Major Areas in M&A

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Abstract

The purpose of this paper is to develop a deeper understanding of merger and acquisitions’ field of corporate finance, particularly with reference to value creation in merger and acquisition. Our aim is to provide a review of empirical literature to identify and evaluate the main areas in merger and acquisitions transactions; in particular to shed some light on valuation issues in M&A’s in context of post acquisition performance of the companies. Most of the time researchers tend to evaluate the impact of M&A’s in terms of financial aspects such as profitability etc. but they ignore the human aspect.
that is the effect of M&A's on the people or employees of the companies. Most of the
times employees are laid off as result of these activities as consequence this create new
but conflicting networks of relationships in new companies.

We found that on average research tend to show that acquiring firms underperformed
the market in contrast to acquired firms, which create value at the expense of bidding
and acquiring companies.

Key Words: Mergers & Acquisitions, Valuations Issues, Value Creation and Cost-cutting
strategies

**Introduction:**

The managers of the firms act in the best interest of shareholders by following the
mechanism of market for corporate control. However, when management of the
companies fails to maximise shareholders value, it creates opportunity for outsiders to
threaten or take steps to replace existing management. This action of outsiders leads to
value creation because shareholders of the company revalue the anticipated cash flows
under new management as suggested by Jordan (2006). However, managers may
involve in acquisition activities to increase personal utility instead of maximising
shareholder's value as argued by Denis and McConnell (2003). Therefore, takeovers
could be negative net present value projects leading to diminishing rather than creation
of value Denis and McConnell (2003).

The measurement of success in merger and acquisition activities is mainly through
quantitative research and is subject to various studies such as Gosh (2001); Healy et al
(1992), in the field of finance or economics and also other directly related fields. People
are normally unobserved in merger and acquisitions, however extensive studies like
Bliss and Rosen (2001), addressed issues from ethical and organizational learning to
more in depth personal perspective. Similarly, increasing trend of international trade
and globalization attracted the attention of many researchers, for instance Rossi and Volpin (2004).

The valuation of the companies is often overlooking in the field of merger and acquisitions. However, it is a very critical part of acquisition process and could be very helpful not only in the pre-acquisition stage but also during the acquisition process as well as at post-acquisition stage Becher (2001). Last but not the least the best practices research in the field of merger and acquisition is usually done in the form of case studies but the quality and intensity of these studies vary widely Marks and Mirvis (2001).

**Performance and Success in M&A**

Companies often engaged in the series of acquisitions and merger activities and early studies such as Barney (1988), tend to show that related acquisitions performed better than other acquisition transactions. However, relatedness itself does not create value for acquiring companies but synergy is the vital factor that helps companies to generate abnormal returns from acquisition programs. For example, Barney (1988) showed that synergistic cash flow stemming from relatedness, which is unique and private creates abnormal returns for shareholders of acquiring firm.

However, later studies such as Hayward (2002), suggested that different level of relatedness results in various degree of success and moderately similar companies tend to be more successful than the companies that are highly similar or dissimilar in business or size to one another. He further concluded that if a firm experienced small losses in past acquisition in contrast to high losses or high gains then it has better chances of success in prospective acquisition. In addition, the timing of acquisition plays a vital role in success of the transaction and should not be too close or far-away from central acquisition Hayward (2002). Similarly, Brown and Eisenhard (1997) argued that companies benefit differently depending upon their experimenting and timing of the merger and acquisition activities.

Moreover, when the acquiring company has some inimitable resources then it can create value by utilizing these resources in target's company as suggested by Capron and Piste (2000). However, they also added that if the source of synergies is recognized in target firm than market associate expected gains to target firm due to the competition among potential bidders. Consequently, this competition raises the price of target firm.
and would create value for shareholders of the target firm but also lead to underperformance of acquirer.

Nevertheless, performance success through merger and acquisitions is still controversial among academics; as Cording et al (2002) sum up this anomaly in following statement:

"These results, combined with the observation of continued growth in merger and acquisition activity, gives rise to the "M&A success paradox." If we assume that managers are rational, and that corporate governance structures serve as a check and balance on poorly conceived strategic actions, we would expect the level of M&A activity to taper off, which has not been observed. To date, scholars have been unable to unravel the M&A success paradox." (Cording et al, 2002; p. 7)

In order to resolve the issue Chatterjee (1992) measured the cumulative average of abnormal returns (CAAR) during the period of 11 months before the tender offer until 60 months after the tender offer. After studying the sample of 577 tender offers between the periods of 1963 to 1986; he suggested that net gain arises for the economy from these transactions but it does not necessarily create gains for everyone involved in merger and acquisition. More specifically, CAAR after 60 months were observed to be negative for unsuccessful bidders, zero for successful bidder and positive for Target Company. Furthermore, Chatterjee (1992) found much higher positive CAAR for restructured target companies in contrast to non-restructured targets.

Certain studies view the merger and acquisition transactions from a different prospective. For example, Golbe and White (1993) proved in their study that macroeconomic environments influence the merger activities and the number of merger transactions increases in time of economic expansion comparative to decrease in programme at the time of economic down turn.

Similarly, Amburgey and Miner (1992) studied the effects of companies’ momentum on merger activities and suggested that managers follow the past patterns.

They reported following three strategic momentums:
- Contextual momentum (general character of a company determines strategic action in consistent way)
- Positional momentum (companies sustain or extend their existing strategic position)
- Repetitive momentum (companies’ repeat previous strategic measures)

Capron (1999), attempted to assess the performance of the merger and acquisition activities by conducting the survey of prime stakeholders in merger activities. One of the primary questions addressed by Capron (1999) in the study was that how well the merger satisfied the objectives after acquisition based on the pre-acquisition objectives? In answering this issue, he concluded that the available financial data is too gross to allow the separation between the types of pure value-creating mechanism. Moreover, he also argued that more often the objective of the companies is to retain the top management team of the target’s firm, whether it’s a conglomerate or related merger.

**International Prospects of M&A**

The emergence of globalisation and increasing trends in international trade fasten the number of local as well as cross-border acquisitions and merger activities. For instance, the cross-border acquisition activities in United States increased to 19% in 1999 from 6% in 1985 Seth et al (2001).

According to the study of Seth et al (2001), the evidence suggests that there are three motives for cross-border acquisitions such as synergy seeking, managerilism and managerial hubris. Moreover, the research tends to show that there is a positive relationship between the level of value creation and reverse internalization, asset sharing, financial sharing and market seeking (as discussed by Seth et al, 2001).

In addition, there seems to be association between value creation and governance system of bidder's country. For instance, Seth et al (2001) argued that bidding companies from group-oriented governance system like Japan and Germany appear to be engaged in acquisitions and merger activities with higher level of value creation in contrast to bidding firms from market oriented governance system such as United Kingdom.
Further enhancement of research in the area of cross-border merger and acquisition suggests that experience in merger and acquisition activities can be utilized to create value in another country. For example, Gugler et al (2003) compared the data of 15 years and proved that post merger patterns are similar across different countries. Moreover, their evidence also signifies that there are no major differences between domestic and cross-border mergers as well as manufacturing and service sectors around the world. With the passage of time and in the era of globalization the merger and acquisitions activities are increasing especially in emerging economies. The multinational companies often use the tools of acquisition and mergers to penetrate in new markets and economies particularly in emerging countries such as Central and Eastern Europe Milman (1999).

However, in many countries MNC mergers and acquisitions are seen as threats by government agencies, privatized companies and state enterprises. Therefore, in order to develop a successful alliance the acquisition or merger program should be designed in such as way that creates value for companies as well as the host-country governments Rondinelli and Black (2000).

Lastly, yet the number of merger and acquisitions across border appears to be increasing but it seems difficult to integrate and manage the successful processes. Hence, Inkpen et al (2000) suggested that the companies should critically evaluate the areas of decision making, communication, networking and socialisation, communication and the structure of authority and responsibility before involving in the process of M&A.

**People in M&A**

Only looking to financial aspects might limit the understanding about the question why M&A activities are so widely used by companies as a tool to grow. Hence, another area focused by academics, such as Karitzki and Brink (2003), is related to merger and acquisitions and people.

Generally, one of the motives for merger activities is to follow the cost-cutting strategies including synergy and target's customers. Often, the employees are laid off in the process of merger and acquisitions and consequently this creates new but conflicting
networks of relationships in new companies as suggested by Vermeulen and Barkema (2001). Thus, it affects the success and results in under-performance of merger and acquisition programmes. Therefore, considering the affects of M&A on employee or managers of the potential target firms are of similar importance as financial issues.

Similarly, the research in the area of executive compensation pointed out that prior to acquisition or merger, management of acquiring company receive significant higher packages comparative to the executives of target firms Lynch and Perry (2002). Hence, failure to reconcile these differences can lead to turnover and morale issues that ultimately affect the success of anticipated integration from M&A. Furthermore, in extreme circumstances, issues like these emerging from dissimilarities create hurdles to achieve the objective of the original merger and acquisitions. Thus, reconciling the differences is one of the major issues faced by the combined company to create value (as discussed in Lynch and Perry, 2002).

Moreover, successful merger or acquisition depends upon the people in both target and acquiring firms. The attitude and opinion of the employees regarding acquisition or merger can change over the time. Schweiger and DeNisi (1991) conducted the survey of employees and compared the attitudes in pre-acquisition and post-acquisition period. Their results show that attitudes of the employees three months after the announcement of merger changed significantly and turn towards continual negative consequences Schweiger and DeNisi (1991).

Likewise, Covin et al (1996) studied the attitude of 2845 employees from a large manufacturing concern in post merger period. The results show significant differences between the target firm and acquiring company’s employees in satisfaction with merger. The employees of acquired company faced high level of dissatisfaction and ultimately felt more stress due to changes introduced after merger. In addition, this stress is aggravated due to the direct competition between target firm and acquiring company. Furthermore, Covin et al (1996) pointed out that factors such as loss of power and status, changes in salary or benefits and lack of managerial direction result in high level of stress and dissatisfaction from merger activities. Hence, it has been suggested that in addition to financial aspects these types of issues should not be overlooked in
order to create value and to develop a successful merger and acquisition programme Karitzki and Brink (2003).

**Best Practices in M&A**

It is often suggested that acquisitions are predominantly unsuccessful and numerous studies like Aiello and Watkins (2000), confirmed this fact. However, generally the conditions and environment is relevant before judging the results. Furthermore, there is lack of research in answering the question; what would happen if both the companies continued in their own separate way. Therefore, estimating the successfulness of merger or acquisition is a tricky anomaly Chaudhuri and Tabrizi (1999).

Moreover, the unsuccessful M&A activities are more highlighted in contrast to successful programmes. Ed Libby, the chairman and CEO of AllState stated that when M&As fails they draw more notice despite the fact that lot of other projects fails in business but no one can see them because they remain within internal walls of the companies Cary (2000). As stated earlier, there is no one strategy that fits all kinds of merger and acquisition activities, however systematic approaches such as suggested by Jan Leschly, can help companies to develop a successful plan. Jan Leschly, retired CEO of SmithKline Beecham suggested that they put their people on the boards of different companies by investing small amounts. Once the companies get going then they decide whether to buy it completely or not Cary (2000).

Likewise, understanding the various components of merger process is very vital to develop a successful merger or acquisition deal. However, it is very hard to enumerate the components especially when these are integrated with each other. According to Marks and Mirvis (2001), the successfulness of merger and acquisition is highly depended on following factors:

- Acquisition Plan (How is the acquisition prepared?)
- Implementation of this plan (How well is the acquisition process conducted?)
- Post-acquisition cooperation between firms (How well the companies work together after acquisition?)
Moreover, they collected a number of factors that were mentioned in previous research such as strategic objective, clear selection, search and selection process etc. They also argued that pre-acquisition planning is very important for successful merger and acquisition plan and more prepared the people will more synergies in a combination will result Marks and Mirvis (2001).

Similarly, Aiello and Watkins (2000) suggested that every M&A deal pass through following five stages:

- Screening potential deal
- Reaching initial agreement
- Conducting due diligence
- Setting final terms
- Achieving closure

They suggested that splitting the merger or acquisition deals in above mentioned stages and approaching them systematically can help companies to create value through business combination Aiello and Watkins (2000). However, sometimes the reasons for M&A failure could be different from the reasons of other M&A success. Gadish et al (2001) studied the causes of merger and acquisition failure and suggested that poor strategic rationale, sever cultural mismatch, overpayment for acquisition, inadequate integration planning and execution, setting rational and problems in executive leadership and strategic communication are the main factors that lead to the under-performance and sometime failure of any merger or acquisition deal.

**Valuations Issues in M&A**

The last area of M&A research focused by academics are the valuation of the companies involved in deal. There are several methodologies such as discounted cash flows or P/E multipliers, used by analyst to value the company. However, Hall (2003) suggested three main methods to estimate the value of business. These are comparable companies’ method, discounted future earning method or asset model, which can be use to appraise the value of company. However, application of these models requires careful judgement.
of analyst and may not be appropriate to apply in all circumstances. For instance, current economic conditions largely affected the public traded company and application of comparable companies’ model can skew the valuation of business Hall (2003).

Moreover, additional premium price needs to be paid for most of the merger and acquisition deals. The valuation of the business could be relatively simple if it is stand alone but additional value created due to synergies and closing acquisition cost integrated in the process construct further challenges in estimation Gadish et al (2001). However, there is range of sophisticated techniques available to help in estimation and often the final price is based on weighted average of number of valuations as suggested by Eccles et al, (1999).

**Evidence of Post-Acquisition Performance and Value Creation**

Many studies such as Dodd (1980) and Firth (1980), have attempted to identify the value creation of corporate acquisitions by examining the stock returns of the acquiring companies. However, empirical evidence suggests mixed results in terms of post acquisitions returns to shareholder of the acquiring firms. Some studies found negative returns to the acquirers Malatesta (1983) and Eger (1983) in contrast to other research, which reported significant abnormal returns for the shareholder of acquiring companies Chung and Weston (1982) and Asquith et al (1983). Particularly the studies of long run performance of acquiring firms provided the evidence of significant abnormal return over the period of one to three years after post acquisition Langetieg (1978). However, contrary to that Agrawal et al (1992) reported the 10 percent loss to acquiring firms in post acquisition period of five years.
The previous research mainly focused to investigate the relationship between types of acquisitions like vertical integration, unrelated acquisitions and related integrations and evaluate the performance of the companies based upon the results of stock returns and accounting profit, but has not concentrated on the reasons of success. Moreover, many academics have been attracted to the paradigm of corporate acquisition and value creation; however, the results of studies of unrelated and related diversification were mixed Lecraw (1984). For instance, Rumelt (1982) proved that higher profitability is associated with related acquisition comparative to unrelated acquisitions. Similar results has been reported by Christensen and Montgomery (1981) and Varadarajan and Ramanujam (1987).

However, other research like Michel and Shaked (1984) found the evidence that unrelated acquisition outperformed the related acquisition. Likewise, Weston et al (1972) also concluded that unrelated acquisitions performed better than related acquisitions. Furthermore, Luffman and Reed (1984) support this notion by studying the unrelated and related acquisitions activities and reported that firms engaged in unrelated acquisition are in better position to create value in contrast to firms involved in related acquisitions. However, there are some studies such as Grinyer et al, (1990), which did not find any significant difference among various types of acquisition and merger strategies.

In fact, most research was unable to find the exact forces which drive the successful corporate acquisitions modes, as stated earlier; therefore it is difficult to identify the determinants of successful acquisition process. More specifically, empirical evidence, for instance Chatterjee (1986) suggests that horizontal acquisitions outperformed the vertical acquisitions and conglomerates and associated with higher synergies. However, some studies like Lubatkin (1983) proved that vertical acquisitions and conglomerates provided superior performance than horizontal acquisitions.
However, to sum up the previous studies Loughran and Vijh (1997) suggested three typical results from various research studies. Firstly, the stakeholders of target firm gained high abnormal returns from acquisitions activities. Secondly, the shareholders of acquiring firms does not gain abnormal returns or very little from tender offers. Finally, the acquiring company’s shareholders gained negative abnormal returns from the merger activities Bradley et al (1983) Kummer and Hoffmeister (1978), Jensen and Ruback (1983).

In general, evidence from academic research shows that acquisitions and mergers do not create value instead results of acquisitions and mergers are associated with negative returns rather than positive. As Ruback (1988) stated:

“Reluctantly, I think we have to accept this result significant negative returns over the two years following a merger-as a fact” (Ruback, 1988; p. 262).

Furthermore, these negative abnormal returns are inconsistent with the hypothesis of market efficiency and tend to show that market participant overestimates the anticipated efficiency gains from takeover transactions Jensen and Ruback (1983). In addition, Agrawal et al (1992) suggested three important implications of underperformance findings. Firstly, the hypothesis of capital market efficiency is a very important concept in corporate finance and systematic poor performance from post-merger transaction is inconsistent with this hypothesis. Secondly, they argued that most performance research examines the returns around announcement dates by implicitly assuming that markets are efficient and therefore ignore the examination of post announcement returns. Hence they noted that market inefficiency findings on post announcement basis could be calls into question. Finally, the findings of underperformance might show poor accounting performance of firms after the merger or acquisition transaction. However, there are studies such as Healy et al (1992), which provided opposite results. Likewise the study by Mercer Management Consulting found that since mid-80s, 57 percent of merger and acquisitions deals, which worth $500 million or more generated poor results over the period of three years after the
acquisition transaction comparative to industry average. Further findings of the study were that during 1990s, the success rate of the acquisition transaction was barely 50 percent (p.39, cited in Smith and Hershman, 1997).

Finally, we can assert that acquiring firms underperformed market after the acquisition, as suggested by most research such as Agrawal et al (1992) examined the post merger performance of companies and reported that acquiring companies underperformed by 10% on average in post-acquisition period over the five years. However, they also argued that it is still an unsettled issue in finance literature and it depends upon how the performance is measured.

M&A is one of the most researched areas in finance, still some issues remain unsettled. The corporate sector has seen significant activities of merger and acquisition since its first appearance in 18th century Gaughan, (1999). Furthermore, past decade has observed sharp rise in the activities of M&A, making it a wave of mega mergers (Angwin, 2001).

**Conclusion**

The managers and shareholders of both companies (target and bidding firms) are often keen to know how the deals of merger and acquisition will affect their firm. Similarly, employees want to know the effects of wealth redistribution of these transactions. Therefore, investors, portfolio managers or any other interested party can use this study to enhance their understanding of merger and acquisitions and the affect on value creation. Managers involved in these activities to maximise personal benefits and suffering from illusion seems hard to believe, because the huge restructuring of companies around the globe neglect this paradigm. Furthermore, it also seems incredulous to argue that managers engaged in mergers to enhance the power and compensation rather than creating value for shareholders. The evidence from empirical research indicates that merger activities do not create statistical significant gain in value or performance Asquith (1983). Moreover, it has also been suggested that on average, shareholders of acquired firm gain at the expense of acquiring firm. Many studies documented this result in different time period and in different locations by evaluating
the accounting data of the firms as well as market value of firm's equity Ravenscraft and Schere (1987).
References


