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ECONOMIC INTEGRATION, GROWTH PROSPECTS AND ENLARGEMENT

INTÉGRATIONS ÉCONOMIQUES, PERSPECTIVES DE CROISSANCE ET ÉLARGISSEMENT

Research monograph

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M&As IN CROATIA - OPERATING PERFORMANCE OF PUBLICLY LISTED FIRMS FOLLOWING TAKEOVER

ABSTRACT

Mergers and acquisitions (M&As) are one of the most widely used means in achieving growth and development of firms. There have been numerous empirical studies questioning the success of M&As in increasing the firms' value for their owners, both in the short and long run, and in increasing operational efficiency of the newly established system. Even though varying in methodology, sample size and structure, monitored time and geographical spread, the majority of research indicate that many M&As fail in accomplishing described criteria, i.e. that they do not increase the firm's business success. Among the reasons of M&As failures most frequently cited are: overpaying the target, inadequate due diligence, mistakes in corporate strategy, difficulties and lack of speed in the processes of post acquisition coordination and integration of the two former firms into one economic system. However, the post-acquisition performance of target firms is relatively neglected and unexplored.

From the Croatian perspective, analyses of the success of target firms following the takeover seem to be relevant and needed. Statistic data shows that Croatian firms participate in cross-border M&As mainly as takeover targets. The privatisation process of state owned firms is to some degree still active and unfinished. Furthermore, takeovers are frequently viewed as an attempt to avoid bankruptcy of under performing firms.

This paper focuses on analysing operational efficiency gains of Croatian firms taken over after the year 2000. On the sample of publicly listed firms, the author analyses a seven-year time spread (two years prior and five-year following the takeover). The gathered data compares relative values of assets, equity capital, staff turnover, labour productivity and profits/losses of sample firms. The results of analyses add some light to the relatively neglected post-acquisition performance of target firms, and provide a better understanding of the M&As processes in Croatia and other developing countries with similar economic background.

Key words: *mergers and acquisitions, reasons for M&A failures, business success of overtaken Croatian firms*

JEL classifications: *D22, L25*

1. M&AS IN RECENT EMPIRICAL LITERATURE

There are many empirical studies on the effects of M&As. The reason for that can probably be found in the fact that in spite of the common opinion that most M&As destroy value,¹ they still present one of the most important means of achieving firm's growth and are a dominant form of FDI investments. According to the World Investment Report (WIR 2000, p. XX), the share of M&As in total FDI is around 80%, while Greenfield investments and profit reinvesting make up for the rest. Analyses of M&A waves during the twentieth century show that in terms of number and value of takeovers the latter waves were stronger. The culmination was seen in the most recent 5th wave that occurred during the 90s with the total value exceeding the 4th wave five times (Gregoriou & Renneboog, 2007).

The reasons why M&As are so popular among firms is because they represent a fast mode of increasing the firm's size; they lead to a potential increase in market power, present a way of entering new markets, allow firms to gain access to key resources or and distribution channels. Possible synergies driven motives are achieving economies of scale and scope, both in production and/or distribution. Moreover, possible synergies may also be found in financial aspects of business as a source of cheaper cash, or better investment opportunities.

When looking at M&As empirical literature, three major groups of studies can be found. First, the most numerous group includes studies analysing the success of M&As in achieving value creation for the overtaking firm's shareholders. These studies are conducted among publicly listed firms, and in spite of methodological differences, they all try to establish what consequences the M&A process had on overtaking firm's share market value. There are short term value creation studies that examine the change in the share price within the framework of just a few days to one year after the takeover (or takeover announcement), and long term studies examining the effect of M&As on firm's share market value in the time span greater than one year - often between two and five years (see Alexandridis et al, 2006; Liodakis & Pang, 2007; Antoniou et al, 2007). Value creation studies are based on the premises that capital markets are well informed and that the change in market value directly indicates the success of an M&A in achieving its goals. The second group of studies are those analysing the effects of M&A on target firms' share price. As already known, after the takeover announcement, the target firm's share price mostly rises and these studies are mainly focused on establishing to what extent. The third group of M&As empirical studies are the ones analysing the post-M&A operating performance change for the involved firms (see Rahmanand & Limmack, 2004; Carline et al, 2007; Martynova et al, 2007; Kastelan-Mrak et al, 2007). Their analyses mostly include several key operating performance indicators within the time span of a few years prior and a few years following the takeover. Unlike value creation studies, operating performance studies do not use stock market data and are focus on just some of the key financial indicators taken from firms' financial reports. As a result, operating performance studies differ greatly as they are founded on smaller sample size and include a different research methodology from the

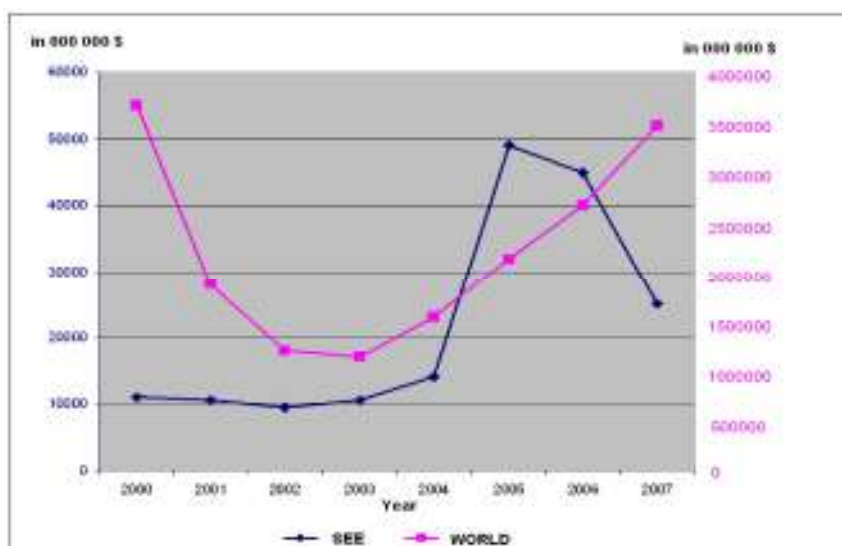
¹ Numerous empirical studies are showing that M&As are often unable to create value for firm owners. Some claim that only 20% of M&A accomplish to do so (Gates, Heimerik and Zollo, 2006, p 3).

value creation studies. Moreover, they also show great methodological differences among themselves making it difficult to compare their findings.

2. M&A PROCESSES IN CROATIA

South Eastern European countries (SEE), including Croatia, have participated with only 2 percent in total M&As value in 2005 (WIR 2006, p.16). Although this percentage is very small, SEE countries are often considered to have great M&As growth potential both in the number of transactions and their value. The value of M&As in SEE during most of the past decade is shown in Figure 1.

Figure 1: Value of M&As in World and SEE Countries



Source: Kummer, C. (2007): Mergers and Acquisitions (M&A) in South Eastern Europe, 2000-2007, MANDA Institute

According to Kummer (2007), Croatia is sixth among the eleven SEE countries with 7% of total transaction number i.e. 288 takeovers at total value of 8.2 billions of dollars in the observed period. However, it should be noted that most of Croatian M&As were of small value. The total value amount was significantly increased by just a few high-value takeovers. For instance, about 50 percent of noted value was accomplished only by three big takeovers (in the pharmaceutical, oil and the banking industry).

When observing the structure of Croatian M&As, it can be seen that some sectors of industry have been consolidated in much greater extend than others. For instance, in the 2000-2005 period, 17 takeovers were in the banking industry. Today, all major Croatian banks are in foreign ownership. At the same time, there were only 4 cross-border M&As with Croatian banks as acquirers (Matejić, 2007). Croatian firms have

been active as acquirers primarily in the insurance industry, 6 out of a total of 8 takeovers in the last decade. In other industries, some relevant M&A activity can be seen in tourism with Croatian touristic facilities as takeover targets. M&As in manufacturing are often desired and considered as necessary due to technological and market lags of Croatian firms but still do not show the scope seen in other industries. Furthermore, despite the importance of the retailing industry in Croatia, M&A activity in this area has been weak due to the fact that most of the investments in retailing has been made through Greenfield investments rather than corporate takeovers.

Croatian firms participate in M&A processes mainly as takeover targets. For the general public, the M&As are considered desirable, as they perceive the acquirers as the saviors of the underperforming Croatian firms. There are, however, some fears that foreign owners consider investing in Croatia just as a means of penetrating the local market, and that, consequently the positive effects on employment, cash-flow and know-how inflow are only short-termed. Despite the numerous empirical studies of M&As in US and Western Europe, their effects in Croatia are still mostly unexplored and unknown. This paper will try to address these issues by analyzing operating performance of Croatian target firms following takeover.

3. THE SAMPLE

The sample consists of 40 Croatian public companies² listed in the *Croatian Securities Exchange Commission's database (Crosec)* on December 31, 2008 that were acquisition targets in the 2001-2007 period.³ Out of the total number of 58 firms initially meeting the criteria, 18 firms had incomplete or inconsistent data and had to be eliminated. This provided for a sample consisting of 24 firms under dominantly domestic private ownership, and 16 firms under dominantly foreign ownership.

The Croatian Securities Exchange Commission's database was chosen because it was one of the rare publicly available sources offering comprehensive company data.⁴ Moreover, the *Crosec database* was rather complete, allowing extraction of general indicators of firm performance (for most of the firms listed) for a 7-year period.⁵ The fact that this database offered data for companies listed on the stock market which are thus subjected to presenting unifying financial reports may have caused, at least partially, a reduction of potential errors in comparing sample firms data.

² Public companies are those having either more than 100 shareholders, capital value exceeding HRK 30 million, or the ones quoted on the Zagreb Stock Exchange. Furthermore, although it is not necessary for the public company to be a listed company (it is rare but firm can meet public company criteria without being listed), all firms in the sample were listed.

³ The Crosec database is no longer active and therefore the last publicly available data span was used for establishing which firms were overtaken and when. The financial data for the latter years that were missing at Crosec database were extracted from companies annual reports submitted to the *Zagreb Stock Exchange*.

⁴ Even in countries with more advanced corporate governance practices it is hard to get pertinent data on ownership distribution, voting power concentration and managerial discretion. See Becht (1997), the Separation of Ownership and Control: a Survey of 7 European Countries, European Corporate Governance Network.

⁵ All data was manually extracted from sample firms' financial reports.

There were some problems with the sample. The sample, especially the sub-sample of firms controlled by foreign owners is rather small. Additional drawbacks in using this sample derive from the fact that the firms vary in size and industry.

Previous research (Kaštelan Mrak et al, 2007) showed that foreign owned Croatian companies tended to have high concentration of ownership, suggesting that those owners were interested in attaining control and entrepreneurial profits. At the time, three types of foreign owners were identified in the sample: 1) industry groups buying into a company as a mean of market/product expansion, which included almost 40% of the firms in the foreign-owners sub-sample in which one largest foreign owner held an average of almost 80% of the equity; 2) single owners, or funds representing a single person who act either similar to an industry group (active investor) or like an institutional owner or fund (inactive investor), which added up for another 17% of firms, with the largest foreign owner holding an average of almost 60% of the equity; and 3) portfolio investors, or investment funds and other investors with a diversified portfolio satisfied to collect rent without exerting more influence in the acquired company, which made up for the remaining 43% of firms in the sub-sample in which foreign owners held an average of 50% of the equity.

4. OPERATING PERFORMANCE OF SAMPLE FIRMS

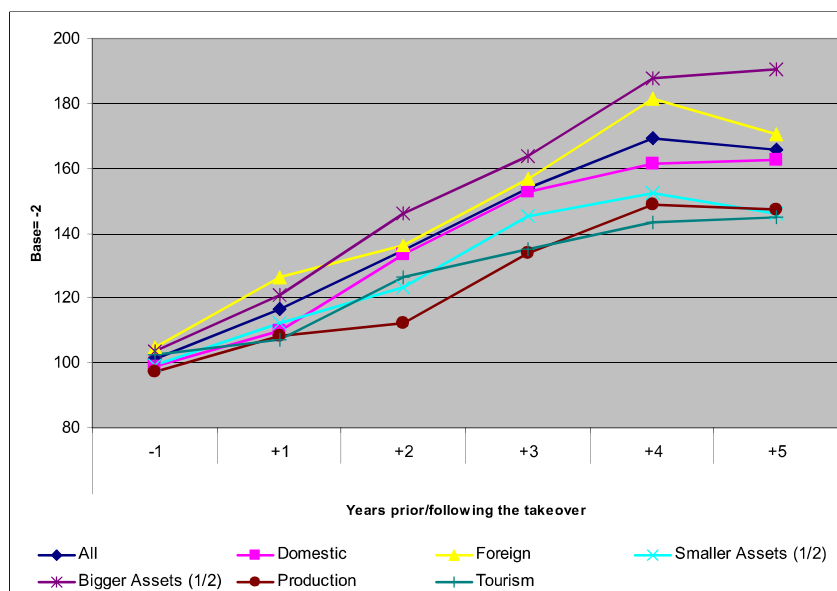
In operating performance analyses few of the key indicators are presented: change in assets, equity capital, revenues, number of employees, labor productivity and profit/losses. In order to allow for the analyses of the long term operating efficiency for each firm that underwent M&A, data was extracted for a seven years period (or shorter if there was no data available) in a way to cover for the two years before the M&A and five years following the M&A.

In most of figures (charts) within the paper, the trend lines indicate the average value movement for all sample firms and several sub-sample groups. The sub-sample groups were created according to the theoretical expectations about the possible differences among these groups in firms' behavior and/or noted performances. The criteria for determining the sub-sample were as follows: identity of acquirer, pertinence to specific industry and the size of the firm. The identity of the acquirer criterion is set to establish the differences, if there are any, among the firms that were acquired by foreign or domestic based acquirer. This criterion adds some light on expectations/fears regarding foreign legal entities owning domestically based firms. The second criterion for sub-sample group creation was set to establish if there are industry related differences among sample firms. This was achieved by establishing the two most frequent industries within the sample which were then isolated forming the sub-sample groups of production and tourism firms.⁶ The third criterion, the size of the firm, varied depending on the specific indicator being analyzed.⁷

⁶ It is important to note that those sub-samples do not cover for all sample firms, but only those, whose core business is in production or tourism.

⁷ For instance, while analyzing change in assets, the sample group was evenly distributed into two new sub-groups, those with higher value of assets and those with smaller value of assets.

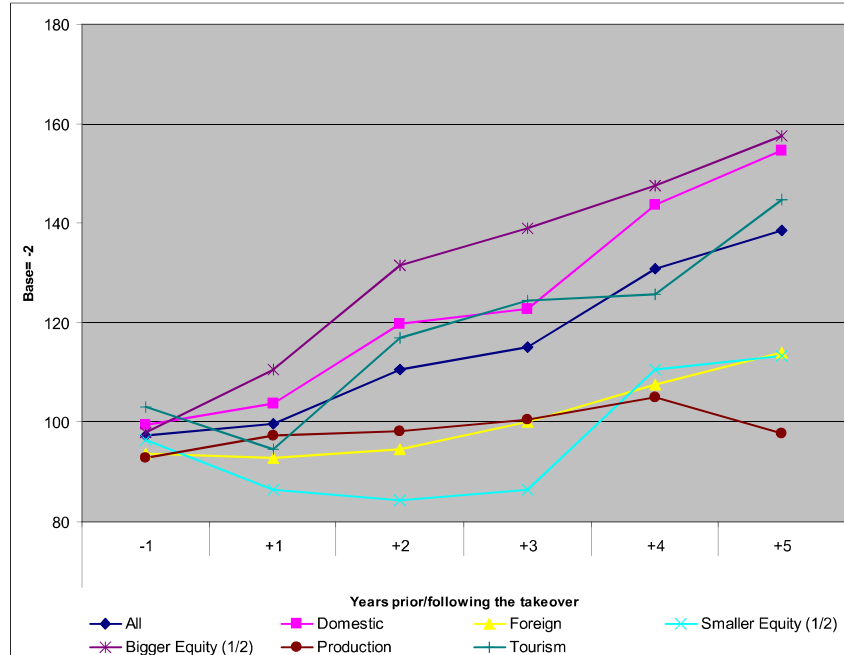
Figure 2: Change in assets



As can be seen from Figure 2, the change in assets shows positive trends for all sample groups in the first 4 observed years after the takeover, and stagnation (or even negative change) in the fifth year. Takeover targets that were bigger in size in the base year showed strongest average assets growth within the observed period when compared to other sub-sample groups. This may result from the fact that bigger firms have better access to fresh capital on debt market but also that the buyers of bigger firms might be more ready to inject fresh capital into their new acquisition. It can also be noticed that firms taken over by foreign subjects have somewhat better results in assets growth than those taken over by the domestic ones, although these difference get smaller in last observed year. The results for the production and tourism sub-sample groups show below average growth in both industries. The average value was distorted by a few sample firms from other sectors (especially from banking industry) that had very high rates of asset growth and have thus moved the overall average on values higher than those accomplished by production and tourism firms.

Change in equity capital (Figure 3) shows that most of the groups (with the exception of firms in tourism) had a decrease in year before the takeovers which probably indicate that takeovers were done while firms were generating losses. This could to some degree confirm that M&As in Croatia for target firms are often a mean of avoiding bankruptcy.

Figure 3: Change in equity capital



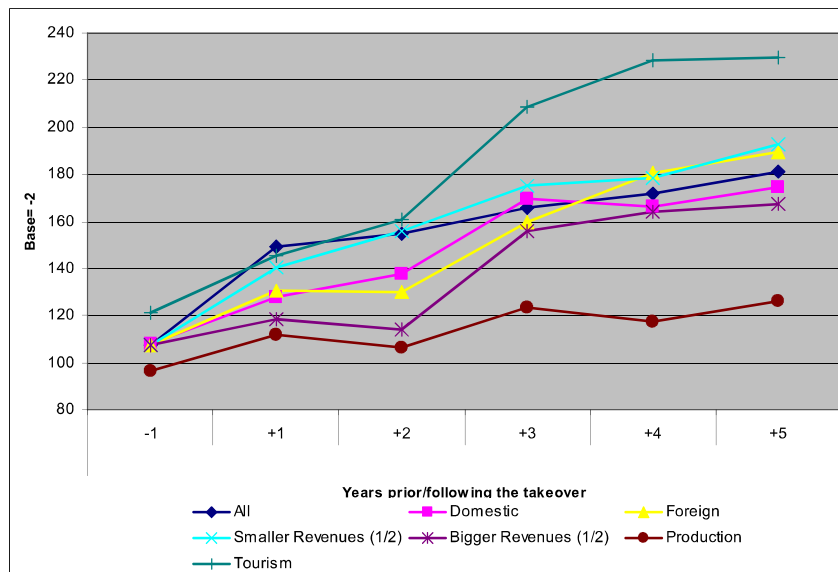
Once again, the sub-sample made of bigger firms⁸ showed highest average growth. At the same time, smaller equity firms had the worst trend in most of the observed period. The difference among these two groups showed to be statistically significant (with high T-test values) in the first three years after the takeover. Production firms were also an underperforming group according to this criterion with a lower average equity capital in the last observed year than in their base year. When comparing domestic and foreign owned firms it can be seen that the equity capital average growth is much higher when domestic ones are concerned. This may be in collision with the common belief that the foreign acquirers will inject needed fresh capital into their acquisition. However, it can also mean that foreign owners, in order to boost acquired firms' performance, choose to inject debt capital rather than equity capital. This may be the preferred option if they are ensuring exit strategy, or if they intend to use transfer prices policies to more easily extract earnings from acquired firms. It is also possible that the losses of the acquired firms neutralized equity capital injections. However, this issue does not fall into the scope of this paper and should be further addressed in future research.

The following operating performance indicator is the change in business revenues. As can be seen in Figure 4, all groups of the sample firms show growth through most of the observed period. The exception is in the second year following the takeover when most groups show a decrease, or at least, slower growth rate of revenues if compared to

⁸ For this indicator those with bigger equity capital

the previous year. However, increased growth can be seen for most of the groups in their third year, most possibly resulting from the finalization of the post-M&A integration and coordination processes, the stage in which the joining of the firms starts to show performance benefits. Moreover, these three years could also be the period needed in order for the effects of restructuring of acquired firms to be noticeable on firm's revenues.

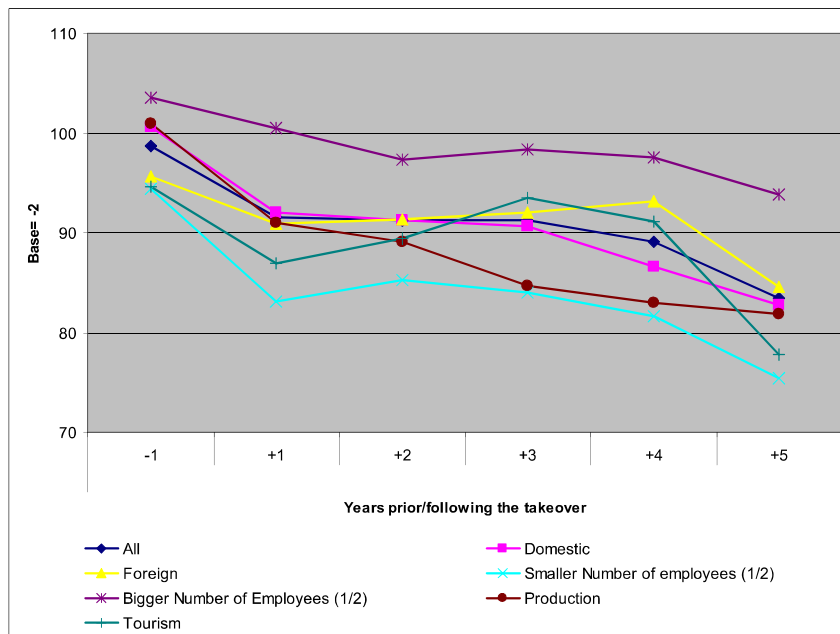
Figure 4: - Change in revenues



The biggest discrepancy among sub-sample groups is between firms in tourism and those in production with the former having the strongest revenue growth rate in sample and latter the weakest. Conducted T-test analyses showed statistically significant difference among these two groups through most of the observed period. Contrary to the two previous two indicators, smaller firms outperformed those bigger in the entire observed period in terms of the change in revenues. Domestically and foreign owned firm groups showed similar trends, with the domestic ones having higher growth in the second and third year, and foreign in the fourth and fifth year following the takeover. While all previous indicators showed upward trends, the change in the number of employees (Figure 5) had a reverse trend. The number of employees generally decreased in the observed period within all the sub-sample groups. Although there are differences among groups, some regularity can be determined. In the first year after the takeover, general average and averages of all sub-sample groups show significant decrease. In the following two years, most groups show stability or increase in the average number of employees. The number of employees takes a new downturn in the last two years, which is especially steep in the last observed year. These trends may, at least in theory, be the consequence of the initial firing of a part of employees in the first

year after the takeover as a result of the post-M&A integration in which some segments of business are consolidated and carried out by one of the joined firms. The second possible explanation could lie in the necessary downsizing due to the target's bad business results prior to takeover. The second downturn, after a few stable years, may be the result of business restructuring in the acquired firms. This issue should also be further addressed in the future as the raw financial data itself does not allow for confirmation of previous speculations.

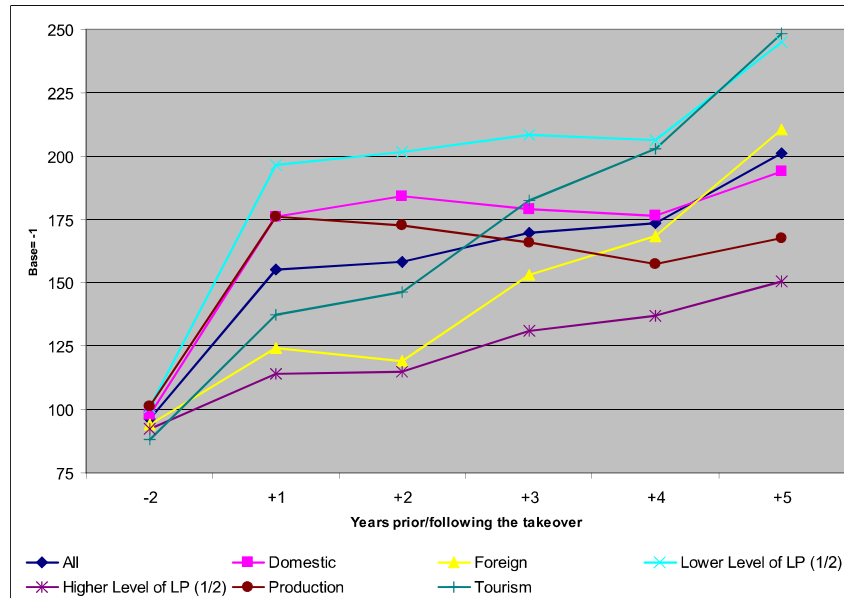
Figure 5: Change in number of employees



When observing differences among sub-sample groups, it can be noticed that the smallest fall in the number of employees is for the group containing bigger firms. It could have been expected that layoffs would be bigger in this group due to the wider integration and restructuring opportunities, but this was not the case. There are two possible reasons for this. Firstly, bigger firms are more likely to have labor unions that can constrain layoffs. Secondly, taking over bigger firms often includes negotiating with the government, which is often a current stakeholder and sometimes even the shareholder. In these cases, the government can and often does insist that the acquirer retains most of the employees.

The next indicator, change in labor productivity derives from the two previous indicators: revenues and number of employees. Due to the problem with missing data, the base year in this indicator is not two years but just one year prior to takeover. Results are shown in Figure 6.

Figure 6: Change in Labor productivity

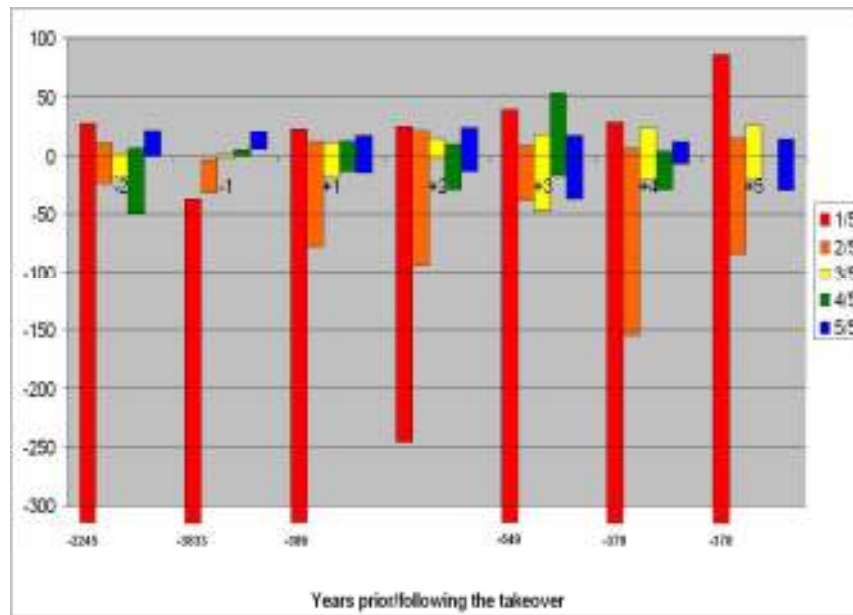


Considering that the change in revenues, as a general tendency, showed increase, and that the change in the number of employees showed decline, a strong growth of their ratio was expected. The sub-sample group of firms in tourism which showed the biggest average in change of revenues, but also a high average percent of layoffs had accordingly the best results in labor productivity. Unfortunately, production firms' sub-sample showed a downturn in post-M&A years, and thus presents the only sub-sample group with a decrease in labor productivity in the last observed year if compared to the first year after the takeover. The biggest sub-sample groups' difference is between groups with previously higher and lower labor productivity ratio, with latter ones clearly outperforming the former ones. This difference showed to be statistical significant in the last three observed years. It can be speculated that the strong growth of firms in tourism and firms with previously lower labor productivity came about as a result of the efficiency enhancing potential triggered off by the post-M&A organizational changes.

The last observed indicator was intended to be the change in profit margins. However, profits show to be quite erratic and therefore no trend line could be created. The overall average and the averages of all sub-sample groups standard deviations were higher than the noted average, so they were unusable. Many sample firms had great spans in financial results showing, in some observed years, rather high profits and/or high losses. Creating trend lines using these data would be misleading so a different kind of graphic display needed to be created. Firms were divided into 5 groups with 8 firms in each by the criterion of noted absolute values of profits/losses in the year before the

takeover. In this sense, the first group consists of firms with biggest losses in the year before the takeover and the last, fifth group, with firms with biggest profits in that year. The results are shown in Figure 6.

Figure 7: Profit margins



Dividing sample firms into groups according to the achieved level of profit is thought to be helpful for determining general trends for those groups after the takeover. However, it can be noticed that even this kind of segmentation showed no visible regularity and resulted with even bigger profit spans at the end than at the beginning of the observed period. Some of the firms that were unprofitable showed major profitability increase and at the end of the period finished among the best performers. Some firms from all groups showed opposite trends, starting from profits prior to takeover and finishing with huge losses afterwards. This kind of erratic results in terms of profitability can be rather confusing especially when compared to the clear trends that firms showed in the sample and sub-sample groups when other operative performance indicators were analyzed. But actually, unpredictability of profitability of acquired firms is quite in line with the questionable success of M&A processes which is emphasized in the major part of M&A empirical literature. However, it should be noted that the profitability of sample firms has its positive features as most of the firms enhanced their overall financial results over the observed period. 21 out of 40 firms in the sample increased their profitability in the years after the takeover, and 18 among them managed to cut their losses and become profitable. Furthermore, the majority of sample firms gained on profit margin performance in 4 of 5 sub-sample groups.

Surprisingly, the only sub-sample group without any profitability gains is the fifth group consisting of 8 firms with highest profit margins prior to takeover.

5. CONCLUSION

This paper presents the results of the broader research considering the effects of M&A processes on Croatian target firms. Some key operating performance indicators were analyzed on the sample of 40 firms through a 7-year time span. The findings are mostly in consistency with the majority of empirical M&A literature concerning the involved firms' operating performance with some noticeable idiosyncrasy brought about by the Croatian economic environment.

Positive trends in the change in assets, equity capital, business revenues, and labor productivity, show that target firms enhanced performance in several respects. Furthermore, the growth in revenues and labor productivity and the increase in asset and capital values point to the intentions of acquiring firms to accomplish gains in the target firms' operative performance. A negative trend concerning the number of employees confirms some publicly debated issues about the negative influence of takeovers on employment. But this can also be seen as an effort taken by the firms to conduct restructuring and increase efficiency.

Profit margin changes show that the majority of firms accomplished some gains in operating performance. The lack of consistency in the pattern of profit margin changes cannot be derived from the trends of other observed indicators. This emphasizes the problem that most of the empirical studies face: the (un)success of M&As is hardly explainable by raw financial data analyses. As it was previously commented, positive trends in most indicators signal the intention of the new owners to boost target firms' performance, but the apparent lack of seeable consistency of these trends with the profit margin change shows that some of the important factors influencing the final M&A success are not reachable solely with quantitative analyses. The potential lead towards these factors might be indirectly perceptible in the curious findings of profit margin analyses that showed profitability enhancement for the majority of the firms with big losses and a profitability decrease for the entire sub-sample group of firms with the highest earnings prior to takeover. Partial success of the former group and decrease of profitability in the latter could mean that the acquirers of the firms experiencing high losses were more cautious and probably better informed about the current condition in the firm they were taking over than those who were taking over profitable firms. Moreover, due to the additional risk in acquiring the "money losing" firms, estimations of future synergetic and/or market benefits were probably done extra prudently and the takeover occurred only when the acquirers were more certain to have a positive financial result. This can lead to the conclusion that ex-ante preparations through *due diligence* and ex-post integration through influence on target firms' governance and other aspects of business are a prerequisite for the overall takeover success.

The analysis of target firms' operational performance had shed some light on the issue of how successful Croatian firms had been in the post acquisition period. Further research should combine financial analyses and qualitative analyses with the aim to

establish: 1) the motives leading acquiring firms towards corporate takeover and the level of perceived success in achieving goals, and 2) organizational factors that dominantly influenced post-acquisition performance.

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