Cross-border mergers and acquisitions in East Asia: trends and implications

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Mergers and acquisitions across national borders have increased in East Asia since the onset of the financial crisis. What has caused this new wave of mergers and acquisitions, what affects have they had, and what advantages might they offer to the region's financially distressed economies?

Recent trends

Cross-border M&A in East Asia's crisis countries (Indonesia, Korea, Malaysia, and Thailand) rose sharply in value from $3 billion in 1996 to $22 billion in 1999, before falling slightly to $18 billion in 2000 (Chart 1). (Unless otherwise noted, the statistical references to cross-border mergers and acquisitions in this article involve acquisitions of more than 50 percent equity by foreign investors.) This rise was due largely to significant increases in such activity in Korea (from $1.3 billion in 1996 to $13 billion in 1999) and in Thailand (where its value was $4 billion in the same year). Compared with other East Asian countries, a large number of cross-border M&A deals involved investment in Malaysia firms prior to the crisis, but because the volume of such transactions did not rise thereafter, Malaysia has become a less significant player. In Indonesia, cross-border M&A, which have traditionally been limited, doubled between 1998 and 1999 to reach $2.7 billion.

As a consequence of these recent increases, cross-border mergers and acquisitions have accounted for an increasing share of foreign direct investment (FDI) flows to East Asia. The share of M&A in East Asia’s FDI rose from 6 percent in 1995 to 13 percent in 1997 and increased further, to 20 percent, in 1999. Thus, the much-talked-about resilience of FDI during the crisis was due entirely to the rapid increase in M&A rather than to traditional foreign investment in “greenfield” projects (those designed to build new means of production).

Recent FDI based on mergers and acquisitions reflects foreign-based firms’ entry into services (nontradable) sectors, whereas greenfield FDI was predominantly focused on manufacturing of goods for export and also of domestic substitutes for imports. Much of the East Asian M&A activity has been in sectors such as wholesale and retail trade, real estate, and financial services.

By breaking into these largely monopolistic activities, foreign investment could have a significant economic impact by bringing modern operational practices into the affected firms and creating greater competition in the domestic economy. Evidence from Latin America strongly suggests that privatization of infrastructure has significantly improved productivity and given the poor better access to services.

Owing to the greater exposure of its services sectors to the discipline of international capital, East Asia is catching up with other regions that have moved more aggressively to attract foreign investment. In East Asia’s financial sector, for example, the share of assets under foreign control rose to 6 percent in 1999 following the sale of distressed banking assets. However, the foreign presence in the region was much lower than in Latin America (where the corresponding share was 25 percent) and in Eastern European countries such as the Czech Republic, Hungary, and Poland (where half of financial sector assets were under foreign control).

M&A and economic recovery

Cross-border mergers and acquisitions can be beneficial to a host country when they prevent potentially profitable assets from being wiped out during domestic financial crises. Given the distress in the domestic economy’s financial sector, a highly indebted, loss-making enterprise may have no option but to become insolvent unless an external partner with financial staying power and confidence in the ultimate viability of the enterprise can finance it. Before-and-after comparisons of cash-flow returns of acquired firms lead to the conclusion that acquisitions bring wealth gains to distressed firms and that those gains are greater in cross-border M&A transactions than in domestic ones (see Hines and Pargyay, 1991; Haltiwanger and Mian, 1996; and Entry, 1993). Mergers can, however, also destroy value if the projected synergies among the merged firms do not materialize or if corporate cultures clash (see Devereux and Dhakal, 2000). In this context, cross-border mergers in the East Asian crisis countries are of special interest.

What have the results been? The evidence is not conclusive. For Thailand, however, Chart 3 shows an inverse relationship between the speed of recovery and the incidence of cross-border M&A. A similar pattern has been observed for Korea and Malaysia. Thus, macroeconomic recovery has apparently not been helped by cross-border M&A.

Buyaat export markets and countries’ ability to compete internationally were the keys to recovery. This does not imply, though, that cross-border mergers and acquisitions have not helped in key distressed sectors. The evidence suggests that cross-border M&A transactions took place in larger numbers in sectors with deeper distress and slower subsequent recovery. In Thailand, 30 percent of mergers and acquisitions occurred in finance and real estate, where activity has declined most sharply and recovery has been slower (Chart 3); similarly, the wholesale and retail trade sector was heavily distressed during the crisis and remains in a difficult situation. In contrast, the transport equipment sector needed to sell off fewer of its assets owing to its greater long-term resilience, which has been reflected in firms’ ability to grow by taking advantage of export opportunities.

Chart 3

Thailand: Cross-border mergers and acquisitions and recovery in production, 1997–99

Source: Thomson Financial Securities Data.

Fire sales

Although long-term benefits may result from mergers and acquisitions, some observers have raised short-term concerns. One is that postacquisition asset sales by foreign investors may be predatory, based on hugely undervalued, or “fire-sale,” pricing. Such fire sales—that is, sales of assets to foreigners at prices below their long-term values—could occur where sellers are critically short of funds and there are few buyers.

This is not an easy proposition to evaluate. While some asset prices dropped precipitously after the crisis, it is not clear whether these prices were below the assets’ long-term values. Krugman (1998) suggests that the recent asset sales in East Asia could be interpreted in two very different ways. Prerequisites asset values may have been inflated by implicit guarantees that ultimately failed, so that the crisis restored asset values to their appropriate levels. In that case, the assets were sold at equilibrium long-term prices. The alternative explanation for M&A activity in the crisis countries is that excessive exchange rate depreciation, perhaps the result of contagion in international...
markets, forced domestic firms to sell assets to pay off short-term debts. Foreign firms that had enough liquidity purchased these firms or projects, which created a stream of profits above their liquidation values once the host country's exchange rate returns to its equilibrium level. Under these circumstances, there was a transfer of wealth from the domestic economy to foreigners, who bought assets at prices below their long-term values.

The limited evidence available goes against the hypothesis that significant amounts of assets were sold at fire-sale prices. Cross-border mergers and acquisitions were higher in Korea, which suffered least from the crisis and recovered fastest. Cross-border M&A transactions not only stopped but actually increased by 30 percent in 1999, despite a 15 percent appreciation of the won beginning in 1998. This suggests, therefore, that foreign firms' acquisitions of assets have been driven more by new opportunities created by policy changes that encouraged M&A than by firms' greater liquidity resulting from foreign exchange depreciations. The widely differing prices at which disposed assets were sold—which ranged from 25 percent to about 80 percent of their book values—suggest that these prices reflect differences in the assets' quality rather than fire sales.

Policy reforms

Since their crises in 1997, both Korea and Thailand have introduced various measures to encourage business consolidations through mergers and acquisitions, as well as to liberalize foreign investment. These policy changes have led to rapid rises in cross-border mergers and acquisitions. Looking ahead, however, there are continued policy challenges, including corporate governance, competition policy, and bank privatization and regulation.

Corporate governance

Certain policy measures are required to avoid the potential drawbacks of, and to gain the most benefit from, cross-border mergers and acquisitions. Enhancing the standards of corporate governance can be a highly effective way of supporting market-driven M&A that maximizes shareholder benefits in the merged or acquired firms by encouraging responsible decision making. Improving enterprise monitoring, disclosure of information, accounting practices, and equity-issuance processes is essential to strengthening corporate governance.

Korea and Thailand have taken steps to increase the number of shareholders able to exercise their rights and, especially, to enhance institutional voter rights. Korea's movement toward adoption of international accounting standards has been welcomed by foreign investors whose concerns over the acquisition of Korean assets had been focused on the valuation of nonperforming loans. Korea has also introduced new requirements that domestic companies increase the involvement of outside directors on their boards. Those measures have helped to increase corporate transparency and accountability, although further progress is required. The March 1999 amendment to Thailand's bankruptcy code is another measure that has encouraged mergers and acquisitions by opening the economy up to market forces. The new code makes it easier for creditors to gain control of debtors' assets to obtain repayments of debts due. Financially distressed sectors with good long-term prospects, such as the hotel industry, have been attracting greater foreign interest since the bankruptcy laws were amended.

Competition policy

Consolidation and rationalization through mergers and acquisitions may lead to a higher degree of concentration in the host market. Maintaining the right balance between market competition and cooperation has been an important concern of East Asian policymakers (see Modo, 1999). To achieve this objective, policymakers need to encourage market orientation by reducing bureaucratic restraints to competition. A recent example of regulatory reform that has facilitated market competition is Thailand's new act on competition and pricing, which was introduced in 1999. Complicating matters, however, is the fact that adopting a new concept of competition may not be appropriate in the "new" economy. The Korean government is encouraging domestic firms to invest in research and development and to form strategic alliances with advanced companies, both of which will increase their competitiveness through technological innovation.

Financial sector reform

Since governments of the crisis countries have, through their direct takeovers and recapitalization initiatives, become owners of substantial portions of their countries' banking systems, the recapitalization of nationalized financial institutions should continue to be given a high priority. Governments' success in achieving this objective will have an important influence on the long-term structure and performance of their economies' financial sectors. So far, efforts at privatization have been partially successful, particularly in Korea and Thailand, although they have been hindered somewhat by the continued growth of nonperforming loans, which prospective investors have difficulty valuing. In addition, long-term efforts to improve financial sector regulation and supervision are required.

Long-term prospects

Cross-border mergers-and-acquisitions activity is still in an early phase in East Asia's financially distressed economies and remains small, relative to their sizes and stages of development. (For example, in 1999, cross-border M&A accounted for 0.9 percent of GDP in East Asia, compared with 1.8 percent of GDP in Latin America.) The recent surge in mergers and acquisitions in East Asia, particularly in Korea, can be attributed largely to policy changes that have facilitated foreign acquisitions of local assets. Liberalization of foreign entry and ownership restrictions and the introduction of international accounting standards and shareholding systems have exponentially increased foreign investors' access to local markets. Cross-border mergers and acquisitions have a significant role to play in the restructuring and continued development of financially distressed East Asian economies.

The most important role for cross-border mergers and acquisitions is in encouraging longer-term reforms, such as operational restructuring and realization of assets, in firms. Foreign participation through M&A could also be more effective in improving efficiency, competitiveness, and corporate governance (see UNCTAD, 2000). Under the circumstances, foreign direct investment, in the form of cross-border mergers and acquisitions, has a significant role to play in the restructuring and continued development of financially distressed East Asian economies.