# MOVING BEYOND THE LOCAL MARKETPLACE: DYNAMICS OF MERGERS AND ACQUISITIONS

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*"The M&A market, like the Lord, helps those that help themselves.*
*But, unlike the Lord, the market does not forgive those*
*who know not what they do"*
Warren Buffett

**Abstract:** Mergers and acquisitions (M&A), as well as the corporate restructuring intercede a great part of the corporate financial world. The most distinguished, the fifth merger wave, found to be five times larger in real terms compared to its predecessor, has involved companies within the service sector, principally those coming from the OECD countries. Historical trends, however, suggest that nearly two-thirds of big M&A have lost the value on the stock market and merely 46% have not been disappointed on their own terms. Hence, this paper aims at assessing the effects, regional and sectorial patterns of M&A, as well as to address some related implications by means of detailed and comprehensive data set.

**Key words: mergers and acquisitions, sectorial break-down, regional divergence, efficiency gains, failure**

## Introduction

Within the last few decades the globalization of business has set off a search for competitive advantages aimed at responding the challenges to obtain scale in the rapidly consolidating world economy. In parallel with the other trends such as liberalization, dramatic changes in the capital markets, as well as the strategic corporate restructuring, the process of globalization has initiated the unprecedented emergence of the cross-border mergers and acquisitions (M&A), as common, high-profile activities for many business entities. In point of fact, almost any firm with the size momentum has experienced such a transaction in its recent memory and is also possible to be considering one or few more candidates at any given time. Namely, the value and number of completed cross-border M&A announced in 2005 was $ 716 billion and 6.134, respectively, a level close to the one in 1999 when the latest bang of the M&A has appeared. Even as the figures are presumed to be a sign of the multinational companies' strategic choice, those are principally encouraged by the rising number of the stock market mega deals. Nonetheless, there is no immediate raise or fall in the capital invested within the target company i.e. cross-border M&A may not add on the capital stock of the host country, but certainly will stimulate the international production facility, as well as the foreign-owned capital stock.

### Theoretical review

Despite the attraction and prevalence of cross-border M&A, academics have sometimes discussed the unreserved pursuit of those transactions as growth vehicles. In principle, there are no clear-cut findings about the effects of M&A on economic efficiency, since some of the research studies indicate to no evidence of profit improvements, but the others point towards significant productivity gains. The context data model built upon a set of variables, such as financial measures (profit, stock price), non-financial ones (companies' reputation), as well as the time frame (initial market reaction, pre- and post-measurement) suggests that on average, target's shareholders benefit more than the acquirer's ones (Schweiger, 2002). Several empirical studies, nonetheless, have confirmed the statistically significant positive correlation between the market share (market concentration) and profits. Economists, however, vary in their explanation of the particular finding. Namely, the so-called Event study makes a comparison between the price of shares before and after the integration process. Related conclusions suggest that target shareholders benefit, but the bidder's usually break, although the combined efficiency gains are generally positive. The second group observes the company profit in pre- and post-integration process which, upon the closer examination, appears to be associated with the noteworthy improvements within the total factor productivity (TFP).[55] Some studies (Machirajy, 2003) have found that M&A activities are likely to benefit the society, principally on account of the increasing value either of the acquirer or target firm, but without any concentration rise. Running a wide-ranging cross-company and cross-industry regression Berg, Duncan and Friedman (1982), estimate the impact of acquisitions on the firms' profitability. The results put forward the short-term efficiency gains dependent upon the industry selection. In other words those are found to be positive for the market oriented acquisitions, but negative in respect with the knowledge-based. Employing an adjusted data set on the size momentum, as well as the beta weighted market return, a group of researchers (Agarwal, Jaffe and Mandelkar, 1992) have found a wealth loss for the acquiring firm of nearly 10% within the period of 5 years. So as to investigate the very statistical relationship, Porter (1987) conducted a study taking into consideration the rate of the new-fangled acquisitions divestment. Interestingly, he noticed that 75% of all the acquisitions within the sample were divested during the few post-integration years. Some related findings also suggest that high level of concentration, as well as the assumed lack of competitive pressure may also be allied with the failure of firms to produce efficiently, but success of the post-integration process, however, depends upon the acquirer's prior experience integrating acquired company.

### Incentives and company appraisal in mergers and acquisitions

A large number of papers on mergers and acquisitions have described them as an alternative form of investment. The very notation is considered to be understandable to some extent since those are influenced by the same factors which have a great impact on the investment decisions. Mergers and acquisitions notwithstanding are to be the

[55] For about $6 billion, Microsoft has achieved its largest acquisition with the leading interactive US ad agency aQuantive. Taking into consideration the particular acquisition, Microsoft expects to develop the relationships with the advertisers and media-owners, as well as to increase the ability in building the next-generation advertising solutions and platforms, such as: cross-media planning, video-on-demand and IPTV.

comprehensive component of a wider strategic plan, aimed at positioning the firm to achieve its long-term objectives. Explicitly, managers hardly ever think about the price increase or static cost cutback while reaching the merger decisions (Scheffman, 1993), thus timing for mergers is unlike to a great extent in comparison with the one of general non-merger business investment (Anddrade and Stafford, 1999). In spite of the broad-spectrum drives to undertake such transactions, there are few groups of factors that specify the major reasons to assume many mergers and acquisitions. Namely, firms usually merge or get acquired to enhance the capacity, enter the new products or geographic areas, lessen some production costs associated with the sector or risk of market volatility, as well as to get hold of a new so called cutting-edge technology.[56] The potential efficiency gains, however, comprise either operational efficiency (better utilization of expertise or information, efficient asset combination, economies of scale, consumption economies of scope, enhanced resource allocation), or the managerial, aimed at creating a market for corporate control as an important protection against the inefficient management. Mergers and acquisitions take also an advantage of the financial benefits, which lead to earnings diversification, thus lessening the variations associated with the profitability and risk of bankruptcy. This category comprises the tax benefits which are not considered to be the major motivating force for the most M&A prior to the mid 1980's. The main reason for the increased M&A activity in 1986, however, was the implemented tax reform within the same period, which expanded the definition of taxable income and diminished the potential tax benefits associated with the M&A. At some stage of 19th and the first half of 20th century, attaining a market power was the primary motive for many mergers and acquisitions. Some economists (Stigler, 1950) called the very period as the "mergers for monopoly" or "mergers for oligopoly" with reference to the particular wave. Bulk of the most recent mergers and acquisitions, however, could not be ascribed as an effort to ensure a market power. In other words, obtaining a good buy is considered to be the foremost reason for many mergers and acquisitions. Bearing in mind that mergers completed by stocks differ from those in cash, many academics wonders whether the "overvalued" stock may permit a particular company to "obtain a good buy". The most recent findings, however, suggest that acquirers which use stock to pay the asset have better information than the target's shareholders. The fourth merger wave have been distinguished by the introduction of leveraged buyouts, most of which financed by the junk bond market. The particular transactions resumed to be performed within the fifth way, mainly in form of a friction within the some of mega leveraged buyouts, such as RJR Nabiso. Many other motives come out to be driving forces for lots of M&A activities. Namely, some target firms seek for an acquirer to break out the unfavorable labor contracts or avoid the financial problems, but also to amplify the risk-return profile (Shleifer and Summers, 1988).

The key aspect of the M&A as a corporate strategy is the value creation for the shareholders of the both partners. The value metrics, however, suggests that M&A have to be considered within the period of three years following the deal in order to provide the acquiring company a point in time to exhibit the actions (Smith, 1999). There are

[56] ExxonMobil is considered to be the leading multinational American company which has integrated petroleum and natural gas production by merging the Exxon and Mobil in 1999. The key point of the reached agreement was the Exxon shareholders to own about 70% of the merged company, while Mobil ones 30%. Today the newly established company is to be the world's largest either by revenue ($377.6 billion in the fiscal 2006), or the market capitalization ($517.92 billion in 2007).

wide-ranging models, applied in the same context to value the target company. The imperative valuation mechanism for many M&A is discounted cash flow analysis that defines the current value of the company considering the predicted upcoming cash flows. In other words, the expected company's free cash flows (true operating cash flows) are discounted using the weighted average costs of capital [WECC=Kb*(1-T)*(B/V)+Ks(S/V), where Kb denotes the pre-tax market expected yield to maturity on debt, Ks represents the market-determined opportunity cost of equity capital, while T, B, S, and V stand for tax rate, debt value, equity value and assets value, respectively). The most applicable methods, however, are the comparative ratios, consisted of two most commonly used relative approaches, such as: price-earnings ratio (P/E ratio) and enterprise-value-to-sales ratio (EV/Sales). The first sub-method gives acquiring company the possibility to make an offer that is multiple of the target company future earnings. Complexity of the particular metric arises, however, with the estimation of an appropriate P/E ratio. The second instrument (replacement cost) refers to the expected costs to replace the target firm. The particular method notwithstanding, has many disadvantages, since tangible asset is considered to be the only one replaced, but not to all the companies. Taking into consideration the above drawbacks, McKinsey has examined the power of free cash flow to explain the market value of 35 US companies. The very high $R2 = 0.94$ has confirmed for another time the reliability of discounted cash flow analysis in evaluating many mergers and acquisitions. Yet, it is worthy to mention that acquirers practically always pay a considerable premium on the stock market value of the target company. Thus, the premium for the purchasers refers to the post-integration synergy they expect to achieve, while it stands for the company's future prospects as regards to the seller. In other words, the success of the post-integration process depends upon the value enlargement of the buyers.

### Regional divergence and sectorial break-down of mergers and acquisitions

From the chronological standpoint, cross-border M&A have made many significant fluctuations over time, both measured as the value or number of deals. At some stage of the 20th century, five waves of M&A have been acknowledged (Andrade, Mitchell, and Stafford, 2001), but special attention has been paid to the 5th, one which has started just about 1995 and broken off in 2000 (Figure 1). The major impact on the particular wave, however, had the substantial transactions of the German, French, Spanish and Nordic companies which have joined the long standing American interest in this domain after a short time lag. In addition, the most distinguishing attribute of the respective period were the so-called mega deals whose value went beyond one billion US dollars i.e. the number and the value of those transactions have almost quadrupled for the period 1996-2000. European companies have been engaged within many of them, but certainly the most reflective one is the cross-border take-over of Mannesmann (Germany) by Vodafone (UK) for about $203 billion in 1999-2000, which is considered to be the most essential transaction even up to the present.

Nevertheless, cumulative distribution of the cross-border M&A within the most recent 6th wave (started in 2003) has confirmed for another time the major role of the OECD countries, both as acquirer or target zone. Namely, 2.154 transactions have been effectuated in 2005 with a full amount of $774 billion. United States, however, are uppermost within the list, acquiring 514 foreign firms with total assessed value of about $158 billion. United Kingdom takes up a first place as the largest value target country ($144 billion), as well as second one as an acquiring with 286 deals estimated about

$94 billion. In other words, 15 out of 20 countries considered to be the largest acquirers, emerge among the top 20 as largest target in the value conditions.

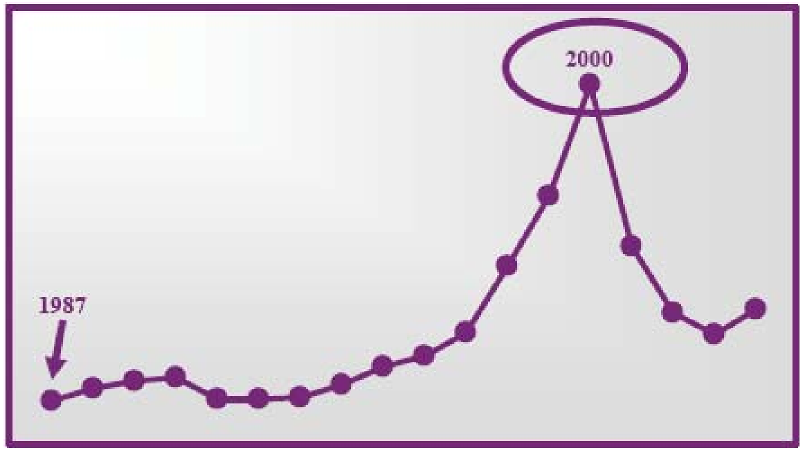


**Figure 1: M&A value in millions of dollars (1987-2004)**

The evidence exposed leads to the conclusion that cross-border M&A are most likely to take place among high GDP nations (Figure 2). In addition, results we have obtained from the statistically significant regression (0.00087<0.05 alpha) using a logarithmic scale, point toward a positive correlation (0.6712) between the cross-border M&A acquirers and their GDP in 2005.

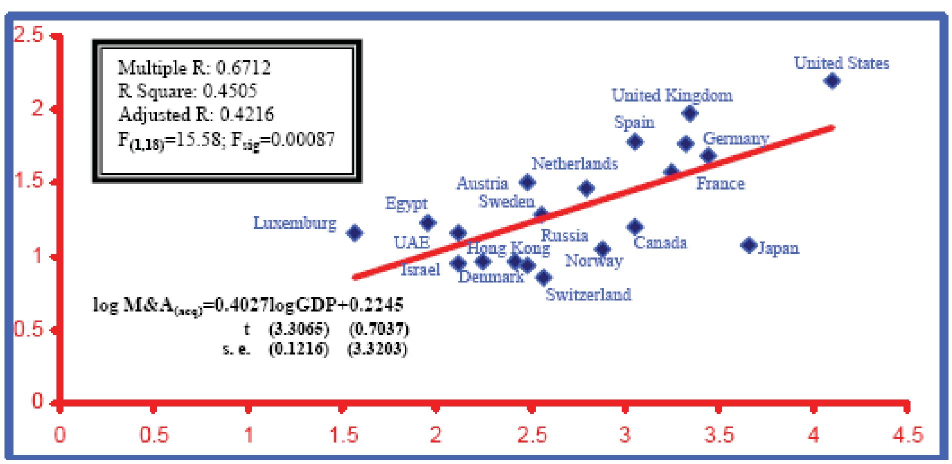


**Figure 2: Relationship between log $M\&A_{(acq)}$ and log GDP, 2005**

In other words, 45% of all variations within the acquiring M&A depend upon the variations in GDP of the countries i.e. 1% positive change in GDP of a particular economy impose 0.40% increased propensity to undertake such a transaction. Some other non-specific factors, however, are found to be the principally imperative determinants of cross-border M&A, such as: distance from the respective country, the recipient's economy corporate tax, average tariff rate, as well as the combined effect of M&A enforcement by the national authorities (Evenett, 2003). Finally, the difference between horizontal and vertical FDI has to be also taken into account while explaining the above outcome. Namely, economies ranked as top 20 are mostly attracted by the high wages of the consumers more than the low factor expenditures. In other words, companies from the respective countries have more lucrative motives while undertaking the particular transaction and usually hunt for large and profitable markets.

Another critical feature of the more recent M&A wave stands for the importance of the sectors while engaging such a transaction. Namely, the examination we made by the Chi-Square test of independence, revealed a sectorial break down of the cross-border M&A at some stage in 1980s and 1990s (Table 1). Based on a benchmark of .05 alpha, the estimated p-value of 0.0000 suggests that there is a statistically significant difference in the proportions among multiple independent populations (sectors).

**Table 1: Chi-Square Hypothesis Testing (PHStat for MS Excel)**

| **Results** | |
|---|---|
| **Critical Value** | **109.7733** |
| **Chi-Square Test Statistic** | **1.62E+09** |
| ***p*-Value** | **0.0000** |
| **Reject the null hypothesis** | |

One outstanding finding is the quite smaller meaning of the manufacturing cross-border M&A within the late 1990s (35.1% as a proportion of the value as a whole, against 62.2% in the previous wave). Moreover, merely three service sectors explain a half of the total M&A in the late 1990s (business services, finance and communications). As related literature argues, the very sectorial dissimilarities are imposed by many political and economic factors. Black (2000) accentuates the failing of the "old anti-takeover coalition" which imposes more stock options for the managers and relates their payment to the corporate performance. He also notes that the lower inflation, as well as the rolling stock markets has diminished the costs in support of financing the cross-border mergers and acquisitions. On the other hand, Evenett (2002) asserts that sectors which confront violent import competition are less likely to make out the cross-border M&A results in higher prices. Thus, sectors where the companies offer a wide-spectrum range of products (banking) are more likely to benefit from the M&A transactions with the financial institutions. Taking into account the prompt technological improvements within the communication sector, he argues the role of the cross-border M&A as a very important mechanism to spread them across the borders. Finally, reduced trade barriers, as well as the more concentrated competition in the markets of manufactures, lessen the necessity to undertake cross-border M&A aimed at reducing some risks associated with the declined market power or higher tariff rates. Increased number of M&A in the service sector, among others, has been induced by the deregulation, privatization, as well as the attenuation on the foreign ownership restrictions in many industrial economies.

### Intellectual property due diligence in mergers and acquisitions

One of most important factors that influenced the fifth merger wave was the valuable intellectual properly provided by the technology sector. The fast growing high tech sector has impelled the corresponding industry entrants to look for an asset in form of intellectual property in order to keep the pace with the technological improvements. This might explain to some extent the success that Cisco and Lucent Technologies has achieved within the fifth merger wave. In point of fact transactions based upon the intellectual property might present the exclusive set of challenges, since the particular asset is often hard to be appraised due to the intangible nature. Therefore, possibility of acquiring the asset less or more valued than the expected is much more grater in comparison with the transaction engaged in tangible assets. Taking into consideration the sensitivity, the successful dealing with intellectual property matters is considered not only from time-costs perspective, but the post-closing difficulties, as well. Thus, acquirers have to bear several moments in mind before the transaction is completed, such as: importance and place of intellectual property in the transaction, tax considerations, due diligence, foreign law, distinguishing between tangible and intangible asset, etc.

### Enhancement of the collective funds as a budding resource of investment

Collective investment funds (private equity firms and hedge funds) are arguably the latest source of investment, particularly in the domain of cross-border M&A. Those might be the most recent illustration of portfolio investment revolving into FDI (Dunning and Dilyard, 1999). Once regarded as useful supplements to mainstream investments, private equity funds are principally completed within the start-ups, companies in distress or those in necessity of venture capital. Those, however, are considered to be a long-term investment and are less liquid in comparison with the publicly traded stocks.

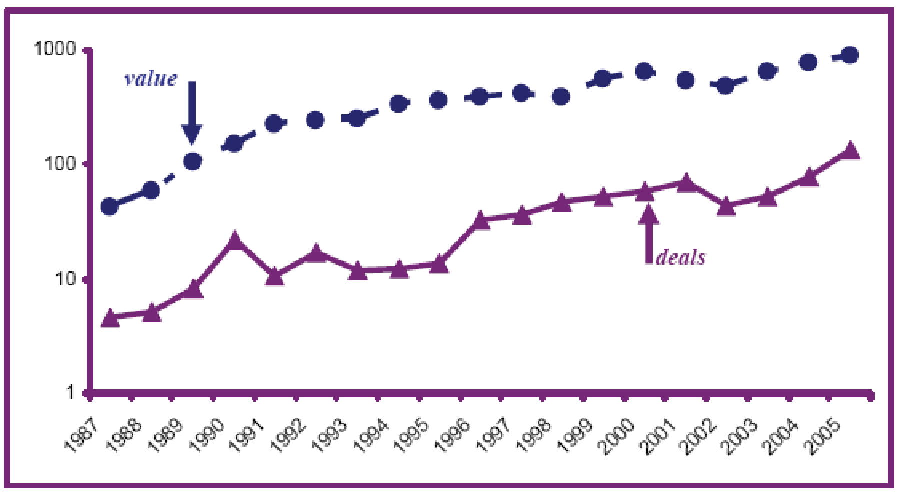


**Figure 3: M&A by collective investment funds (1987-2005)**

Within the last few years such funds have extended in the other regions aside of United States and United Kingdom, attracted by the companies with growth potentials, but in financial crisis (Asia), or the rising integration of financial markets and implementation of a single currency (Europe). Hedge funds are also big players as lenders in leverage buyout transactions with a record $1.200 billion gained in 2005. Yet, private equity firms, together with some additional borrowings obtain a majority of shares in the target company, thus they tend to have a much longer time frame than the other funds. In 2005, private equity firms invested in various industries and sectors, such as: services sector, including real estate (Europe), the banking industry in developing Asia, and finance and leisure industries in Japan. In addition, evidence suggests that such investments permanently broaden the scope of their activities and encounter more litigation, reaching a record of $135 billion i.e. 19% of the cross-border M&A as a whole in 2005 (Figure 3). The rising value of deals attempts some new funds to enter the market and undertake such transactions within the service sector of developing countries (80% of the total value), Asia in particular. These figures, however, have been a subject to strong debate about the impact of the private equity funds on the host economies. Explicitly, firms get certainly hold of an external equity and better utilization of their potentials (Colombo and Grilli, 2005), but scope of the private investors' activities might give them an exceptional political influence over private corporate behavior. In many cases, they sell again the target companies within a very short point in time, after bleeding white the profits out of them.

### Mergers and acquisitions: why they fail to achieve the intended purpose?

Companies usually merge and finish up the business increasing their economic supremacy, but the most important concern comes out from the possibility to obtain an increased market power or augmented competitive advantages aimed at reaching better stock prices (Sikora, 2005). Many studies, however, have found that nearly two-thirds of big mergers have lost the value on the stock market and merely 46% have not been disappointed on their own terms. M&A, however, do not fail as one of the partners haven't fulfilled the obligations of due diligence. Some other issues associated with the market share, strategic shifts, financial performance, reputation and patient origin are considered to be the major obstacles to post-integration success. Moreover, mergers executives very often suffer from having a ”realistic outlook” and usually discount the business strategy, thus buying the competition is the foremost driving force regardless of the shares price afterward. In addition, focal point for many merging companies is declining the costs, thus they tend to overlook day-to-day the business, failing to create the value for the shareholders. A large number of scholars point toward the neglict of the issues related to human resources as one the major rationale for many M&A failure, such as: poor communication among the people at any stage of the organization, information withholding from employees on side of the senior executives, loss of key people and talented employees, thus losing the corporate productivity and customers, power politics, corporate culture clash, an inadequate planning, etc. Nevertheless, it is noteworthy to mention that the particular factors are to be important, but not the unique to maximize the likelihood of achieving a successful merger if those are being dealt on time.

### Conclusion

Mergers and acquisitions are to be the fastest and the best way for many companies to get ahead. At least in the theory, those improve the operating performances, mainly induced by the increased synergy and economies of scope, as well as the possibility for cutting the costs, rising the production activities, strengthening the company's market position, entering new markets, acquiring the new cutting-edge technology etc. Taking into consideration that behind the M&A stand the possibility to create value over and above the one of the both companies many issues related to the costs and benefits have to be a subject of detailed analysis before the transaction is completed. Thus, acquirers usually employ different legitimate methods to value the target companies, such as price/earning ratio, enterprise value to sales ratio, replacement cost, but also discounted cash flow analysis which is thought out to be the key valuation instrument for many companies. The most important to be noticed, however, is appearance of the mergers and acquisitions in form of waves, whereupon the ones from 1920s and 1960s have augmented the economic concentration in manufacturing, mainly determined by the accelerated industrialization of the economies. The more recent waves, seen to be five times larger even corrected for the increasing price of the financial asset, have appeared particularly in the service sector (communication, finance and business services), once again among the OECD countries. The reasons behind emerge from the market-seeking motives of the most companies engaged in M&A i.e. those are interested in higher wages of the consumers, more than the low factor expenditures. Recently, the most imperative resource for many mergers and acquisitions are the collective investment funds accomplished within the start ups, companies in distress or those looking for buyouts financing. Yet, a large number of the big mergers and acquisitions are being disappointed on their own terms, failing to create value due to the many reasons, such as: loss of revenue momentum, lack of management prudence, as well as inability to prevail over the practical challenges.

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