

The Impact of Merger and Acquisition Announcements on Firms' Stock

Performance:

Evidence from Hong Kong Stock Market

by

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Abstract

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This paper examines the impact of merger and acquisition (M&A) announcements made by companies listed on the Hong Kong Stock Exchange, acquiring domestic Hong Kong firms and cross border firms within Hong Kong from 2007 until 2012. The event study methodology is employed to detect whether abnormal returns exist around the announcement day. A sample size of 44 events is utilized.

This study found that the M&A announcement effect is significant over the event period (day -2 to day 2) for those companies when the estimation period is day -90 to day -30. Investors can earn abnormal return by trading an acquiring company 2 days before the announcement date.

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Chapter 1 Introduction

1.1 Purpose of study

Merger and acquisitions (M&A) continuously play a very important role in business activities. While M&A was a common phenomenon primarily in the U.S., now they take place all over the world. This paper uses an Event Study Methodology to test whether an M&A have an impact on a firms' stock price, and to investigate the informational value for M&A announcements to the shareholders to earn abnormal returns. The focus of this paper is to examine the effect of Hong Kong firms acquiring domestic Hong Kong firms and cross border firms within Hong Kong from 1997 to 2012.

This paper examines two hypotheses of the price change from the M&A announcements. Will they increase or decrease the value of share price? To test these two hypotheses, this paper will analyze 44 firms in the Hong Kong market to demonstrate the impact of share price changes on the listed companies.

1.2 Background of the M&A announcement

Stock markets are volatile, and the factors that can influence stock market movement are complicated, including internal development, world events, and interest rates. It is mentioned in many studies that news releases have an impact on firms' stock price performance. Numerous studies have stated that mergers and acquisitions became a very common way for a company to extend business, gain an increased market share and achieve cost efficiency. Soludo (2004) pointed that by using M&A activities, companies aimed to achieve cost efficiency and to diversify and expand on the range

of business activities through economies of scale. M&A activities have been a common form for more than four decades in North American and European markets. In Asia, most of the M&A activities have taken place after the Asian financial crisis in 1997. However, do mergers and acquisitions still create value for firms and as such are they wealth creating or wealth reducing? This question is still ambiguous. The need for studying the rationale behind a M&A becomes significantly important since the results can help investors know whether they can earn abnormal returns by investing in acquiring firms or not.

In the globalization progress, many companies choose an M&A as a way to extend business, improve existing business and gain more market share. Many investors are interested in investing in those companies. Thus, to study the impact of M&A on acquiring firms becomes extremely important. Tracking back to the history, there have been about five M&A waves, and each M&A wave is triggered by economic factors. According to EconomyWatch, “the first wave mergers commenced from 1897 to 1940.” (History of Mergers and Acquisitions, 2010, para.2) These occurred between monopolistic companies that were involved in railroad and the electricity industry. “The second wave mergers that took place from 1916 to 1929 focused on the mergers between oligopolies, rather than monopolies as in the previous phase.”(History of Mergers and Acquisitions, 2010, para.4) The 2nd wave ended up with the market crash in 1929 and the Great Depression. From the same article we know that the 3rd M&A occurred in 1965.

“The mergers that took place during this period (1965-1969) were mainly conglomerate mergers. Mergers were inspired by high stock prices, interest rates and strict enforcement of antitrust laws” (History of Mergers and Acquisitions, 2010, para.7)

The following wave is the one that started from 1981 and ended in 1989. The most recent merger wave which was the 5th wave merger “was inspired by globalization, stock market boom and deregulation.” This M&A wave was involved in the banking and telecommunications industries.

M&A have become increasingly widespread in the 1990's. According to the UN's World Investment Report (UN, 2000), worldwide M&A grew at an annual rate about 42% over the period 1980-1999 to reach \$2.3 trillion in 1999. More than 24,000 M&A took place during that period. Standard & Poor's has predicted that consolidation through M&A would reduce the number of auto companies from 40 in 1998 to about 20 in the 21st century.

As a developed market, Hong Kong's stock market is one of the major stock exchange markets in the world, and the 2nd largest market in Asia. It has seen significant growth in the past few decades. A very interesting thing is that the Hong Kong Exchange and Clearing Ltd. (HKEx) was created by a series of merger activity. Now, HKEx is a consolidated stock exchange institution. The creation of HKEx is a standard example of explaining the rationale behind the M&A. Therefore, Hong Kong is quite a suitable market for an M&A activity study.

1.3 Delimitation

The investigation on the effect of M&A announcement on Hong Kong can be examined in different point of view, either on the acquired firms, the acquiring firms or the industry as a whole. Number of researches stated that M&A announcement has positive effect on targeted firms. Evidence as provided by Bradley et al (1988), Ariff

and Finn (1989), and Liang (2009) suggested that M&A activities create abnormal returns for targeted firms. Thus this paper commits itself to acquiring firms where the impact is more uncertain as to whether M&A announcement is wealth creating or reducing event.

Chapter 2 Literature Review

This section provides a brief overview of background information; relevant theory and findings and conclusions we have referred to Chapter 1.

2.1 Motives for M&A

To study the motives behind M&A can help the investor to know whether they can earn abnormal returns on merger deals and to better understand the rationale behind a specific M&A deal. If companies choose M&A as a strategy to improving and developing existence business, then there is the risk that lies behind the strategy. Why would investors like to take risks by investing in a target or an acquiring firm? This is a very important question and one that investors looking for returns via M&A need to consider. By understanding the key motives for M&A, it makes easier for investors to estimate the likely success or failure of the transaction.

According to Berkovitch and Narayanan (1993), there are three major motives for takeovers: synergy, agency, and hubris. This paper uses the correlation among targeted firms, acquiring firms and total returns between them to distinguish the three major takeover motives. They found that synergy is the primary motive for takeovers with positive total gains. They also found out that there is a negative correlation between targets and acquirers under the agency hypothesis. Finally, the hubris hypothesis found zero correlation.

The synergy motive suggests that takeover occurs because both targets and acquirers can benefit from the positive return. As quoted from the article:

The synergy motives assumes that managers of targets and acquirers maximize shareholder wealth and would engage in takeover activity only if it results in gains to both sets shareholders. Therefore, it follows that the measured gains to both target and acquirer shareholders would be positive.(p.5)

Actually, the synergy motive for M&A motives was first described by Penrose (1959).

The similar theory is mentioned by Seth, Song and Pettit (2000). It proposes that acquisitions take place when the value of combined firm is greater than the sum of the value of the individual firms. (p.388)

The second type of motive is agency. It is suggested that takeovers occur because they enhance the acquirer management's welfare (Berkovitch & Narayanan, 1993).

Acquiring firms choose the most suitable targeted firm that could increase its own welfare. They stated that "target shareholders, realizing their value to the acquirer management, will attempt to obtain some of this value."(p.5). The targets have some bargaining power that they will use this power to benefit themselves. Therefore, the target and acquirer gains are negatively correlated.

In this article, the hubris hypothesis was discussed as well. They point out that:

The hubris hypothesis maintains that acquisitions are motivated by managers' mistakes and that there are no synergy gains.(p.5).

This means that M&A deals are a zero sum game between targets and acquirers.

If the hubris hypothesis holds in its strictest form, one should not observe positive total gains in takeovers. (p.6)

2.2 Development of Relevant Studies

A study report published by Dafu Securities (2009), located in Hong Kong, stated that the trend of Hong Kong M&A's can be characterized into three major aspects. The

first group is “local companies already in a globalization trend will continue to be on the lookout for suitable overseas investment opportunities.” The second one is “locally listed H-shares and red chips would continue to make use of their listing vehicles in Hong Kong for M&A activity on the Mainland.” Finally, “the HKSAR Government would be an emerging player in the local M&A market as it sees the needs to privatize certain of its operations.” This study mainly focuses on the first type of M&A. An interesting point of view is to look at the future development of the Hong Kong stock market in the context of keeping a certain degree of the open market policy.

Numerous studies have examined the effects of M&A announcements. For example, Dodd and Ruback (1977) analyzed both targets and bidding firms’ shareholders earned positive abnormal returns and significant gains from a successful takeover. Asquith (1983) investigated the effect of merger bids on stock returns. The evidence shows that the targeted shareholders can benefit from the increased probability of M&A, but decreases in the probability of harm the shareholders of both the target and bidding firms. Within the same year, Jensen and Ruback (1983) found that the average excess returns to target firms were 30% and 20% for the successful tender offers. However, acquiring firms only gained an average of 4% around tender offers- no abnormal returns.

In addition, Bradley et al. (1988) concluded that the tender offer in M&A deals has a positive effect on targeted firm. They found that the competition among bidding firms increases the returns to targets and decreases the returns to acquirers. These ideas can be combined to show that M&A’s deals are a benefit for target firm, but the effect on

bidding firms is uncertain. Ariff and Finn (1989) examined the value effects on earnings, dividends, and capital change announcements on share prices in Singapore. They found that those announcements have a positive impact on share prices. However, investors cannot trade at the time of the announcement, but earn an abnormal profit after taking transaction costs into consideration.

Flugt (2009) examined the value generated to target and bidder shareholders by the announcement of M&A's in the European Union during the period 2000-2008. In this paper, the author confirms that the targeted firms earn cumulative abnormal returns resulting from synergies, but in the meanwhile, bidders' cumulative abnormal returns are on average zero.

Liang (2009) examined the impact of M&A announcements made by U.S. companies listed on the New York Stock Exchange (NYSE) and Chinese companies which listed on the Shanghai and Shenzhen stock exchanges, on acquiring firms' stock returns by using an event study. He found that the announcement effect is not significant over the event period (day -10 to day 10) for the U.S. companies, but significant for Chinese companies during the 10-day period before the announcement day.

M&A activities occur in Hong Kong are not as common as in North American and European markets. In Asia, most of the M&A activities occurred after the Asian financial crisis in 1997. Cheung and Mun (2009) claim a total different opinion against the findings above after they investigated the effects of M&A announcements on the pricing behavior of the Asian bidding and target firms. Their results indicate that M&A announcements are treated as good news for bidding companies, but not

regarded as good news for target firms.

Travlos and Papaioannou (1991) examined the impact of the payment method on acquiring firms' stock return at the announcement date. They found that the abnormal returns for acquirers on the announcement day are negative for both stock exchange and cash offers. Suk and Sung (1997) studied the effects of the method of payment (cash offer or share exchange) around the announcement date. The result indicated that there was no difference between a cash and share offer.

2.3 The Wealth Effect of M&A Activities

The wealth effect is the core issue that investors would like to investigate. A number of studies have estimated the effects of M&A activities on stock prices of target and acquiring companies during the event window by using "an event study" methodology. Flugt (2009), Liang (2009), and Gopaldaswamy et al. (2010) provided examples by using the event study methodology in their papers. The estimations of the changes of the abnormal stock price around the announcement date are a measure of the value implication of M&A activities. In addition, abnormal returns are measured by the difference between actual and expected stock price returns. Where the actual return is the post-event price for a firm on an event date and the expected return is defined as prior to the event date. The expected return is the normal return investors can get if the M&A announcement does not occur. Andrade (2001) found that the average abnormal returns for acquiring shareholders were equal to 0.7% which is not a statistically significant number. Thus, they conclude that the evidence is not sufficient to prove acquiring shareholders were losers in M&A activities.

Chapter 3 Methodology

3.1 The Objective of the Test

The purpose of this paper is to test if there is any impact of M&A announcements on share prices and whether they are wealth increases or decreases. This paper will use “an event study” methodology to test the significance between M&A announcement and share price.

3.2 Data Collection

To obtain sample of this study, all firms that are either an acquirer or a target of M&A announcements were identified during the period of 2007-2012. Moreover, both the acquirer and the target firms are listed in the Stock Exchange of Hong Kong (SEHK) during the period. A total 57 deals met those criteria. Due to the data limitation, the final deals were narrowed down to 44 deals. All data were collected from the Bloomberg system. This paper will focus on the 44 deals during 2007-2012.

3.3 Methodology

As mentioned earlier, this paper will use an event study for the research methodology. This methodology is designed to investigate the effect of an event on a specific dependant variable. In this paper, the dependent variable is the stock price of the acquiring company. The basic idea of this paper is to seek to determine whether there

is an abnormal stock price effect that are associated with a specific event by comparing the performance with the event and without the event.

The key assumption of event study methodology is that the market must be efficient. The theory of the efficient market hypothesis indicated that any change in stock price caused by the event will happen immediately. This theory will allow us to observe the economic effect in a relatively short period.

A number of statistical models are available to calculate the abnormal return. For example, the risk-adjusted model, the multi-factor model, and Capital Asset Pricing Model (CAPM) model. This paper will use CAPM model (see Equation 3.1) to test whether the firms can generate abnormal return or not.

$$R(i, t) = \alpha(i) + \beta(i) R(m, t) + \varepsilon(i, t) \quad (\text{Equation 3.1})$$

where

$R(i, t)$ is the stock return for stock i

$R(m, t)$ is the return of the benchmark market index

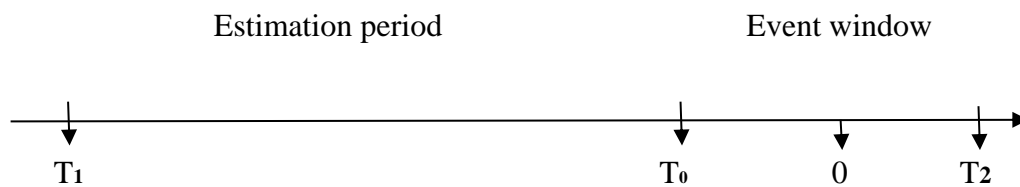
$\beta(i)$ is the sensitivity of stock i to the market return

$\varepsilon(i, t)$ is the error term

One of the event study procedures is to identify the estimation period, event window, and post-event window. The estimation period is the period that no specific event had occurred. It used to estimate the expected return of the stock. The event window determines the number of days that are used to observe the possible actual returns which caused by the event. Let (T_1-T_0) express the estimation period, and (T_0-T_2) as

the event window (see Figure 3.1). I use 180 days before the event and 5 days in the event period. The length of estimation period is based on Armitage (1995), who stated that when handling with daily studies an estimation period of 100-300 days are sufficient for satisfactory assessment of the parameters in statistical pricing models. This period cannot be too long since a long window could risk any possible if finding any other significant event. However, if the period is too short, we may risk not catching the effect of the event. The event window is set to 2 days containing the announcement day and the day prior to it and after it.

Figure 3.1



The announcement data is expressed as day 0 (see Figure 3.1) in the event window. The announcement data are identified as the day that acquiring company or targeting company first published M&A information. In order to find the effect of announcement on stock prices, we need to figure out the abnormal return (see Equation 3.2) in the event period. The abnormal return can be demonstrated as the actual return subtracts expected return if the event had not occurred.

$$\text{Abnormal Return (AR)}(i, t) = R(i, t) - E(R(i, t)) \quad (\text{Equation 3.2})$$

where

AR(i, t) is abnormal return for stock i on day t

R(i, t) is the actual return for stock i on day t

$E(R(i, t))$ is the expected return for stock i on day t

Abnormal return measures the impact of released information on stock prices over the given period of time. To capture the total effect on stock movements, the cumulative abnormal return (see Equation 3.3) is obtained by summing all abnormal return for that given period.

$$\text{Cumulative AR}(i, t) = \sum \text{AR} \quad (\text{Equation 3.3})$$

If ordinary least square (OLS) regression shows that the abnormal return of M&A announcements are statistically significant, we can conclude that M&A announcements have impact on stock movements.

3.4 Hypothesis

The theory and literature reviewed in Chapter 2 point toward that M&A deals are a benefit for the target firm, but the effect on acquiring firm is uncertain. This effect will be tested in this paper. To find the impact of M&A announcement on share price the following hypothesis is formed:

Hypothesis 0: Investors in Hong Kong stock market cannot earn abnormal returns by trading the acquiring firm around the announcement date.

Hypothesis 1: Investors in Hong Kong stock market can earn abnormal returns by trading the acquiring firm around the announcement date.

The OLS regression method will be used in testing above hypothesizes. This method is based on a t test which infers if the cumulative abnormal returns are significantly different from zero, we reject the null hypothesis. This implies that investors in Hong

Kong stock market can earn abnormal returns by trading the acquiring firms around announcement date. Furthermore, this is evidence that M&A announcements have an impact on stock price movements.

Chapter 4 Test Results

Using the Stata program to run the regression model, the results (see Table 4.1) show that the cumulative abnormal return is positively correlated with its constant. This implies that market reacts positively related to M&A announcement. Although, the t value is 5.17 which seems highly statically significant at 5% level, p value indicates an opposite result. Since the P value is 0.122 which is greater than 0.05, we cannot reject the null hypothesis.

Table 4.1 Estimation period: Day -180 to -1

```
. reg cumulative_abnormal_return if diff==0
```

Source	SS	df	MS			
Model	0	0	.	Number of obs =	2	
Residual	.010802816	1	.010802816	F(0, 1) =	0.00	
Total	.010802816	1	.010802816	Prob > F =	.	
				R-squared =	0.0000	
				Adj R-squared =	0.0000	
				Root MSE =	.10394	

cumulative~n	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
_cons	.3802433	.0734943	5.17	0.122	-.5535899	1.314077

P value is called exact level of significance or the exact probability of committing a Type I error. The p value is defined as the lowest significance level at which a null hypothesis can be rejected. In this case, p value is 0.122 which is greater than the lowest significance level which is 0.05. Thus, we do not reject the null hypothesis.

The cumulative abnormal returns are not statistically significant from zero. Investors in Hong Kong stock market cannot earn abnormal return when the estimation period is 180 days.

Although the result shows insignificant relationship, it does not imply cumulative abnormal returns are not significant at any time within this period. To confirm the

result, we need to verify the estimation period. Since the original estimation period seems long enough, let's narrow it down. The following tables present test results for different estimation periods.

Table 4.2 Estimation period: Day -150 to -1

```
. reg cumulative_abnormal_return if diff==0
```

Source	SS	df	MS			
Model	0	0	.	Number of obs =	14	
Residual	4.91737419	13	.378259553	F(0, 13) =	0.00	
Total	4.91737419	13	.378259553	Prob > F =	.	
				R-squared =	0.0000	
				Adj R-squared =	0.0000	
				Root MSE =	.61503	

cumulative~n	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
_cons	-.158023	.1643732	-0.96	0.354	-.5131296	.1970837

The coefficient is -0.158023 which still shows market reacts negative to the M&A announcements. P value is 0.354 which indicates cumulative abnormal return is statically insignificant. For day -150 to -1, we still reject the null hypothesis.

Table 4.3 Estimation period: Day-120 to -1

```
. reg cumulative_abnormal_return if diff==0
```

Source	SS	df	MS			
Model	0	0	.	Number of obs =	26	
Residual	27.4864755	25	1.09945902	F(0, 25) =	0.00	
Total	27.4864755	25	1.09945902	Prob > F =	.	
				R-squared =	0.0000	
				Adj R-squared =	0.0000	
				Root MSE =	1.0486	

cumulative~n	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
_cons	-.399441	.2056378	-1.94	0.063	-.8229599	.0240778

For day -120 to -1, p value is 0.063, which still statically insignificant. Under this result, the null hypothesis cannot be rejected. Investors in the Hong Kong stock market cannot earn abnormal return by trading acquiring firm for the given estimation period.

Table 4.4 Estimation period: Day -90 to -1

```
. reg cumulative_abnormal_return if diff==0
```

Source	SS	df	MS			
Model	0	0	.	Number of obs =	35	
Residual	40.4476731	34	1.18963744	F(0, 34) =	0.00	
Total	40.4476731	34	1.18963744	Prob > F =	.	
				R-squared =	0.0000	
				Adj R-squared =	0.0000	
				Root MSE =	1.0907	

cumulative~n	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
_cons	-.3550891	.1843628	-1.93	0.062	-.7297594	.0195812

For Day -90 to -1, the regression gives us a similar result compare to Day -120 to -1's.

In the t test, a statistic is said to be statistically significant if the value of the test statistic lies in the critical region. In this case, the null hypothesis cannot be rejected, since the calculated t value doesn't lie in the critical region.

Table 4.5 Estimation period: Day -90 to -30

```
. reg cumulative_abnormal_return if diff==0
```

Source	SS	df	MS			
Model	0	0	.	Number of obs =	35	
Residual	59.164951	34	1.74014562	F(0, 34) =	0.00	
Total	59.164951	34	1.74014562	Prob > F =	.	
				R-squared =	0.0000	
				Adj R-squared =	0.0000	
				Root MSE =	1.3191	

cumulative~n	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
_cons	-.5116306	.2229763	-2.29	0.028	-.964773	-.0584881

In "2-t" rule of thumb, if the number of degrees of freedom is 20 or more and the level of significance sets at 0.05, then the null hypothesis can be rejected if the t value exceeds 2 in absolute value. For Day -90 to -30, the calculated t value is 2.29 in absolute value greater than 2, thus we reject the null hypothesis, and conclude that investors can earn an abnormal return.

Chapter 5 Conclusion

This thesis provides an overview of impact of M&A announcement and more specifically on whether Hong Kong firms acquire domestic firms or cross border firms within Hong Kong stock market from 2007 till 2012 have been wealth creating or wealth reducing events for acquiring firms. Moreover, using the event study methodology with data extracted from Bloomberg program the hypotheses were tested by using OLS regression model to determine if there was a cumulative abnormal return with event or without the event.

The analysis finds evidence that acquiring firms receive a positive and significant abnormal return two days before the announcement date and two days after the announcement date. Investors who trade on information regarding an acquiring company's M&A activity can earn abnormal returns on a 2-day short event window, by buying the stock 2 days before announcement and quickly selling it 2 days after the announcement, or doing the opposite. The days that abnormal returns may exist can be verified for different time period.

M&A create synergies and economies of scale, expanding operations and cutting costs. The impact of M&A announcement on stock price movements are mainly depends on market expectations. M&A deals are complicated especially for acquiring firms. When an acquiring firm releases an M&A announcement, if market considers this is a wealth increasing event for the firm, then market react positively and vice versa.

Even though the evidence in this paper shows that investors can earn abnormal returns

by trading acquiring firms, there is some limitation of this study that needs to be mentioned. The first limitation is sample size. In this paper, the sample size is 44. With much larger samples we can have more robust tests of the hypotheses and the results could be different. However, it is difficult to collect data due to information limitations. Secondly, cross-sectional data can be utilized. As far as the value of these and other empirical results to investors, caution needs to be exercised.

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Appendix A: List of M&A Announcements

Company Name	Announcement Date
Silver Grant International	5/12/2011
Yuexiu Property Co Ltd	12/31/2010
K Wah International Holdings Ltd	1/7/2010
Shanghai Zendai Property Ltd	4/29/2008
HKC Holdings Ltd	3/12/2008
Lifestyle International Holdings Ltd	4/25/2007
SRE Group Ltd	10/28/2009
Coastal Greenland Ltd	1/4/2010
China Aoyuan Property Group Ltd	6/19/2009
Keck Seng Investments	7/6/2009
C C Land Holdings Ltd	9/5/2007
Yuexiu Real Estate Investment Trust	1/14/2008
North Mining Shares Co Ltd	7/5/2009
China Overseas Grand Oceans Group Ltd	8/15/2007
Coastal Greenland Ltd	10/12/2007
Zall Development Group Ltd	8/22/2011
Zhuguang Holdings Group Co Ltd	10/19/2010
Television Broadcasts Ltd	12/21/2007
Nan Hai Corp Ltd	11/14/2007
Blackstone Group LP	6/15/2008
Tomson Group Ltd	10/11/2010
Link REIT/The	12/22/2011

China Overseas Grand Oceans Group Ltd	8/27/2007
Shangri-La Asia Ltd	12/31/2010
Shanghai Industrial Urban Development Group Ltd	6/27/2008
Capital Estate Ltd	3/5/2008
Henderson Land Development Co Ltd	6/9/2008
Allied Properties HK Ltd	9/15/2011
New World China Land Ltd	11/27/2009
Henderson Land Development Co Ltd	8/3/2007
Yueshou Environmental Holdings Ltd	8/15/2007
Shanghai Forte Land Co	1/8/2010
Sun Hung Kai Properties Ltd	9/20/2010
Allied Properties HK Ltd	5/14/2008
Shanghai Zendai Property Ltd	8/1/2007
Greentown China Holdings Ltd	5/8/2009
Goldin Properties Holdings Ltd	12/30/2008
Kerry Properties Ltd	4/28/2008
Lai Fung Holdings Ltd	10/30/2007
China Aoyuan Property Group Ltd	7/6/2009
China Agri-Products Exchange Ltd	5/11/2007
China Construction Bank Corp	1/31/2008
Tianjin Development Hldgs Ltd	12/3/2007
SPG Land Holdings Ltd	9/30/2009