, but from the method used to identify whether abnormal

returns exist. Nevertheless, Agrawal, Jaffe and Mandelker (1992) find that once the merger has been completed, the mean abnormal return of acquirers is significantly negative (-10.26%). They also find that the results of Franks, Harris and Titman (1991) were sensitive to the study-period (1975-1984). Agrawal, Jaffe and Mandelker (1992) find a small insignificant return of 2.8% over this window, whereas the mean abnormal returns are significantly negative over the other periods. Loughran and Vijh (1997) and Rau and Vermaelen (1998) have found similar long-horizon results for US firms involved in a merger.

Barber and Lyon (1997) and Lyon, Barber and Tsai (1999) have criticised methods of calculating long-term security returns. Regardless of certain biases, the evidence leans towards under-performance by acquiring firms over a long-horizon period. The reasoning behind this evidence has been the focus on recent studies. Loughran and Vijh (1997) suggest that acquirers paying by shares highlight to the market that these shares are over-valued, and the market reacts accordingly. The authors report a lower average abnormal performance for bidders in equity bids as compared to cash-bids. Gregory (1997), Franks, Harris and Titman (1991), Franks, Harris and Mayer (1988) and Dodds and Quek (1985) also report similar findings.

When examining the long-term performance of acquirers, important factors such as the choice of methodology, bidder characteristics, the market (US versus UK), study period and the type of deal (merger versus tender offer) have to be considered. The evidence coming from the US strongly suggests that tender offers, unlike mergers, do not result in wealth losses for acquirer shareholders over a long-horizon. Petitt (2000) examines the long-term performance of a sample of 80 French acquiring firms involved in tender offers. The findings contrast US evidence. Petitt (2000) find acquirers under-perform by over 25% over a window of 39 months.

Disciplinary (Hostile)

Theory indicates that poorly performing management with poor pre-bid performance will be subject to hostile approaches from more successful bidder firms. Takeovers are deemed to be disciplinary when the board of directors reject the deal proposed by the bidder and recommend to shareholders that the bid should not be accepted. The

majority of research examining disciplinary takeovers have identified targets with weak pre-bid performance while also examining managerial change within the target firm on completion of the acquisition. US evidence supports the disciplinary hypothesis where mediocre pre-bid performance is evident and removal of key management of the target occurs on completion of the deal (Martin and McConnell (1991), Agrawal and Walking (1994), and Denis and Denis (1995)). In the UK market the evidence is less conclusive. Franks and Mayer (1996) find little evidence of poor target performance before the bid, which is in contrast to the findings of Kennedy and Limmack (1996). Both UK studies do however go on to report high restructuring levels in terms of the target's top management. Nevertheless, very little has been done to measure the long-term wealth effects of hostile (disciplinary) bids on the shareholders of the bidder.

Our study measures the long-term post acquisition performance of the shareholders of bidders who have successfully completed a hostile takeover. 31 hostile acquisitions are examined as identified by Acquisitions Monthly in the period 1990-1998. We hypothesise that the hostile bidder identifies an underperforming firm and removes the inefficient parts of the target, such as management and underperforming assets. From this it is thought the performance of hostile bidders in the post-acquisition period will be beneficial to the shareholders.

Hubris Management

Hubris is associated with overpayment and excess pride. It is argued that unnecessary optimism from bidder management in evaluating the deal leads to excessive premiums being paid (Roll, 1986). In addition, a hubris management conscious of potential competing bids ensures that the deal is accomplished irrespective of the cost. In effect, the excess premium will remove the potential gains from the takeover. Hubris is evident in a takeover deal when management believe that they are superior to the target's management and feel that this will be reflected in the post-acquisition performance of the company. Studies by Lang, Stulz and Walking (1989) and Servaes (1991) measure managerial and financial performance in bidders and targets and find that well-managed bidder firms benefit from large gains in tender offers. Servaes (1991) confirms similar results in the case of mergers. Holl and Kryazis (1997) also

support the findings of Lang, Stulz and Walking (1989) and Servaes (1991) by showing that high-valued companies acquire lower-valued target companies with the aim of maximising corporate wealth. As expected a hubris management will likely be part of a large and successful firm, similar to the high performance bidders studied by Lang, Stulz and Walking (1989), Servaes (1991) and Holl and Kryazis (1997). Nevertheless, though these studies show positive gains for the bidder, the high premiums that arise from a hubris management will be detrimental to the overall value of the bid.

Therefore, while past studies have shown that high-valued and successful bidders benefit in tender offers and mergers, we hypothesise that returns to hubris bidders will be negative. Hubris bidders are identified by having high valuation ratios (book-to-market and price-to-earnings) that are greater than the bidder's respective industry average and also where the premiums paid to the target shareholders are substantially more than the 40% premium usually seen in the average acquisition (Jensen, 1993).

It is hypothesised that hubris management overestimates the benefits from the acquisition and the completion of the deal will entail a very high premium. It is expected that this may diminish the possible gains from the acquisition and will be detrimental to bidder shareholders in the long-term post acquisition period.

Synergistic Takeovers

Jensen and Ruback (1983) and Healy, Palepy and Ruback (1991) note that where there are economies of scope and synergy, two firms combined will operate more effectively and are worth more together than when they are separate. One of the objectives of this study is to examine takeovers that aim to produce benefits stemming from synergy and increased market share by acquiring a firm that operates in the same industry as the acquirer. Berkovitch and Narayanan (1993) find that 75% of their total sample of 330 successful tender offers have correlations that suggest that the synergy motive dominates and thus supports the reasoning that the most convincing intention behind an acquisition may be synergistic gains. Limmack and McGregor (1992), Seth (1990), Slusky and Caves (1991) and Sudarsanam, Holl and Salami (1996) have studied takeovers that occur within the same industry. Areas such as related versus

unrelated acquisitions, short-term returns, and evidence of operational synergies have already been studied.

This paper examines 37 takeovers where the main motive of the bidder is the pursuit of synergistic gains. Our study examines bidders that are large in size as it is expected that synergistic gains, if achieved, would be reflected more in large companies. Therefore, this study examines bidders that have a market capitalisation of above £500M with synergy being the motive for the bid. It is hypothesised that large bidders that pursue operational synergies will provide gains to its shareholders over the long-term period.

III. Data and Methodology

Data

The samples relating to specific motives behind takeover bids are from the period 1990 to 1998. Daily share price data were obtained from FT Prices, Sequencer and Extel. News searches to find the first announcement date of the bid and the information content of the bid were done by using McCarthy CD-Rom and Acquisitions Monthly.

This paper examines the long-term performance of a relatively large sample of acquiring firms, measured using abnormal returns. Secondly, the overall sample of acquirers is separated into the main underlying management motive behind the deal. Using pre-bid accounting data of the acquirer and acquired firm, we apply specific screening processes to identify the main motives behind the bid. As a result the long-term performance of hostile, synergistic and hubris bidders are measured to determine whether differences exist amongst these samples and the impact each one has on the long-term wealth of shareholders.

Hostile Bidders:

A sample of successful hostile takeovers by UK public firms are obtained where the target company's board rejected the initial bid and in turn recommended to their shareholders not to accept the bidder's offer. This information is obtained from Acquisitions Monthly. The paper analyses 28 hostile bidding firms.

Hubris Bidders:

We use valuation ratios and bid premium sizes as the measures to identify the sample of hubris bidders. Specific measures are applied to examine the evidence of hubris within bidding companies that were successful companies before the acquisition, and the effect the resulting hubris has on the shareholders. This paper attributes a hubris management to a firm that has operated very successfully in the past, and pays a large premium in an acquisition. Two ratios are used to identify companies that were successful before the bid; the market-to-book and price-to-earnings ratios are compared to that of other companies within the same industry. We examine companies with high ratios as compared to industry peers to indicate that the management is competent and successful. Thereafter a sub-set is formed, where high bid premiums are used as a proxy to identify a hubris management. The screening process identifies 15 hubris bidders.

Synergistic Bidders:

Following Flanagan (1996), synergistic takeovers are identified when the bidder and target firms share the same three- or four-digit SIC code. Our study examines bidders that have a market capitalisation exceeding £500M as it is felt larger bidders will pursue larger targets in order to gain more from operational synergies. Subject to the above criteria, we find 32 bidders successfully acquired firms within their industry in the period 1990 to 1998.

Thereafter, a general sample of 48 friendly bidders, that are not associated with these motives, is also examined. We also form a matching portfolio that controls for industry, size and year. Each firm is assigned a control firm that is within the same industry (matched by 2-digit SIC code), and of a similar size in terms of turnover in the year of the takeover announcement. Once we identify a firm to match each bidder in our samples the next step is to treat each control firm as though it completed an acquisition at the same point in time as the bidder it is matched to. This process is carried out for each bidder. However, due to data constraints we could only identify 59 matching firms (19 firms matched to hostile bidders, 25 firms matched to related bidders, and 15 firms matched to hubris bidders). This method allows us to compare

how these firms perform against a range of similar sized firms, matched by industry over an identical time-period.

Methodology

When measuring abnormal returns Brown and Warner (1985) indicate that the sensitivity of returns are low in regard to the specific methodology that is used. However, this is not the case when measuring security returns over a long-horizon. Fama (1998) emphasizes that returns are sensitive to the model used to calculate the returns; the method of aggregating the returns; and also the test chosen to determine whether the impact of the event is significant. Many studies have used the market-model to calculate abnormal returns and suppose the returns are explained by a single factor – that of the market. However, other studies have noted that returns are better explained by other factors. Fama and French (1992) explain returns by two other factors, that of firm-size and book-to-market values. Whereas Gregory (1997) and Higson and Elliot (1998) use a 10 size-portfolio to measure long-run performance.

To assess the performance of the samples of bidder firms, standard event study methodology is used (Dodd (1980)). Daily stock returns are defined as:

$$R_{it} = (P_{it} - P_{it-1}) / P_{it-1} \quad (P_{i,t} \text{ is the closing price on stock } i \text{ at time } t.)$$

The market return, (R_{mt}), is calculated by the return on the FTSE All-Share Index. Each bidder's abnormal return is calculated over each day of the post-acquisition period as:

$$AR_{it} = R_{it} - R_{mt}$$

The abnormal returns of the n bidder in each bidder group are collected to determine the average abnormal return for each day.

$$AAR_t = \sum_{i=1}^n AR_{it} / n$$

The final step is to calculate the cumulative average abnormal return over the long-horizon study period. The returns are examined for a period of 18 months before the first announcement through to 3-years post-bid. This period is similar to other studies examining the long-term performance of bidder firms.

$$CAAR = \sum_{-days}^{+days} AAR_t$$

Buy-and-hold abnormal returns are calculated as follows

$$\prod_{t=1}^{days} (1 + AR_{it}) - 1$$

To test the null hypothesis that the mean cumulative or buy-and-hold abnormal returns are equal to zero for a sample of n firms we employ the following two parametric test statistics as described in Barber and Lyon (1997):

$$T_{CAR} = CAR_{it} / (\sigma(CAR_{it})/n^{1/2})$$

$$T_{BHAR} = BHAR_{it} / (\sigma(BHAR_{it})/n^{1/2})$$

Where CAR_{it} and $BHAR_{it}$ are the sample averages and $\sigma(CAR_{it})$ and $\sigma(BHAR_{it})$ are the cross sectional sample standard deviations of abnormal returns for the sample of n firms

IV. RESULTS

Table 1 details the CAAR performance of the bidder samples from a period of 18 months before the takeover initiation through to a period of three years after the first successful bid announcement. Table 1 also shows how the specific samples perform against firms matched by size, industry and year. Table 2 displays the BHAR over the same period.

Hostile Bidders

The pre-bid performance is measured in the 18 months prior to the first public announcement of the hostile bid. Thereafter, the three years after the completion of the acquisition is examined. As seen in Table 1, the $CAAR_{t-18months-t-1month}$ does not show much deviation from the market, the pre-bid BHAR shows a positive gain of 2.99% in this period, but is not statistically significant. The hostile bidder performance is relatively strong over the post-acquisition period of 3-years (CAAR of 1.95%), as compared to the benchmark (FTSE-AllShare Index). The BHAR is higher in this instance, showing that hostile bidder shareholders would gain 4.76% in the 3 years after the first takeover bid is announced. These results are not similar to Agrawal et al (1992) who find that acquiring firms in mergers earn significantly negative cumulative abnormal of 13.58% over the three years after the merger. Furthermore, Rau and Vermaelen (1998) report bidders underperform by 15.23% compared to an equally weighted control portfolio. However, these authors look at general acquisitions and do not separate by motive.

Also shown in Tables 1 and 2 is the performance of hostile bidders to that of their respective industry index and this once again shows that these bidders perform better over the study-period (CAAR of 1.59% and BHAR of 2.09%).

When studying long-term returns it is important to control for both size and industry. We also control for the year of the bid initiation and so match firms to respective bidders who were in the same industry and of similar size just before the takeover approach. As seen from Table 1, hostile bidders seem to underperform their peers in the pre-bid period (-5.11%). This result is worth noting, as bidders are typically firms that have performed consistently well. Underperformance may be attributed to the lack of investment opportunities the company has and a takeover is one method of rejuvenating performance. However, in the post-acquisition period these bidders increase their performance and the CAAR at the end of the study period is significantly positive at 7.22%.

We suggest that the reasoning behind these findings is that the hostile bidders have continued in the same vein as they approached the bid – in a ruthless manner. The hostile bidders have taken control of the target and have the momentum to continue

making the decisions they feel are profitable for the organisation as a whole. This may differ from friendly takeovers where bidder management tries to incorporate the target in perhaps more amicable ways.

Hubris Bidders

As expected from our detailed screening process, we would expect hubris bidders to have performed well in the pre-bid period. This can be seen from Tables 1 and 2 where the CAAR and BHAR for these bidders are 9.30% and 7.33% respectively for the pre-bid period of 18 months before the bid approach. These firms also slightly outperform their industry indices over the same time frame. Similarly, the hubris bidders outperform their matching counterparts considerably; $CAAR_{t-18months-t-1month}$ is above 25%. However, this is not the case in the 3-year post-bid period. Hubris bidder shareholders lose by large amounts in this period, cumulative abnormal returns decline by nearly 17% from the announcement date and the post-bid BHAR is shown at -20.32%. These declines in performance are due to the bidder management suffering from hubris, paying an excessive premium for the target, and not being able to create sufficient value from the deal to validate the takeover price. The post-period subjects the shareholders to losses and the large gain enjoyed before the bid is now lost with the CAAR being -6.67% at the end of the study period when compared to the matching sample.

Synergistic Bidders

Tables 1 and 2 also present the performance of bidders involved in related takeovers. In the three years after the completion of the acquisition, bidding firms experience significant positive abnormal returns (CAAR of 16.11% and BHAR of 26.94%). Once again this is in contrast to the studies of Agrawal *et al.* (1992) and Rau and Vermaelen (1998). Agrawal *et al.* (1992) find acquiring firms in mergers earn significantly negative cumulative abnormal return of 13.58% over the three years after the merger. Furthermore, Rau and Vermaelen (1998) report bidders underperform by 15.23% compared to an equally weighted control portfolio.

Agrawal *et al.* (1992) also looked at conglomerate (non-related) and non-conglomerate (related) deals. The authors report strong negative performance over the five-year post-acquisition period. Surprisingly, they find that non-conglomerate merger

performance is worse than the conglomerate sample. In addition, their study considered the possibility that non-conglomerate mergers were then concentrated in industries that also underperformed in post-acquisition period studied. Agrawal *et al.* (1992) found that this was not the case.

Our paper also examines how the bidders in related takeovers have performed compared to the industry the company was concentrated in. Our findings are in contrast to that of Agrawal *et al.* (1992). We find that the bidders in related takeovers outperform its industry index by approximately 14% (CAAR) and 28% (BHAR) over the study-period. However, it must be noted that when comparing the related bidder to its industry performance it is assumed that the profile of the bidder is the same as that of the industry as a whole. However, usually the bidder is larger than the average company within the industry and therefore may affect our results.

To take into consideration that our sample of related bidders may be of various sizes and our results may be distorted, we matched similar sized firms in the same industry at the same point in time as the bid announcement, therefore ensuring no time-bias is prevalent. Once again as shown in Table 1 we find that our related bidder sample outperforms the matched sample by a substantial amount in the post-acquisition period (CAAR 26.90%). This study considers large related bidders and one possible explanation for the significant gains found is that large companies by acquiring sizeable competitors increase their market power, and this is perceived favourably by the market.

General Sample

It was also important to test the performance of bidders that did not show any of the main motives we tried to screen for. The control sample (bidder^{general}) returns are analysed so as to compare it to the returns of the different bidder samples this study examines. It is expected that the returns would be similar to that found in the previous studies of Agrawal *et al.* (1992) and Rau and Vermaelen (1998) where bidder shareholders significantly lose in the post-acquisition period. Tables 1 and 2 support this view and we find that the bidder^{general} sample loses by around 15% over the study period.

V. CONCLUSION

Existing evidence has shown that the wealth of bidder shareholders significantly diminishes in the period after a takeover. This evidence raises the question as to why firms are drawn into the market for corporate control. This paper re-examines this important dilemma, with emphasis placed on distinguishing between the main underlying forces of the takeover. According to theoretical considerations we devise specific screening processes to study three major merger motivations.

The results of this paper provide strong evidence showing that the market identifies with the underlying motive of the takeover and reacts differently with regard to the condition of the bidding firm and the specifics of the takeover bid. Disciplinary takeovers, in the form of hostile approaches, do not lose over the post-acquisition period. We hypothesise that the reason behind this is that hostile bidder ensures it gleans the best value from the target in a ruthless manner and also the takeover serves in displacing inefficient management. However, the excess premium that is usually a requisite to win control of the target, will moderate shareholder gains in this period. We also examine perhaps the most convincing theory regarding mergers and acquisitions, that of increasing the efficiency and profitability of the firm through synergy. The market reaction was as expected, significantly positive over the long-term where the deal would result in greater market share, power and a larger customer base. This study also provides strong support that a hubris management, identified as being successful in the period before the instigation of the bid, is damaging to shareholder wealth. The losses found in the long-term study-period are due to management's overconfidence in creating value from the takeover, ensuing in an excess premium, thus transferring the value of the deal away from their own shareholders to those of the target.

By investigating specific merger motivations this paper has provided evidence against the widely held view that bidders in general significantly underperform in the long-term post-acquisition period. We have shown that the market reacts according to the underlying motive of the takeover and this is reflected in differing performance levels over the period studied. The results of this study have valuable implications for the stockholders of bidding firms. It is shown that hostile takeovers do not diminish the

wealth of the bidder shareholders when approaching a target firm. The results of the hubris takeover show that shareholders need to be wary of their management, especially when the company has shown success in the past and the management participates in the market for corporate control. Acquisitions in the same industry are seen as a positive step towards improving performance. Overall, the results of this study provide distinctive insights into the market for corporate control, how these bidders perform over the long-term and the implications this has for the shareholders.

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Table 1. CAAR Performance of Bidder Samples			
<i>Against Market</i>			
	Pre (-18 months)	Post (36 months)	Overall Period
Hostile	0.0086	0.0195	0.0281
Hubris	0.093 **	-0.1874 **	-0.0944
Related	0.0416	0.1611 **	0.2027 **
General	0.0346	-0.19 *	-0.1554
<i>Against Industry</i>			
	Pre (-18 months)	Post (36 months)	Overall Period
Hostile	0.0358	-0.0199	0.0159
Hubris	0.0564	0.0048	0.0612
Related	0.0001	0.1415 *	0.1416 *
<i>Against Matched Firms</i>			
	Pre (-18 months)	Post (36 months)	Overall Period
Hostile	-0.0511	0.1233	0.0722
Hubris	0.2507 **	-0.3174 **	-0.0667
Related	0.0095	0.2595 **	0.269 **

Table 2. BHAR Performance of Bidder Samples			
<i>Against Market</i>			
	Pre (-18 months)	Post (36 months)	Overall Period
Hostile	0.0299	0.0476	0.0436
Hubris	0.0733	-0.2032 **	-0.1461 **
Related	0.0699	0.2694 **	0.4236 **
<i>Against Industry</i>			
	Pre (-18 months)	Post (36 months)	Overall Period
Hostile	0.0714	0.0013	0.0209
Hubris	0.0426	-0.0092	0.0271
Related	0.0054	0.2135 *	0.2862

***, ** and * denote statistical significance at the 1%, 5% and 10% levels

Figure 1

