Mergers and Acquisitions

Acquisition: where one firm purchases another from its shareholders and control of the firm is with acquiring firm

-but increasing importance of private takeovers

Merger: where two or more companies come together to form a new company

-but rather uncommon actually

In fact precise dividing line not clear –often a dominant firm in mergers

Important implications for individual companies and can have a huge impact for acquirer, acquired and merging companies.

Daimler Chrysler $38 billion merger saw share values fall 40% from time of announcement of merger May 1998 to December 2000.

Why occur?

Neoclassical theories:

One firm bids for another if the value the potential acquirer places on the potential victim is greater than the value placed on it by its current owners

Discounted expected earnings

$$V = \sum_{t=1}^{T} \left(\frac{(1-r}{(1+i)^t} \right) \pi_t^e$$

Where π_t^e is expected rate of profit at time t , i is the rate of discount and r is the retention ratio

Retention ratio= prop of profits retained by firm

and the value placed on the company can vary depending on the expected profit, the rate of discount, the time period T and the retention ratio

- Possible increase in market power
- Rationalisation of surplus capacity leading to lower costs combinations
- Economies of scale and scope
- Synergy: means that the sum of the two might be greater than the sum of the parts
- 2 + 2 = 5

Major emphasis in N-C is that difference in market value between the two is result of expected future profits

Also consider it mutually beneficial:

- Owners realise a higher value than would otherwise
- Acquirer pays price below what values the company at
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Process seen as major mechanism through which firms are forced to remain profit maximisers

-more applicable to quoted company with many shareholders than privately owned

Managerial theories

Theories that focus on managers pursuing growth not necessarily maximising profits
Takeover threat becomes constraint on managers

Faster growth will give higher retention ratio, lower dividend payout and lower the valuation ratio

Valuation ratio = $\frac{share\ market\ value}{value\ of\ \ assets}$

Ratio market value to book value

- Probability of being acquired rises with declining valuation ratio
- Or there is a minimum valuation ratio that need to prevent being taken over

Problem in observing this as there are measurement problems

- Can get market value of quoted companies but share prices change all the time and general level shows considerable fluctuations
- Value of assets can be measured by book value but can vary across firms in treatment of depreciation and inflation

But departure from profit maximising can be

- Inefficiencies –not max profit in V
- Sacrificing dividends for growth
- X inefficiencies

Managerial theories focus on takeover as essentially hostile

Market Power theory

N-C and managerial only deal with acquired company but also need to considered the acquirer

M&A are way of dealing with problems

1. Aim to increase market power of firms involved
2. Adverse change in economic environment triggers search for market power: fall in demand relative to capacity; international competition in domestic market; legislative changes
3. Need to maintain size relative to rivals customers and suppliers in market (NB relative rather than absolute)
    a. Battle with rivals
    b. Bargain with suppliers
    c. Protect from acquisition

Need not be inconsistent with profit maximisation
In this approach threat of acquisition plays lesser role in disciplining firms

Management interests

Expand managerial theories to argue that the pursuit of managerial interests lies behind many acquisitions –behavioural

- Relation between size and security
- Relation between size and growth and executive income

- Incentive for managers to grow through acquisition

Likely Impact on:

- Profitability
- Efficiency
- Growth
- Concentration
- Management

Merger Waves

Mergers and Acquisitions do tend to occur in waves. In between these there is relatively little activity.

Merger Waves in US

	Current $	2000 $	Number
1898-902	6.9	136	3012
1926-1939	7.3	69	4828
1966-1969	46	236	NA
1983-1986	618	NA	91617
1997-2000	4500	4500	31152

Source: Buckley and Ghauri

Similar pattern for UK

Latest wave when compared to 80s and 90s differs in amount of cross border activity

- By 1986-2000 26% of total acquisitions were cross border
- 0.5% of world GDP in mid 80s but 2% by 2000 (UNCTAD, 2000)
- Acquisition now 80% of industrialised countries FDI
- UK companies play an increasingly important role

Acquisition of privately held companies becoming increasingly important.

- 1985-98 94% UK cross border acquisitions private 58% of value because tend to be smaller
- 1985-98 88% UK domestic private and 25% in value

Recent evidence 2000-2002 shows decline in FDI

- Developing countries most affected
- Seems to results from marked decline in cross border acquisitions.
- New phase?

Despite increasing importance of private company M&A, nearly all empirical work on publicly quoted companies

Andrade et al (2000) find studies show:

- Merger activity in 90s as in previous period clustered by industry
- Different waves associated with different prime causes
- Acquiring shareholders earn neutral or negative returns over short run announcement period.
- Possible market doesn't accurately predict future performance of acquired company so need to look at long run.0
- Long run post acquisition studies find mixed results some negative and some zero.

Buckley and Ghauri (2002) provide some brief case studies of mergers from the Economist that show complexities involved and how they can go wrong:

Ang and Kohers (2001) Analyse private sample and compare with public for US – ends 97-8. Find:

- Unlike public companies, private mergers provide significant gains for both bidders and targets
- Returns for acquirers of publicly held targets are sig positive on average and premiums paid to private targets are higher than those paid to publicly traded targets

Conn et al (2003) is a recent contribution for the UK:

- Consider publicly quoted and private companies 1984-98
- Cross border acquisitions result in lower announcement and long run returns than domestic
- Announcement and long run returns are positive for high tech
- Announcement returns are zero and long run returns negative for non-high tech
- National cultural differences between target and bidder has negative impact on long run returns

Have seen:

- Mergers and Acquisitions are important –though mergers rare

- There are various theoretical reasons for them to occur but need relatively eclectic understanding

- Certainly more than just way of companies being forced to maximise profits

- M&A occur in waves and characteristics/reasons can vary

- Private increasingly important and cross border

- Mixed results on returns from M&A: announcement and long run.

- Expect them to continue to be an important part of corporate life –but in waves and very recent downturn