CREATING VALUE FROM MERGERS AND ACQUISITIONS

THE CHALLENGES

Second edition

STAGE 1: Corporate strategy

STAGE 2: Organizing for acquisitions

STAGE 3: Deal structuring

STAGE 4: Post-acquisition integration

STAGE 5: Post-acquisition audit

Five stages in M & A
Creating Value from Mergers and Acquisitions

The Challenges

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- Chapter learning objectives to help you track your progress
- Answers to some chapter review questions to check your understanding
Reviews of the first edition

‘Simply a “must read” for all persons who require a broad understanding of the various issues involving planning and executing acquisitions and mergers.’
Tom Berglund, Professor of Finance, Swedish School of Economics and Business Administration, Helsinki, Finland

‘The book is extremely comprehensive and current. I think you really have done an excellent job summarizing so much of the literature. It is a very nice piece of work.’
Henri Servaes, Professor of Finance, London Business School

‘This weighty, well-written, well-researched and easy-to-read tome is set to become a standard work.’
The Times Higher Education Supplement

‘An excellent textbook . . . One of the many strengths of this book is that it truly takes an international perspective and does not just stick to the US viewpoint. An excellent overview of the empirical research findings . . . clarity of presentation makes this book a very attractive textbook on both undergraduate and MBA level.’
European Financial Management

‘This is a big book in more ways than one. It is the first that tries to provide encyclopaedic coverage of M & A for practitioners and students alike . . . an authoritative guide to the theory and practice of M & A.’
Professional Investor

‘If you apply the findings of a recent book, things may not be too awful. Within a comprehensive and very readable survey of the theory and practice of mergers and acquisitions, . . . reviews the transatlantic literature on whether M & A works.’
John Plender, Financial Times

‘As well as synthesising academic work on takeovers [the book] presents a common-sense approach to the consideration of M & A that might constitute a noisier conscience for over-optimistic boardrooms.’
Ed Warner, The Guardian
To Nandhini, the memory of Alfred Kenyon and
the numerous scholars who have enriched my understanding of M & A

I have stood upon many a tall scholarly shoulder
To raise my gaze and see farthest
Yet my vision is short and
I am searching for shoulders taller still

(adapted from Sir Isaac Newton)
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Companion Website for students
• Chapter learning objectives to help you track your progress
• Answers to some chapter review questions to check your understanding

For instructors
• Instructor’s Manual containing an overview of each chapter along with solutions to review questions, additional questions and end of chapter cases
• PowerPoint slides highlighting key concepts, figures and tables from the book
• References to additional case studies highlighting key issues
• Teaching hints on how students can learn the practical aspects of M & A

Also: The Companion Website provides the following features:
• Search tool to help locate specific items of content
• E-mail results and profile tools to send results of quizzes to instructors
• Online help and support to assist with website usage and troubleshooting

For more information please contact your local Pearson Education sales representative or visit www.pearsoned.co.uk/sudarsanam
The first edition published in 2003 has been well received and numerous reviewers and users have commended its structure, scope, comprehensiveness and clarity of writing. They have also welcomed the focus on mergers and acquisitions (M & A) in Europe and the presentation of empirical evidence along with theory. The first edition has been translated into Chinese as was its predecessor, The Essence of Mergers and Acquisitions. Since its publication, the M & A market has undergone a number of interesting developments. The meltdown in 2000–2001 was followed, contrary to expectations, by a rapid resumption of M & A activity that surged to its peak in 2007. Private equity sponsored M & A was a major contributor to this surge and it was aided enormously by the torrent of liquidity in credit markets. The credit crunch of 2007 stopped this surge in its tracks and the deepening credit crisis and the drying up of liquidity brought this latest M & A wave to an end in 2008. This recent wave was much more global than before with emerging market firms spreading out their wings to become global players through acquisitions. This revised edition traces these developments.

The continuing Europa project of enlarging the European Union to bring within its fold more and more Nordic, Central and Eastern European, and Southern European states has resulted in an economic region that is now larger than the USA. This is reflected in the larger value of M & A deals involving companies in the EU than the value of US deals. At the time of writing the EU includes 27 member states with a population surpassing that of the US. An important legislative milestone in the EU was the approval of the Takeover Directive by the European Parliament in 2004. Since then the Directive has been incorporated into the UK domestic law and into the domestic laws of other member states. Regulation of takeovers in the EU now therefore derives from law, although in the UK the City Takeover Panel has retained its self-regulatory character.

Our understanding of the M & A process has grown thanks to new scholarship in different disciplines that influence the framework used in this book. In the last edition I described the merger waves that had taken place in the US, the UK and continental Europe over the previous century or more. Several scholars have attempted to develop new theories of merger waves and test them with empirical data. The results, while answering some questions, still leave others, about the timing of mergers and the relationship between industry merger waves and aggregate merger waves, unanswered. Nevertheless they allow us to think of more comprehensive theories of merger waves. Both theoretical and empirical research on the structure and evolution of corporate governance provides new insights into the relationship between corporate governance and takeovers. There is now much greater empirical evidence on the impact of executive compensation contracts on manager’s risk incentives in undertaking M & A. There is also much more evidence on the consequences of good or bad acquisitions for managerial incentives and jobs.

An exciting new development is the behavioural and psychological perspective on CEO’s and other top managers’ motivations and incentives for making high risk and value-destroying acquisitions. Clinical psychology applied to organizations provides us with more insights into M & A transactions and their value outcomes that cannot be explained on the basis of rational economic models alone. More recent research in the areas of corporate divestitures, leveraged buyouts, and the financing of acquisitions has given us a better understanding
Preface to the second edition

of the M & A process. Theoretical developments and empirical research in post-acquisition integration processes drawing from a range of disciplines concerned with individual, group and organizational behaviour provides new insights into the factors that can undo good acquisitions and make M & A more of a challenge.

In addition to drawing upon new theoretical and empirical research mentioned above, I have also used the opportunity of the revision to improve the exposition of the regulatory issues. I have covered more US antitrust and takeover regulations to provide a balanced comparative analysis of mergers in the US and Europe. In discussing bid strategies and defence strategies I have again enhanced the coverage of US laws, regulations and recorded transactions to achieve a better balance between the two regions.

Users of the previous edition have commented very favourably on the logic and cogency of the structure of the chapters built around the five-stage model. This structure is therefore retained. While the number of chapters has been kept at 24, the old chapter 6 on consolidating mergers has now been dropped and much of its content where still relevant is now included in Chapter 13. Chapter 2 now includes new merger wave theories and discusses the empirical evidence for them and its limitations. I have expanded discussion of game theory and real options as frameworks for explaining various M & A characteristics such as merger waves and serial acquisitions in Chapters 3 and 14. A new chapter, Chapter 12, provides the organizational, psychological and governance perspectives on M & A. Chapter 13 now deals with target selection and provides many practical analytical tools for identifying the right target/s to bid for. Chapter 14 now covers a wider range of valuation models with illustrations. Chapter 17 (antitrust regulation) and Chapter 18 (takeover regulation) have been updated and expanded to provide more in-depth coverage of the US and continental European laws and regulations. Chapter 20 (bid strategies) and Chapter 21 (defence strategies) have been similarly updated and expanded. Since the first edition, I have been working as a member of the UK Competition Commission (CC) and have sat on inquiries into the competition effects of mergers. This experience has deepened my understanding of not only antitrust issues in mergers but also how merger regulation works. In revising Chapter 17 on antitrust regulation I have been able to draw upon my experience as a regulator. The content of this chapter, however, in no way reflects the views or opinions or position of the CC except where they are explicitly acknowledged and cited. Chapter 21 (post-acquisition integration) now reflects the recent literature on the organizational, cultural and sociological aspects of integration and Chapter 22 similarly draws upon the insights provided by new research on organizational learning.

In addition to updating the relevant information in various chapters, I have also sought to improve the clarity of presentation and its reader-friendliness. Several new illustrations and case studies have been included while some have been retained from the previous edition because of their continued value to the reader. I have also used figures and diagrams to present the ideas in the book in a more accessible way.

The book is primarily intended for MBA and Master’s level programmes in management as well as advanced undergraduate courses in industrial organization, finance, business strategy, and corporate governance, plus those preparing for professional exams. However, the structure is modular and different chapters from the book can be used on courses that include substantial discussion of M & A such as courses on strategic management, industrial economics, finance and regulation. On such courses some overview of M & A (e.g. Chapters 1 and 3) may be combined with more specific focus on the strategic, economic, finance and regulatory aspects of M & A. I have used this book on M & A courses on MBA, executive MBA and Master’s in Finance programmes by following the modular approach. I have also used parts of the book on executive programmes.
The book is accompanied by a web-based source of supplementary teaching resources for lecturers using this book as the main text book. These resources include answers to review questions and questions for the end-of chapter cases. Powerpoint slides for the chapters are also available. References to additional cases from sources such as the Harvard Business School with a brief description of the main issues dealt with in those cases are also provided. How such extended cases complement the material in the book is also indicated. Lecturers who wish to supplement the illustrations and short cases in the chapters with longer cases may therefore be able to locate such cases easily. Hints on how students can be taught to learn about the practical aspects of M & A through, for example, simulated games are provided. There is a similar web-based supplementary resource bank for students with answers to selected review questions and additional sources of information on M & A deals.

Sudi Sudarsanam
This book builds on and extends the author’s previous title *The Essence of Mergers and Acquisitions* (Prentice Hall International, 1995). This title has been translated into Spanish, Polish, Chinese, Indonesian and Thai. Since that book was published, we have experienced perhaps the most sweeping merger wave in history. At the peak of the wave in 1999, the value of mergers and acquisitions in the US alone was about $2 trillions (where a trillion is equal to $10^{12}$). Europe similarly witnessed historically unprecedented levels of mergers and acquisitions reaching a peak of $1.5$ trillions in 1999. Asian countries have also experienced high levels of merger activity. Since the publication of the *Essence* book, the merger phenomenon has also been examined by scholars extensively and our understanding of the causes and consequences has advanced as a result.

Mergers and acquisitions (M & A) are undertaken by companies to achieve certain strategic and financial objectives. They involve the bringing together of two organizations with often disparate corporate personalities, cultures and value systems. Success of mergers may, therefore, depend on how well the organizations are integrated. There are a variety of stakeholders in the merging companies who have an interest in the success of mergers. Shareholders and managers are two of the most important stakeholders, but others include employees, consumers, local communities and the economy at large. Mergers can have anti-competitive implications, and hence in many countries they attract rigorous antitrust scrutiny.

One of the most puzzling aspects of the merger phenomenon is the widespread perception that mergers and acquisitions do not create value for the stakeholders and in fact destroy value. If so, given the stupendous scale of the investment that mergers represent and the losses to stakeholders, including possible welfare losses to the community as a whole, we need a serious investigation of the reasons for such failure. In some cases, the feverish atmosphere, the inexorable momentum and thrill of the chase of a hostile bid may drive managers to foolish excess in the bid premium they pay. The causes of failure may, in other cases, stem from the fragmented perspective that managers and other players in the acquisition game have of the M & A process. The book’s central focus, reflected in the title, is on the challenges to the corporate strategy of using mergers and acquisitions as an instrument to create shareholder value. Challenges mean both threats and opportunities. This book is about both.

**What is the approach?**

The book regards M & A as a process, rather than as a transaction, which requires insights from a number of disciplines to understand and effectively carry out. It considers that this process is a multi-stage one and that a holistic view of the process is necessary to appreciate the inter-stage links and develop effective value creating M & A strategies. To develop this holistic view, the book draws upon multiple perspectives developed by scholars in different disciplines. The book emphasizes critical examination and empirical validation of the predictions and prescriptions from these perspectives. It seeks to signpost risks and potential problems and improve the odds of successful M & A. Because of the increasing importance of M & A in
individual countries, in regions and across countries, the book deals with the above issues from an international perspective. The book seeks to provide a balanced treatment of M & A drawing upon the conceptual, empirical and practitioner perspectives.

The specific themes and structure of the book

The book consists of four parts, in addition to the Introduction to the broad themes of the book:

- **Part 1** provides an overview of M & A, a five-stage model of the M & A process, historic overview of merger waves, five different but complementary perspectives on mergers and assessment of the success of mergers in the US and Europe.

- **Part 2** deals with stages 1 and 2 of the five-stage model – the framework for competitive strategies and the place of M & A in those strategies, the different types of M & A, their value creation potential, the empirical evidence on value creation and the risks in different acquisition types. Part 2 draws on evolving paradigms such as game theory, shareholder value management, resource-based view of competition, network externalities, real options and change management. It incorporates the recently revised perspectives on several established paradigms, including corporate governance, modern industrial revolution, vertical integration, antitrust regulation and conglomerate diversification. Part 2 is also concerned with corporate restructuring through divestitures, and leveraged and management buy-outs. It discusses strategic alliances as an alternative to M & A and also the issues involved in how firms organize themselves for acquisitions.

- **Part 3** deals with stage 3 of the M & A process model – fundamentals of M & A deal structuring and negotiation, target valuation models, accounting rules, paying for the acquisition, antitrust and takeover regulations, the role of advisers, bid strategies and tactics, and defences against hostile takeover bids.

- **Part 4** of the book deals with the fourth and fifth stages of the M & A process model, the organizational and human aspects of acquisitions, the organizational challenge of change management and creating organizational processes and systems to ensure organizational learning about M & A.

- The book concludes by identifying factors that contribute to acquisition failure and those that increase the odds of acquisition success.

- In each part, the book covers M & A in North America and Europe, the two most active M & A markets in the last two decades.

The style of the book is to a large extent non-technical, and the accent is on the practical aspects of mergers and acquisitions. This practical orientation is strengthened by the copious use of illustrative examples from actual acquisitions and mergers carried out in the last few years. Quantitative areas of the subject such as valuation are explained with worked examples. To increase reader friendliness, complex information, such as reviews of empirical studies and regulatory rules, is presented in tables. Major points and conclusions are presented as bullet points to focus the reader’s attention. Technical issues such as empirical methodology are located in appendices to chapters. Where necessary, graphics are used to highlight complex information and facilitate reader access. At the end of each chapter the implications for the practice of M & A are drawn and presented as bullet points. A companion website to help readers and instructors with additional discussion material and references to case study material will be set up.
Target readership

Both the *Essence* title and this book have evolved out of a specialist MBA elective course on Mergers, Acquisitions and Divestments (MAD) which I have been teaching at the Cranfield School of Management in the UK and had previously taught at City University (now Cass) Business School, London. MAD is generally one of the most popular electives on the MBA menu. The book is intended to be used by MBA students of mergers and acquisitions. At the MBA level, the book may be used in courses in corporate finance, business strategy, industrial economics, corporate restructuring, organizational change and corporate governance. It may also be used in similar courses at the undergraduate level and by students preparing for professional examination bodies, such as the Stock Exchange and the Association of Corporate Treasurers. It will be of use to managers, investment bankers and other practitioners in corporate finance, strategy, organizational change and law looking for a rigorous integration of the conceptual, empirical and practical aspects of M & A as well as a holistic view of the M & A process. I have used different parts of the book on executive training courses on M & A or specific aspects of M & A such as financing and negotiation.

*Sudi Sudarsanam*
It has been a long and arduous task to revise this book for its second edition and in the process I have received much support from friends and colleagues, which lightened the burden. The very favourable response to my first book, *The Essence of Mergers and Acquisitions*, and the first edition of this book, upon whose foundations rests the current revision, encouraged me to prepare the revised edition. With the help and cooperation of Isabella Barnard, my secretary at Cranfield School of Management, I was able to gather hundreds of journal articles, upon which I have drawn. She also helped with the final preparation of the manuscript. I received further data collection help from Dzung Nguyen and Tim Broadhurst, my doctoral students both at Cranfield School of Management. I would very much like to thank the staff at the Cranfield School of Management library, in particular Mary Betts-Gray, for the help they have provided in collecting the material for the book. Part of the work for the revision was completed while I was visiting Santa Clara University in California in 2008 and 2009. I wish to thank Professor Sanjiv Das, Chair of the Finance Department at the Leavey School of Business there and Professor Meir Statman for facilitating my visit. I wish to thank Nandhini and her husband Radhakrishnan for providing me with a ‘home away from home’ during that time and making the writing of this book a less daunting task. My tedium in writing the book was many times relieved by the delights of watching their baby daughter Ananya grow.

Professor Hersh Shefrin of the Leavey School of Business, a world authority on behavioural finance, kindly spared his time to comment on the psychological perspectives on M & A in Chapter 12. Professor Richard Taffler of Edinburgh University read parts of the manuscript relating to the same aspects of M & A and I benefited from his suggestions. Among my colleagues at Cranfield, I wish to thank Dr Tarik Diouchi for his comments on parts of the manuscript, especially those relating to real options. Dr Paul Guest offered suggestions, based on his use of the first edition on his courses, to improve the book. Leonidas Barbopoulos of St. Andrews University in Scotland read large parts of the book and updated me on some of the more recent literature in different areas.

Professor Scott Moeller, Director of the Mergers & Acquisitions Research Centre at Cass Business School in London, having used the first edition on his M & A courses, made numerous suggestions for improvement, which I have taken on board in revising the text. Professor Luc Renneboog of Tilburg University reviewed the first edition for *European Financial Management* and his suggestions have enhanced the presentation in the new edition and led to enlarged coverage of topics like valuation models and real options. Russell Sparkes, reviewing the last edition for *Professional Investor*, suggested more coverage of corporate governance. The revised edition provides more detailed discussions of the impact on M & A of corporate governance in both bidders and targets in various chapters including Chapter 12. I took heart from the highly complimentary anonymous reviewers of the first edition, who made excellent suggestions for its improvement. I hope that I have incorporated most of these.

I received numerous and substantive comments on the first edition of this book and have sharpened the intellectual rigour and focus of the second edition in the light of those comments. Among those that provided the comments are:

- Professor Colin Mayer of the Said Business School at Oxford University;
- Professor Henri Servaes of the London Business School;
Authors' acknowledgements

- Professors Georges Selim and Mez Lasfer of the Cass Business School at City University London;
- Professor Nick Travlos of the ALBA Graduate Business School, Athens, Greece;
- Professor Nikhil Varaiya of the San Diego State University;
- Professor Tom Berglund of the Swedish School of Economics, Helsinki;
- Professor Rezaul Kabir of Tilburg University;
- Professor Raghu Rau of Purdue University;
- Professor Jay Dahya of Baruch College at City University, New York;
- Professor Arie Melnik, Haifa University, Israel; and
- Dr Dimitri Kyriazis of the University of Piraeus, Athens.

I owe special thanks to Professor Alfred Kenyon, formerly of Cass Business School, London. He read the manuscript of the first edition with a great deal of enthusiasm and zest and came forward with very incisive comments. His combative, but good-natured, arguments about my presentation of the material concerning corporate strategy models and their implications for mergers and acquisitions not only made me think more critically about the issues he raised but also renewed my faith in the book and its usefulness. As a former corporate treasurer of Plessey Plc, Alfred combined his practical insights with a robustly conceptual approach. Sadly, Alfred passed away after the publication of the first edition and the revised edition is the poorer for the loss of his wise and perceptive comments. I dedicate this edition to his memory.

I have used the previous edition in teaching courses on M & A on full time MBA programmes, executive MBA programmes, executive programmes and Masters in Finance programmes at Cranfield School of Management, Santa Clara University in California, ALBA Graduate Business School in Greece, the Management Centre, University of Innsbruck in Austria and the University of Szczecin in Poland. The questions my students raised about the various aspects of M & A have led me to think more deeply about them and the revised edition has benefited from such a reflection.

Above all, I wish to thank my wife Padhma for her continued support and endurance of my pre-occupation with writing this edition.

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text

**The Financial Times**

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CHAPTER 1

Introduction

Mergers and acquisitions, by which two companies are combined to achieve certain strategic and business objectives, are transactions of great significance, not only to the companies themselves but also to many other constituencies, such as workers, managers, competitors, communities and the economy. Their success or failure has enormous consequences for shareholders and lenders as well as the above constituencies. Companies invest billions of dollars in making acquisitions. Mergers and acquisitions (M&A) have happened in history in the last 110 years or more in waves. In the 1990s wave the value of M&A deals in the US rose from a mere $200bn in 1992 to $1.75 trillions (where a trillion is equal to $10^{12}$) in 1999 before the market crashed. Some of the largest deals in history were done during that period. America Online (AOL) acquired Time Warner (TW) for about $165bn in early 2000. But two years later AOL had to write off nearly $60bn of the acquisition cost in goodwill write-down and restructuring charges. Goodwill is one of the intangible assets a firm acquires when it buys another company. The merger wave in the new millennium peaked in 2007 at $1.2 trillions.

Europe experienced a merger wave no less spectacular in its magnitude than that on the other side of the Atlantic. The value of M&A deals in Europe at the height of the merger boom in 1999 was nearly $1.5 trillions. The largest acquisition in European corporate history was the UK mobile telephone company Vodafone’s hostile acquisition of the German telecom company Mannesmann in 1999 for over $150bn. The new millennium witnessed a stupendous wave in the European Union, peaking in 2007 at $1.2 trillions and matching the US wave of the same period.

Two years after acquiring Mannesmann, Vodafone wrote off several billion dollars to take account of impaired goodwill. There were several multi-billion dollar deals during the 1990s boom. With the meltdown in the M&A market and the stock market crash in 2000–2001, acquirers in many of these deals suffered enormous losses. Shareholders of these acquirers have suffered stupendous losses, not only from the stock market crash but also from the precipitous fall in the value of these acquisitions. The stock market crash of 2008 is also likely to have wiped off billions of dollars of value from the deals made before the crash.

Shareholders may lose their investment because of the imprudent acquisitions made by their companies. Acquiring companies are often motivated by the need to make efficiency savings in production and other activities. These are often achieved at considerable cost to workers, in the form of job losses, and to communities, in the form of terminated economic activity that plants and factories being shut down represent.
Shareholder wealth gains are usually measured by abnormal returns, i.e. returns in excess of an appropriate benchmark return. An extensive review of the value-creating performance of acquisitions reported in numerous studies from the US, the UK and continental European countries provides clear evidence that shareholders of acquirers experience wealth losses on average or, at best, break even. On the other hand, shareholders of target companies are better off, with abnormal returns in the order of 20% to over 43%. The poor wealth experience of acquirers is common to many countries. In many of the studies there is a sharp deterioration in acquirer performance several years after deal completion.

Evidence from management surveys, reviewed in Chapter 22, confirms the view from the large-sample statistical studies that a high proportion, if not the majority, of acquisitions fail to deliver their objectives. Mergers and acquisitions more often destroy, rather than enhance, value for the acquirer shareholders. The odds of positive and significant value creation for acquirer shareholders may even be less than 50%, which is what one would get with the toss of a fair coin. Thus M & A transactions are high-risk corporate transactions. The cost of failure is egregious when one considers the value of M & A transactions, especially during merger waves, as noted above.

However, one striking aspect of the post-acquisition performance is that there is some variation in acquirer and target shareholder wealth performance across merger types. In the US, tender offers, i.e. offers to buy shares made directly to the target company shareholders, often without the support of the target management, generate more wealth for the acquirer shareholders than mergers made with management support. In the UK, hostile acquisitions generate larger wealth gains than friendly mergers. Relatively small acquisitions create more value than large acquisitions. These patterns suggest that certain types of acquisitions are more successful than others, and the transactional characteristics of an acquisition influence the performance outcome.

The more detailed literature review in Chapter 16 on payment currencies in acquisitions provides further evidence that deal structure makes a difference to value creation. Cash-financed acquisitions create more value than stock-for-stock acquisitions. Thus choice of deal type or payment currency has a significant effect on wealth outcomes for shareholders. This points to the risk attached to inappropriate deal structures, and the need for acquirers to choose the deal structure very carefully.

**Can we identify the sources of failure?**

The evidence presented above paints a rather unflattering picture of acquisitions, and raises important questions about the reasons for acquisition failure. To answer these questions we need a good understanding of the M & A process and its various stages. We need to understand the interconnectedness of these stages, and how weaknesses in prosecuting one stage can feed into the subsequent stages and erode the chances of overall success. We need to understand the motivations of different players, their expectations and their payoffs to determine their influence on the outcome of acquisitions. We need to understand not only the economic and strategic logic of acquisitions but also the organizational context of their conception and implementation. Above all, we need to avoid fragmented perspectives on different stages of M & A that regard each stage as the sole determinant of success or failure. There is often a ‘disconnect’ between the different stages of the M & A process, and managers ‘lose the plot’ about what the merger is about and how it is to be executed. We need an understanding of the
Stage 1: How good is the corporate strategy development process?

M & A is a means to an end, and is an instrument for achieving the objectives of corporate and business strategies. Business strategy is concerned with ways of achieving, maintaining or enhancing competitive advantage in product markets. Corporate strategy is concerned with ways of optimizing the portfolio of businesses that a firm currently owns, and with how this portfolio can be changed to serve the interests of the corporation’s stakeholders. M & A can serve the objectives of both corporate and business strategies, but M & A is only one of several instruments. The effectiveness of M & A in achieving these objectives depends on the conceptual and empirical validity of the models upon which corporate strategy is based. Given an economic and regulatory environment, and the process and systems in merging organizations, to define the limits of success. Such an understanding stems from systematic organizational learning built into the acquisition process.

Mergers, acquisitions, takeovers and buyouts

The terms ‘merger’, ‘acquisition’, ‘buyout’ and ‘takeover’ are all part of the mergers and acquisitions parlance. In a merger, the corporations come together to combine and share their resources to achieve common objectives. The shareholders of the combining firms often remain as joint owners of the combined entity. An acquisition resembles more of an arm’s-length deal, with one firm purchasing the assets or shares of another, and with the acquired firm’s shareholders ceasing to be owners of that firm. In a merger a new entity may be formed subsuming the merging firms, whereas in an acquisition the acquired firm becomes the subsidiary of the acquirer. A buyout is acquisition of a company or one of its component businesses, and generally implies that the acquirer is a group of investors, including specialist private equity firms and managers of the business being bought.

A ‘takeover’ is similar to an acquisition, and also implies that the acquirer is much larger than the acquired. Where the acquired firm is larger than the acquirer, the acquisition is referred to as a ‘reverse takeover’. Although the terms ‘merger’ and ‘acquisition’ are often used interchangeably, they have precise connotations in certain contexts, such as when acquirers choose which accounting rules to apply in consolidating the accounts of the two firms involved. While the distinction is important for specific contexts, we shall, in general, use the terms interchangeably. We provide precise definitions of these different types of M & A in later chapters.

The five-stage (5-S) model

We divide the M & A process into five stages:

- corporate strategy development;
- organizing for acquisitions;
- deal structuring and negotiation;
- post-acquisition integration; and
- post-acquisition audit and organizational learning.

This model is shown in Figure 1.1. In this chapter we outline the important aspects of each of these stages and their links. The rest of the book is devoted to elaborating on these aspects.
inappropriate corporate strategy model, M & A is likely to fail to serve the interests of the stakeholders, e.g. unrelated diversification for which the company brings no parenting advantage or the overhyped business to consumer (B2C) model of the dotcom era. With an unsustainable business strategy model M & A is likely to fail to deliver sustainable competitive advantage, e.g. a strategy that seeks easily replicable sources of competitive advantage.

Corporate strategy analysis has evolved in recent years through several paradigms – industry structure-driven strategy, competition among strategic groups, competence or resource-based competition, etc. Under the industrial organization model of competition firms choose cost leadership or product differentiation within narrow segments or broad segments (the range of focus), but in general they respond to Porter’s five forces – current rivalry, threat of entry of new competitors, threat of substitutes, buyer power, and seller power. Under this model, firms make acquisitions to gain market power, gain economies of scale and scope or internalize vertically linked operations to save on the cost of dealing with markets, thus adding further cost savings.

In recent years the resource-based view of competition has gained ground. The resource-based view is a conceptual framework for understanding firm-level growth, using resources as the basic building blocks. These resources may be financial, human, intangible, physical, organizational or technological. How a firm’s management conceptualizes its resource base will define its strategy for growth. Competitive advantage is now regarded as deriving from unique and idiosyncratic organizational resources and capabilities rather than from industry and market factors. Sustainable competitive advantage grows out of those valuable, rent-generating capabilities that cannot be easily imitated or substituted. Some members of an organization may be unaware which resources give it its unique competitive advantage. The resources and capabilities that give a firm its distinct competitive advantage are also known as its core
competences, postulated by Prahalad and Hamel as the source of sustainable competitive advantage. These are embedded within organizational routines and cultures, i.e. ‘our way of doing things’, and remain tacit.

Acquisitions may be interpreted within the resource-based model as a search for partners with complementary resources and capabilities, which can be leveraged with those of the acquirer to the enhanced competitive advantage of both firms. This model can also explain different types of acquisitions – related and unrelated or conglomerate. The resource-based view of acquisitions raises important issues that may define the riskiness of those acquisitions. The acquiring firm may not be aware what its resources and capabilities are. It will be even less aware of the resources and capabilities of its intended merger partner. There will be further uncertainty about how complementary these capabilities are. Thus corporate strategy based on exploitation of resources, and acquisition strategy based on exploiting complementary resources, may run the risk of being based on incomplete knowledge. Traditional due diligence is unlikely to provide a reliable audit of the two firms’ resources and capabilities and how they can leverage one another.

The tacit nature of resources and capabilities also means that it is difficult to quantify and value the benefits of the competitive advantage that they confer. Thus valuation may be seriously flawed. Post-acquisition integration of the complementary resources and capabilities is also a difficult exercise, since the related knowledge is tacit and embedded within the organizations. This difficulty raises the risk of integration failure. Acquirers can easily destroy the value of the acquired firm by attempting to gain non-existent synergies. Moreover, acquiring firms should pay at least as much attention to issues of cultural fit and organization dynamics during the pre-merger search and due diligence process as they do to issues of strategic fit and deal structuring.

Our review of acquisition performance in Chapter 4 also provides some evidence that post-acquisition operating performance, stockholder value creation and even the capacity for innovation are less likely in unrelated mergers than in related ones. Growth by unrelated acquisitions has resulted in the conglomerate firms being valued at a discount (‘the conglomerate discount’) to the sum of the values of the individual businesses. ‘Unrelated diversification is a bad idea from the point of view of the bidding firm’s shareholders in the 1980s’.

In this view, poor acquisitions are a manifestation of an agency problem in the acquirers, which is lacking in effective corporate governance. Thus poor acquisitions may be a consequence of, or aggravated by, governance failure.
against the behavioural biases of CEOs that cause them to overvalue acquisitions and underestimate their risk.

Not all firms regard the M & A function as a separate function distinct from corporate development or corporate strategy. In some firms, however, separate M & A functions exist to provide an internal capability to undertake acquisitions on behalf of the firm as a whole or on behalf of business units that lack such a capability. A framework is developed in Chapter 12 for effective organization of the M & A function within acquisition-active firms. The aim of this framework is to develop the acquisition function as an important organizational capability and as a core competence of the firm. The various components of the acquisition function are described. Such a function serves as a repository of the firm’s M & A-related skills, knowledge and capabilities. It also serves as a gatekeeper for ideas for M & A generated by the different parts of the firm and by external advisers. In the context of specific acquisitions, the acquisition function provides the strategic direction, organizes the resources for teams responsible for deal making, directs those teams, and ensures that deal-making leads to acquisitions that deliver the firm’s strategic objectives and shareholder value. The salient characteristics of such an organization for acquisition are described and the obstacles to its creation highlighted. At this stage the firm lays down the criteria for potential targets of acquisitions consistent with the strategic objectives and value creation logic of the firm’s corporate strategy and business model. We present a template for target selection in Chapter 13.

Stage 3: What are the pitfalls in deal structuring and negotiation?

This stage consists of:

- valuing target companies, taking into account how the acquirer plans to leverage its own assets with those of the target;
- choice of advisers to the deal, such as investment bankers, lawyers, accountants, and environmental consultants;
- obtaining and evaluating as much intelligence as possible about the target from the target as well as from other sources;
- performing due diligence;
- determining the range of negotiation parameters, including the ‘walk-away’ price, negotiating warranties and indemnities;
- negotiating the positions of senior management of both firms in the post-merger dispensation;
- developing the appropriate bid and defence strategies and tactics within the parameters set by the relevant regulatory regime, etc.

The choice of advisers must be guided by the scope for conflicts of interests. Compensation contracts for advisers such as investment banks need to be drawn up, taking such conflicts into account, although custom and practice may influence the content of these contracts. Evidence shows that incentive contracts for investment banks may be perverse from the bidder’s point of view. Whether investment banks add value to deals, and how their expertise and reputation influence takeover bid outcomes and shareholder wealth, are important questions for corporate deal-makers.

Negotiations are conducted in an atmosphere where the bidder and the target may have private information that the other party does not have. Each can use this information advantage to gain favorable terms during negotiation. Effective techniques developed for negotiations under such circumstances must be followed to avoid buying ‘a lemon’. The negotiation team must be trained and experienced in these techniques. It must have the right balance
Stage 3: What are the pitfalls in deal structuring and negotiation?

among various relevant functions, top management and line management. It must operate with clear guidelines and well-defined limits so that overpayment is avoided.

The due diligence process is unlikely to provide a comprehensive view of the target firm, so the limits of due diligence must be borne in mind in assessing the information imbalance between buyer and seller. Traditionally, due diligence carried out by accountants and lawyers focused on accounting, tax, contractual liability issues, etc. However, in recent years the need to extend the scope of due diligence has become widely recognized. Due diligence is no longer just concerned with reducing risk. It should also contribute to effective management of the acquisition and the leveraging of the acquirer and acquired firms’ resources and capabilities so that the goals of the acquisition can be realized.

In order to be useful in valuing and negotiating deals, and in effectively integrating and managing the acquired businesses, due diligence needs to cover the following aspects of the target company:

- commercial, e.g. competitive position, customer relations, patents;
- operational, e.g. production technology, processes and systems;
- financial and tax, e.g. historical accounting information, potential tax liabilities;
- legal, e.g. onerous contracts, product or environmental liabilities;
- human resource, e.g. compensation, training, employee relations;
- organizational, e.g. structure, management style, power distribution;
- information systems, e.g. performance, cost, complexity, compatibility.

Due diligence teams must therefore draw upon a wide range of competences, both from within the acquirer and from external sources. Coordinating a team of such diverse specialists is itself a demanding and specialized function. The coordinator contributes to the setting up of the due diligence team and to its functioning by identifying the areas that need focusing and by keeping the team to a more rounded and holistic, rather than a functional, view of the acquisition. While mapping the areas that due diligence should focus on is relatively simple, gaining access to the required information is a formidable challenge.

In hostile deals, and in deals with companies listed on the stock market, due diligence is likely to be deficient. Due diligence may also be inadequate in assessing the intangible assets of the target firm. Where the strategic logic is driven by such intangibles, and value realization depends on the ability of the firms to leverage their intangible resources and capabilities, due diligence may be particularly weak. Absence of intelligence about the target should not induce complacency or encourage excessive optimism and overpayment in the hope of some mythical real options that may not exist. The sorry tale of the dotcom and telecom boom of the late 1990s provides a salutary reminder of the scope for such exuberant follies. Intangibles depend on people, teams and organizational networks. Thus due diligence needs to include a human resource component.

We have noted that payment currency and type of acquisition – merger or tender offer, or hostile or friendly – have significant consequences for shareholders. The tendency to be over-generous with stock for stock offers, driven by current high stock valuation during a market boom, has to be checked, and stock exchange ratios must be determined by realistic expectations of future growth as well as by stock market conditions. The huge write-offs of goodwill by companies such as Vodafone, AOL and Vivendi, following their late 1990s acquisitions, are very good examples of companies being over-generous with their stock, believing that because the acquisition was carried out through the use of shares the company had not incurred any cost or value erosion. Risk of inappropriate payment currency or excessive acquisition premium must be mitigated by a careful justification based on realistic expectations. There needs to be a mechanism to provide this ‘reality check’.
Stage 4: Don’t count the chickens yet! Post-acquisition integration

At this very important stage the objective is to put in place a merged organization that can deliver the strategic and value expectations that drove the merger in the first place. Integration has the characteristics of a change management programme, but here three types of change may be involved:

- change of the target firm;
- change of the acquiring firm; and
- change in the attitude and behaviour of both to accommodate coexistence or fusion of the two organizations.

The integration process also has to be viewed as a project, and the firm must have the necessary project management capabilities and a programme with well-defined goals, teams, communication plans, deadlines, performance benchmarks, reward for meeting deadlines and benchmarks, and sanctions for failure, etc. Such a methodical process can unearth problems and provide solutions so that integration achieves the strategic and value creation goals. A company must discover a pattern of change that builds momentum and promotes the shared vision, confidence, leadership capacity and capabilities that will make the next change possible.

Merging firms’ managers and employees may often be too distracted by the integration process to ‘keep an eye on the ball’, i.e. they may neglect to ‘mind the store’ and its customers, who then will turn to the firms’ competitors – perhaps for good. The integration time is also a time of great uncertainty for the managers and the workforce. They may be lured away by the competitors. Thus the integration programme must assuage staff anxieties but also develop a key personnel retention policy. ‘Executives from an acquired firm are an intrinsic component of the acquired firm’s resource base and their retention is an important determinant of post-acquisition performance. There are strong economic motives for initiating acquisitions but there are also strong social processes at work that may seriously affect the outcomes’.

One of the major problem areas in post-merger integration is the integration of the merging firms’ information systems (IS). This factor needs to be considered at the previous stages of the 5-S model. This is particularly important in mergers that seek to leverage each company’s information on customers, markets or processes with that of the other company, as in a banking and insurance merger or in the merger of banks, e.g. the merger of the two largest Swiss banks, Union Bank of Switzerland and Swiss Bank Corporation. The compatibility of IS must be considered just as thoroughly as any strategic, operational, organizational or political issue. IS integration in M & A depends on a mix of both technical and organizational factors. Organizational culture compatibility must also be considered alongside IS synergies.

Acquisitive firms must also consider post-merger integrative capabilities as a core competence. ‘GE Capital has been working to make acquisition a core capability’. Development of such core competence requires the setting up of robust systems and processes for integration. It also requires systems and processes that allow the lessons from past integration exercises to be archived, diffused and internalized by the acquirer’s organization. Each integration experience should not be lost in organizational amnesia so that history needs to repeat itself.
Stage 5: How did the merger go? Post-acquisition audit and organizational learning

This stage may often be neglected for several reasons:

- lack of organizational emphasis on learning;
- each deal considered so unique that past experience of mergers is deemed irrelevant;
- lack of centralized and ongoing function that is responsible for archiving the past and diffusion of learning;
- past learning not codified but resides in individuals’ experience, with those individuals being co-opted into deal-making teams when necessary;
- individuals’ past experience not systematically communicated but spread haphazardly through anecdotes and folklore within the organization;
- ‘the trail gone cold’ – difficult to trace the acquired or merged firm since it is now part of a larger strategic business unit or subsidiary, so lessons cannot be learnt.

The importance of organizational learning to the success of future acquisitions needs much greater recognition, given the high failure rate of acquisitions. Post-merger audit by internal auditors (IAs) can be acquisition specific as well as being part of an annual audit. IA has a significant role in ensuring organizational learning and its dissemination.

Objectives of the book

The various objectives of the book are as follows:

- To provide the reader with an overview of the subject of mergers and acquisitions.
- To provide a balanced treatment of M & A, drawing upon the conceptual, empirical and practitioner perspectives.
- To treat M & A as a process, rather than as a transaction, which requires insights from a number of disciplines to understand and carry out effectively.
- To describe the multi-stage character of M & A and underline the necessity for a holistic view of the process to appreciate the inter-stage links and develop effective value-creating M & A strategies.
- To provide a critical and empirical examination of the predictions and prescriptions from multiple perspectives on M & A.
- To identify the challenges to value realization through M & A as an instrument of corporate strategy.
- To signpost risks and potential problems and help improve the odds of successful M & A.

Outline of the book

The book is divided into four parts. Part One provides a historic overview of merger waves, five different but complementary perspectives on mergers, and an assessment of mergers based on numerous empirical studies from different countries. Chapter 2 traces the merger waves in the US, the UK and Europe. Chapter 3 sets out the different conceptual perspectives on M & A, providing the framework for the analysis of different M & A types in the rest of the book. These perspectives represent the economic, strategic, finance theory, managerial and
organizational perspectives. Chapter 4 assesses the empirical evidence for the success or failure of mergers from the perspectives of different stakeholders.

**Part Two** deals with Stages 1 and 2 of the five-stages model. It provides a framework for examining the rationale for different types of mergers and acquisitions driven by different corporate and business strategies, their value creation potential, empirical evidence on such value creation, and the obstacles to value creation. Part 2 draws on the perspectives set out in Chapter 3 and adds to the overall empirical evidence on M & A by examining the empirical evidence relating to different M & A types.

The different merger types discussed in Chapters 5 to 8 include horizontal and related mergers, vertically integrating mergers, conglomerate mergers and cross-border mergers. Chapter 9 presents strategic alliances as alternatives to mergers, and sets out the conditions under which they are preferable to mergers. Corporate divestitures involve buying and selling of businesses as a way of increasing corporate business focus. These are analyzed in Chapter 10. Other forms of corporate-refocusing transactions are also discussed by way of comparison with divestitures. Chapter 11 traces the evolution of leveraged buyouts (LBOs) as an alternative to traditional strategic acquisitions by corporations, and contrasts the sources of value in strategic acquisitions and LBOs. Chapter 12 discusses the acquisition decision-making process within acquiring companies, and how this process may affect the success of the acquisition. It provides a psychological and governance perspective on the acquisition decision process. It identifies the obstacles to firms organizing themselves effectively for successful acquisition. Chapter 13 sets out a framework for target selection based on the acquisition strategy and the desirable characteristics of target firms.

**Part Three** deals with Stage 3 of the 5-S model and is concerned with deal structuring and negotiation in Chapters 14 to 21. Chapter 14 provides a framework for valuing target companies in acquisitions. Accounting rules for business combinations are set out in Chapter 15. How acquisitions are paid for, and the factors influencing the choice of payment currency, are examined in Chapter 16. Antitrust regulation and takeover regulation and their implications for deal structuring and conduct of takeover bids are discussed in Chapters 17 and 18 respectively. The roles of different advisers in M & A transactions, and potential conflicts of interest between acquirers/targets and these advisers, are highlighted in Chapter 19. Chapters 20 and 21 describe the various bid strategies and takeover defence strategies to fend off hostile takeover bids.

**Part Four** is concerned with Stages 4 and 5 of the 5-S model. Chapter 22 deals with the organizational and human aspects of acquisitions, the organizational challenge of change management, and the challenges to effective post-acquisition integration. It provides survey evidence on these issues and identifies critical success factors. Chapter 23 emphasizes the need for performance audit and organizational learning. It identifies several impediments to learning, and suggests how these may be overcome. Chapter 24 summarizes the main themes of the book, identifies the challenges to successful M & A, and provides guidance to increase the odds of success.

Because of the increasing importance of M & A in individual countries, in regions and across countries, the book deals with the above issues from an international perspective. We seek to provide comparative analysis of the various issues in M & A in the US, continental Europe and the UK. Discussion of cross-border acquisitions enhances this international perspective. Each chapter contains numerous short illustrations to exemplify practice or to elucidate complex issues. An overview of each chapter and the implications for M & A practice are presented at the end of each chapter. Short cases are included in chapters to highlight the main issues covered by that chapter, and to facilitate class discussion. Review questions are also provided.
for further class discussion. Throughout, the emphasis is on enunciating the ideas, concepts and principles that underlie M & A and on making them relevant to both scholars and practitioners.

The book is accompanied by a website that provides additional learning material for students. It also includes additional teaching materials and aids to instructors using this book for their teaching. PowerPoint® slides and answers to review questions are included. Links to more extended case studies are provided, with suggestions as to how they can be best used to highlight the issues raised in different chapters.

Notes and references

Historic, conceptual and performance overview of mergers and acquisitions

As Chapter 1 argues, the mergers and acquisitions process needs to be viewed as a multi-stage process with each stage giving rise to distinct problems and challenges to companies undertaking such transactions. To understand the nature and sources of these problems we need a good understanding of the external context in which M & A take place. This context is not purely economic but includes political, sociological and technological contexts as well. The context is also ever-changing. Thus M & A could be regarded as a dynamic response to these changes. We need an understanding of the historical evolution of M & A and what factors have influenced the level and character of M & A activity in different time periods. In Chapter 2 we attempt a historical sweep of M & A activity over the past 120 years, and cover both the US and Europe.

Our five-stage model conceptualizes the M & A process as being driven by a variety of impulses, not all of them reducible to rational economic paradigms. Both economic and non-economic factors affect the M & A process. We need an understanding of the M & A process informed by insights drawn from a broad range of disciplines and intellectual constructs. Without this underpinning we shall be unable to identify, let alone resolve, the problems associated with M & A. We provide a broad overview of five different conceptual frameworks that can elucidate the M & A process in Chapter 3.

Before embarking upon a detailed analysis of the M & A process and its putative challenges, we have to establish whether there is any credible evidence of performance failure. Since, as we shall describe in later chapters, there is a range of stakeholders in the M & A process, we need an understanding of what failure means and how it is measured.
This means that success of M & A can be assessed using a variety of perspectives and models. In Chapter 4 we review the historical evidence of the success of mergers and acquisitions primarily from the shareholder value point of view, but also from a wider perspective.

When we complete this review – historical, conceptual and performance-based – we shall be ready to undertake the detailed analysis of the various stages of the M & A process that this book is concerned with.
CHAPTER

Historical overview of mergers and acquisitions activity

Objectives

At the end of this chapter, this reader should be able to understand:

- the nature of merger waves and the possible reasons for the waves;
- the occurrence of mergers in industry-specific clusters, and the reasons for such occurrence;
- rational economic and behavioural models of merger waves; and
- the implications of merger waves and industry clusters for corporate strategy through mergers and acquisitions.

Introduction

One of the striking aspects of mergers and acquisitions as a phenomenon is that they occur in bursts interspersed with relative inactivity. This pattern is called the wave pattern of mergers and has been observed in the US with perhaps the longest history of mergers for over 100 years, in the UK from the early 1960s and, more recently, in continental Europe. What triggers these waves and why they subside are not fully understood, although alternative theories of merger waves have been propounded and several possible contextual explanatory factors have been identified. Another, possibly related, aspect of the phenomenon of merger waves is that mergers often happen in industry clusters. Different industries undergo abnormally intense merger activity at different times. This pattern points to some industry-specific factors that may trigger the clusters.

In this chapter we first provide evidence of merger waves, and highlight the increasingly global nature of the waves of the 1980s, the 1990s and the more recent burst of mergers in the new millennium, drawing upon published analyses. We identify the characteristics of the time periods and examine whether they may have any causal links to the merger waves. We review recent studies that have put forward alternative theories of merger waves. These may be broadly divided into rational economic or neoclassical theories and behavioural theories. The neoclassical theories explain merger waves as being triggered by economic upheavals that cause differences in valuation of corporate assets and hence reallocation of these assets from low-valued to high-valued uses. Such upheavals may be due to technological innovations or
social or demographic changes, political changes etc. The behavioural theories posit that merger waves occur during times of stock market misvaluation of corporations. Managers of both acquirers and the targets of those acquisitions take advantage of such misvaluation and opportunistically engage in acquisitions. These alternative perspectives have implications for the timing of merger waves, what kinds of firms would be bought or sold to whom, how the acquisitions are paid for, and the value gains to those firms that engage in mergers at different stages of a merger wave.

Merger waves at the macro level hide another pattern, namely, industry-level waves or clusters. Arguably it is the industry-level clusters that aggregate to form waves at the macro level. We therefore focus also on the industry clustering of mergers, and review the empirical studies that have demonstrated a causal link between industry-specific developments and these clusters. We illustrate the impact of some of the environmental and industry-specific influences on takeover activity in certain industries.

The waves and clusters imply that firms implement their growth strategies or refocusing strategies fairly close on the heels of one another. Some of the firms may be first movers while others may be ‘me-too’ runners. This sequence of strategic moves and countermoves may raise or lower the risk and the chances of success of those moves. We elaborate on this and other implications of merger waves and industry clustering. Whether a firm is the first mover or a me-too runner influences the competitive outcomes of the restructuring game and the value gains to shareholders. There are competitive advantages and costs to being a first mover.

We review the empirical evidence for the macro-level wave theories and the industry shock theories. We defer discussion of the empirical evidence on the relative value gains of first movers and me-too players to Chapter 4, where evidence on the performance of buyers and sellers in M & A deals is presented.

The wave pattern of takeovers in the US

Several countries have experienced high levels of takeover activity followed by a slump over the past decades. The US has perhaps the longest history of substantial takeover activity, going back to the 1890s. Figure 2.1 shows the level of merger activity in terms of number of mergers from the 1890s to 1978. We can observe three distinct peaks in (1) 1899, (2) 1929 and (3) 1970. In terms of value of the mergers the last peak actually occurred in 1968 rather than 1970. The three waves are characterized respectively as

- merging for monopoly (1890–1905);
- merging for oligopoly (1920s);
- merging for growth (1960s).

The first wave

The first peak was reached in a period of economic expansion following a decade of economic stagnation. Industrial production grew by 100%. This wave involved an estimated 15% of all manufacturing assets and employees. An important characteristic of this merger wave was the simultaneous consolidation of producers within industries, thus qualifying for the description ‘horizontal consolidation’. Many of the giants of the US corporate world, such as General Electric, Eastman Kodak, American Can, American Tobacco and DuPont, were formed during the first wave through such consolidation. Approximately 71 important oligopolistic or near-competitive industries were converted into near monopolies by merger. More than
First three US merger waves, 1890–1978


1800 firms disappeared into consolidations. Of the 93 consolidations whose market shares could be traced, 72 controlled at least 40% market share and 42 controlled at least 70% of their industries. This massive restructuring of American industry remained intact for the next 50 years. For this reason, George Stigler described the first wave as merging for monopoly. Although the Sherman Act to control and prevent monopolies had come into effect in 1890, it had little immediate impact on the progress or ferocity of the first wave.

The second wave of the 1920s

This was a much smaller wave than the first in terms of its relative impact. In total it involved less than 10% of the economy’s assets rather than the first wave’s over 15%. It followed the 1903–4 market crash and the First World War. During that fallow period, and following the enormous public concern over the huge increase in the monopoly power of big business that resulted from the first wave, stronger antitrust enforcement was effected. In 1911, in a landmark judgement, the US Supreme Court ordered the break-up of Standard Oil, the Rockefeller empire formed during the first wave. Market monopolies were clearly established as illegal. Since the Sherman Act addressed only issues of substantial monopoly power, and generally did not apply to stock for stock mergers, the Clayton Act was passed in 1914 to 'arrest the
creation of trusts, conspiracies and monopolies in their incipiency and before consummation'. (We discuss the antitrust regulations in more detail in Chapter 17.)

The second wave accompanied economic growth and stock market boom. An estimated 12,000 firms disappeared during this period. For several reasons, the impact on the market structure of industries was much less dramatic than during the first wave. In industries previously dominated by one giant firm, the mergers led to the formation of strong number two companies. In the manufacturing sector most mergers resulted in small market share increases for the merging firms, or in vertical integration. Thus the second wave represented a move towards oligopolistic structure in many industries. It collapsed in 1929 with the stock market crash of that year, and in the following four years of worldwide depression many of the utility-holding companies formed during the recent wave collapsed into bankruptcy.

The third wave of the 1960s

The end of the Second World War saw a steady increase in takeover activity until the middle of the 1960s, when it spurted to an explosive level. In 1950 Congress passed the Celler-Kefauver Amendments to the Clayton Act of 1914 to tighten up the antimerger regime, but by the mid-1950s the third wave was well under way. The third wave also surpassed in duration the two preceding waves, lasting until 1971 (see Figure 2.1). The mergers during the third wave were not large, and did not involve large acquirers. They were mostly unrelated mergers, aimed at achieving growth through diversification into new product markets. Whether this bias towards diversification was the result of the more stringent antitrust regime that precluded market power-increasing horizontal or vertical mergers remains a matter of inconclusive debate.

Among the Fortune 500 companies, the percentage of firms in the unrelated business category increased from about 4% in 1949 to about 9% in 1964 before reaching over 21% in 1974. In the related-business category during the same period the percentage of firms increased from under 26% to just over 42%. These dramatic increases contrasted with the declines over the same period in the percentage of single businesses (from 42% to 14%) and dominant businesses (from 15% to 10%)\textsuperscript{4}. The third wave therefore resulted in a massive strategic shift in the business composition of US firms towards greater diversification. There was little impact on the market structure of individual industries, or on aggregate concentration by large firms\textsuperscript{5}. Thus the third wave merits the description ‘merging for growth’. Its end coincided with the great dislocation caused by the oil crisis induced by the Organization of Petroleum Exporting Countries (OPEC) in 1973 and the following inflationary spiral and economic slowdown.

Comparison of the three waves

The total numbers of mining and manufacturing acquisitions during the three waves were 2600 (1890–1905), 8000 (1920s) and 12,000 (1960s). In dollar (constant 1972 dollar) terms these acquisitions cost $6.4bn ($26bn), $12–15bn ($24–30bn) and $70bn ($69bn). Thus the 1960s wave was considerably bigger in value terms. On the other hand, in terms of assets acquired, as a percentage of total mining and manufacturing assets in the US, the 1890s wave was much more sweeping, with 15% of assets acquired compared with about 7–9% in the 1920s and 10% in the 1960s\textsuperscript{6}.

Gilson and Black identify four characteristics of the first three waves\textsuperscript{7}:

- Relatively few mergers had market monopolization as their goal. The first wave increased the market power of merging firms, but this declined in the following two waves.
All three occurred during sustained periods of economic prosperity and rapidly rising stock market levels, peaking almost with the stock market and then receding with the following economic recession.

Many mergers were simply ordinary business transactions among entrepreneurs seeking to exit an industry profitably through a merger or through being acquired.

Many mergers were accompanied or stimulated by massive changes in the economy’s infrastructure, such as railroad building or the advent of electricity (see below for further discussion of the impact of these exogenous factors).

The fourth, fifth and sixth waves of the 1980s, 1990s and the new millennium

The late 1970s witnessed a small revival of takeover activity, but this did not last long, owing to the second oil crisis in 1979 and the deep recession of the early 1980s. It was in the middle of the 1980s that there was a fresh surge of takeover activity leading to the fourth merger wave in US history. This wave in fact consists of two waves: acquisitions (Figure 2.2a) and divestitures (see Figure 2.2b). To provide a comparison of the stock market levels during the merger waves the Standard and Poor’s 500 index level is also shown. It is clear that merger waves seem to track the stock market level, either slightly leading or lagging the latter. We comment on this tracking below in the context of the merger wave theories.

The two types of corporate restructuring are very highly correlated, with a correlation coefficient of 0.93 (0.81) between number (value) of acquisitions and divestitures. Divestitures generally constitute about 21–129% of the acquisition activity during this period. The median is 63%. While divestitures in general rise and fall with acquisitions, in the years following the peak of the acquisition wave they tend to rise and stay high, for example in years 1989–92 and again in 2001–03. Thus many US corporations engage in simultaneous expansion and downsizing of their businesses, expanding those that offer scope for greater competitive advantage and exiting those in which their chances of gaining competitive advantage are limited, or their historic competitive advantage has been exhausted.

In contrast to the earlier periods, the period starting in the mid-1980s experienced an active market in corporate assets. Maksimovic and Phillips confirm this in their study of the plant level ownership changes through mergers and divestitures of partial and full segments by US corporations. Prior to 1984, asset divestitures represented a relatively flat percentage of plant reallocations, whereas after 1984 they rose and fell more in line with M & A. Many US companies not only made numerous acquisitions but also sold off some of their component businesses in a move towards increasing the focus of their business portfolio and restricting it to what they deemed were core businesses in which they judged themselves to have a core competence and competitive advantage. In this sense, these firms were reversing many of the diversifying acquisitions they had made during the conglomerate wave of the 1960s. Shleifer and Vishny describe the initial conglomerate expansion and subsequent return to the core businesses as a ‘round trip’. The fourth wave subsided after 1989 by number (1988 by value) and the fifth wave enveloped the US economy from 1993 to 2000.

The fourth wave was characterized by a number of new developments on the M & A scene:

- The emergence of hostile tender offers.
- Predatory bust-up takeovers in which a ‘predator’ or ‘raider’ mounted a bid for a diversified underperforming firm and after the acquisition dismantled the portfolio by selling off the various parts of the acquired company.
- A high level of divestiture activity by diversified firms in pursuit of a strategy to focus on their core businesses.
A more benign antitrust regime towards related mergers than during the 1960s and 1970s. Many of the divestitures following bust-up takeovers were sold to related acquirers. The emergence of private equity firms encouraging and facilitating leveraged buyouts (LBOs), management buyouts (MBOs) and going-private (from public company status to private company status) deals that relied on heavy debt relative to equity and growth in the sub-investment grade debt instruments called junk bonds to finance LBOs. The average size of the acquisitions dwarfing the corresponding size of deals in the 1960s.
The 1990s wave

The fifth wave of the 1990s to some extent continued the theme of focus on core competences as the source of competitive advantage. As can be seen in Figure 2.2a, the fifth wave is the mother of all waves so far, assuming truly tsunamic proportions. At its height in 1998, the value of the M & A deals was $1.6 trillions compared with the previous peak of $343bn in 1988 (both in 2007 $). The value of divestitures in 1999 was $439bn compared with the previous peak of $199bn in 1988. Figure 2.2b shows that the 1990s divestitures were far more numerous than in the 1980s. In terms of value the 1990s peak does not dominate the 2007 peak12.

The 1990s wave coincided with the re-emergence of the resource-based view of competitive strategy in the second half of the 1980s (see Chapter 3). Firms made acquisitions on the basis of the need to augment their resources and capabilities in order to enhance their competitive advantage. The 1990s saw the emergence of new technologies such as the Internet, cable television and satellite communication, which spawned new industries and firms with new technological capabilities. The fifth wave also was a period characterized by:

- shareholder value as a compelling imperative, and the emergence of shareholder activism with traditional institutional investors benchmarking corporate investment and financing decisions against shareholder value creation13;
- globalization of product, services and capital markets;
- new supranational trading blocs such as the Single Market of the European Union, the North Atlantic Free Trade Association (NAFTA), which includes the US, Canada and Mexico, and creation of the World Trade Organization, which lowered barriers to trade and capital mobility and increased the opportunities for corporate growth;
- government policy changes in the area of healthcare, deregulation of industries such as banking and utilities, and privatization of public sector enterprises;
- government policy changes in antitrust enforcement and defence procurement;
- restructuring of mature industries such as automobiles, banking and food;
- the convergence of technologies in voice, video and data transmission, leading to blurred boundaries among industries selling goods and services based on these technologies;
- consolidation of fragmented industries by financial buyers and strategic buyers; and
- continuation of the move towards core businesses or specialization started in the 1980s14.

Into the millennium

The great crash of the 1990s did not dampen the animal spirits of the takeover market for long. Soon takeover activity started its upward swing into a sixth wave that climaxed in 2007. This wave was much smaller than the 1990s wave but larger than the 1980s wave. The main drivers of this recent wave were the following:

- Private equity acquirers, who filled the void left by the strategic buyers, who had been bruised by the crash of the 1990s. This period, until 2007, saw a benevolent economic environment with enormous liquidity, low interest rates, and renewed incentives for leveraged buyouts (see Chapter 11 on private equity and leveraged buyouts).
- Hedge funds emerged as important players in the M & A market, often attacking firms making takeover bids and forcing them to drop their bids15.
- They also, along with other traditional mutual funds, became active shareholders, often mounting highly publicized attacks on corporate managements for their failure to follow strategies that would enhance shareholder value, e.g. divestitures and share buybacks.
Shareholder activism became a more important factor for corporate managements to consider in their acquisition and divestiture decisions.

An important development that might have a long-term impact on the level and nature of M & A deals was the passing of the Sarbanes-Oxley Act (SOX) in 2002 as a reaction to the scandals involving many acquisitive companies such as Worldcom, Tyco and Enron. The fraudulent and criminal shenanigans of the top managers of these companies, many of whom were convicted and imprisoned, gave rise to a strong legislative response in the form of SOX, which imposes more stringent corporate governance and disclosure rules on US-listed firms. It has increased the monitoring responsibilities of the board of directors, thereby seeking to constrain the excesses of deal-making during the dotcom bubble of the late 1990s. Whether boards will rise to the challenge and discharge their responsibilities effectively remains to be empirically verified.

Takeover activity in the European Union

The huge rise in takeover activity, including divestitures in the US during the 1980s and 1990s, was part of a global phenomenon, as evidenced by the experience of the European Union (EU) as a whole and, in particular, the UK, the second largest M & A market after the US. We survey the EU merger trends first, before focusing on the UK scene. The EU of 27 nation states of Europe is now the largest economic bloc in the world in terms of gross domestic product (GDP). In 2005 the GDP of the EU was over €11 trillion compared with over €10 trillion of the US.¹⁶

The EU member countries have experienced increasing levels of takeover activity since 1984, as shown in Figure 2.3a. For the sake of continuity of comparison we provide data for all 27 member states, even though many of them were not members of the EU for the entire period, 1984–2007. To preserve comparison with the US merger waves, the value of deals is stated in 2007 US$. We can identify two waves, a small one during 1986–1992 and a vastly bigger one between 1996 and 2002. In the first wave the value of mergers rose from $50bn in 1986 to $147bn in 1989 before falling to $52bn in 1993. It then rose, in the second wave, to $1231bn in 1999 before a precipitous decline to just $237bn in 2002. Thus the two recent merger waves in the EU parallel those of the same period in the US. While the scale of the 1980s wave is much smaller than its US counterpart, the 1990s waves in the two regions are much closer in intensity.

In Figure 2.3a for comparison we show the European stock market level proxied by the Financial Times Stock Exchange Western European Index (FTSEWE) during 1984–2007. There is a striking parallel between the stock market movement and the merger waves in terms of value of deals. We return to this parallel in our discussion below of theories of merger waves.

Divestiture levels in the EU have shown much steadier growth in number, as shown in Figure 2.3b. The total value of divestitures increased from $4bn in 1985 to $115bn in 1990. After falling from this peak, they reached the next peak in 2000 at $401bn before falling off to $219bn in 2001. Divestitures as a proportion of mergers and acquisitions range from 2% (in 1984) to 208% (in 1993), but are about 30–70% in most years. The median is 65%. This level is not dissimilar to that in the US (63%). The correlation between number (value) of acquisitions and divestitures is 0.92 (0.86). Divestitures play a similar role in corporate restructuring in both the EU and the US. In the EU they are, however, increasingly more important for companies in restructuring their business portfolios than in the early 1980s, driven by a more...
pronounced emphasis on shareholder value and the more competitive markets promoted by the EU. These trends have forced firms in the EU to operate their businesses more efficiently.

In the new millennium there is strong revival of merger and divestment activity up to 2007. Indeed, divestments show a much stronger upward trend than acquisitions. In terms of deal value, whereas acquisition levels are still below the peak reached in 1999 (see Figure 2.3b), divestitures have hit a greater peak in 2007 at $490bn. This pattern mirrors the US pattern of divestitures (see Figure 2.2b). It points to the merger and divestment activity in these two regions as being part of a much larger global merger wave.

Analysis of the distribution of takeover activity in the EU further shows that during the 1990s purely domestic M & A, i.e. transactions involving two or more firms registered in the same member state, accounted for the bulk of the activity. As shown in Table 2.1, this proportion ranges from 65% in 1994 to 49% in 2007. Over the 17-year period there is a perceptible decline

Figure 2.3  (a) EU merger waves, 1984–2007; (b) EU divestiture waves, 1984–2007

All deals completed and acquirers hold > 50% of target share after transaction; only deals with transaction value disclosed included; for acquisition deals either target or acquirer is a EU firm. For divestitures deals, the target is a EU firm; EU = 27 current members plus Switzerland; deals categorized according to announcement year; deal value in 2007 US$. US Consumer Price Index – All Urban: All Items used to adjust for inflation.

Source: Thomson Reuters.
Table 2.1 Evolution of national, community and international M & A transactions in the EU (% of all transactions including divestitures)

<table>
<thead>
<tr>
<th>Year</th>
<th>National</th>
<th>Community</th>
<th>International EU target</th>
<th>International EU bidder</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>61.7</td>
<td>16.6</td>
<td>12.1</td>
<td>9.6</td>
<td>100</td>
</tr>
<tr>
<td>1992</td>
<td>63.6</td>
<td>14.7</td>
<td>13.3</td>
<td>8.4</td>
<td>100</td>
</tr>
<tr>
<td>1993</td>
<td>63.7</td>
<td>14.4</td>
<td>13.6</td>
<td>8.4</td>
<td>100</td>
</tr>
<tr>
<td>1994</td>
<td>65.3</td>
<td>11.9</td>
<td>12.6</td>
<td>10.2</td>
<td>100</td>
</tr>
<tr>
<td>1995</td>
<td>62.2</td>
<td>14.2</td>
<td>12.5</td>
<td>11.2</td>
<td>100</td>
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<tr>
<td>1996</td>
<td>61.6</td>
<td>13.8</td>
<td>12.8</td>
<td>11.7</td>
<td>100</td>
</tr>
<tr>
<td>1997</td>
<td>60.0</td>
<td>14.4</td>
<td>14.0</td>
<td>11.6</td>
<td>100</td>
</tr>
<tr>
<td>1998</td>
<td>59.2</td>
<td>13.0</td>
<td>14.9</td>
<td>12.9</td>
<td>100</td>
</tr>
<tr>
<td>1999</td>
<td>57.9</td>
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<td>11.5</td>
<td>14.7</td>
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</tr>
<tr>
<td>2000</td>
<td>54.9</td>
<td>18.9</td>
<td>10.1</td>
<td>16.2</td>
<td>100</td>
</tr>
<tr>
<td>2001</td>
<td>56.0</td>
<td>17.4</td>
<td>11.2</td>
<td>15.4</td>
<td>100</td>
</tr>
<tr>
<td>2002</td>
<td>59.3</td>
<td>16.4</td>
<td>12.3</td>
<td>12.0</td>
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</tr>
<tr>
<td>2003</td>
<td>57.4</td>
<td>16.0</td>
<td>14.9</td>
<td>11.7</td>
<td>100</td>
</tr>
<tr>
<td>2004</td>
<td>55.6</td>
<td>15.4</td>
<td>16.0</td>
<td>13.1</td>
<td>100</td>
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<tr>
<td>2005</td>
<td>53.3</td>
<td>16.8</td>
<td>16.3</td>
<td>13.6</td>
<td>100</td>
</tr>
<tr>
<td>2006</td>
<td>52.6</td>
<td>17.2</td>
<td>15.2</td>
<td>14.9</td>
<td>100</td>
</tr>
<tr>
<td>2007</td>
<td>49.0</td>
<td>18.1</td>
<td>16.4</td>
<td>16.5</td>
<td>100</td>
</tr>
</tbody>
</table>

All deals completed and acquirers hold > 50% of target share after transaction; only deals with transaction value disclosed included; EU = 27 current members plus Switzerland; deals categorized according to announcement year; in national transactions, both target and acquirer are in same country; in Community transactions, target and acquirer are in different EU countries. In international transactions, either target or acquirer is not in the EU.


in the proportion of national mergers, from about two-thirds to just under half of all M & A in the EU. Mergers of firms from different member states of the EU, the Community mergers, represent a more stable proportion, 12–19%. Similarly, non-EU international acquisitions of EU firms are also relatively stable, in the range 10–16%. By contrast, acquisitions of non-EU targets by EU firms increase from 8% in 1992 to 17% in 2007. International acquisitions including EU firms as either targets or as bidders grew from 22% in 1991 to nearly 33% in 2007.

The pattern of M & A activity suggests that, while takeover activity has increased within the EU, activity between the EU and the rest of the world has shown a more dramatic increase. This points to much greater globalization, but also to a more outward strategic thrust by EU firms. We discuss international and cross-border mergers and acquisitions in more detail in Chapter 9.

Main characteristics of the European merger waves

The late 1980s and the 1990s, which witnessed the two merger waves in the EU, were epochal and turbulent times in the history of the continent. This was a period of continual changes, with newer and ever more audacious (or foolhardy, according to Eurosceptics) initiatives being taken in the spheres of politics, economics and the social institutions to further European integration. Among them are the Single Market initiative, which came into effect in 1992, and the European Monetary Union project, which has ushered in monetary union among 12 out of 15 member states with the introduction of a single currency, the euro, from 1999. This was also the period when the Cold War ended, the Berlin Wall collapsed, and the countries of Central and Eastern Europe (CEE) started dismantling state control of their
takeover activity in the European Union

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economies and adopting free markets and private enterprise with the enthusiasm and passion of the newly converted. This paved the way for integration of the CEE countries and the Baltic states into the EU. From 15 member states in 2002 the EU has now expanded to 27.

These historic events were also accompanied by the spread of deregulation and privatization by member states to improve the competitiveness of the EU economies, including the Central and East European member states. Although stock markets have traditionally been less important as a source of funding for non-UK EU firms than in the US, the stock markets experienced prolonged bull phases. In the 1990s, and in the recent years of the new millennium, technological changes in information technology, telecommunications and biotechnology provided new growth opportunities, which EU firms sought to exploit through mergers and acquisitions. Utility firms such as Deutsche Telecom, France Telecom and Vivendi, and French and Italian banks, recently privatized or part privatized, played an important role in creating the merger wave of the 1990s through domestic, intra-EU and extra-EU mergers and acquisitions.

A milestone in the history of European M & A was reached in 2004 when the EU Parliament approved the 13th Company Law Directive, which regulates takeovers in the EU. This takeover directive, implemented by member states in 2006, recognizes the rights of shareholders to determine the outcome of takeovers and, in particular, takeovers resisted by a target firm’s incumbent management: that is, hostile takeovers. It lays down general principles and articles that would lower barriers to takeovers in the form of ownership structures that would impede hostile takeovers and the ability of incumbent managements to set up defences against such takeovers and pursue actions to frustrate them. The directive also provides for mandatory takeover bids triggered by an investor increasing its ownership above a critical threshold. This directive is indeed a momentous development, albeit born in the midst of controversy and, to a significant extent, compromised by various opt-out provisions. Its impact is yet to fully unfold (see Chapter 19 on takeover regulation in different countries).

In the 1990s companies such as Vivendi, originally a water and sewage utility in France, belied their history by taking to acquisitions, deal-making and diversification with breathtaking agility and panache. Financial services firms such as Deutsche Bank have dared to take on the Americans and barge their way into the bulge bracket of investment banks by acquiring targets such as Bankers Trust. Many EU firms, long accustomed to the comfort of their sheltered markets or state protection, were fearful of the winds of change, but others tasted the exhilaration of freedom borne by that wind. These forays were not always very successful, and in some cases such as Vivendi brought the acquirers as well as their top managers to their knees. This experience has not deterred EU firms from exploiting the growth opportunities opened up by globalization and high economic growth around the world until 2007 (see Table 2.1 above).

Takeover activity in major EU member states

Traditionally, the UK has stood out among all the EU member countries in terms of the intensity of M & A activity and its exposure to international M & A. In the period 1991–2001 the UK accounted for 31.4% of the EU’s M & A activity, although its share of the EU’s GDP was only 13%. In contrast Germany (16% and 28% respectively), France (14% and 18%), Italy (6% and 13%), Spain (5% and 7%) had much smaller shares of M & A activity and less than their share of EU’s GDP. This dominance of the UK has continued in more recent years, as shown in Table 2.2, which reports the number and value of M & A deals involving a firm in the named country as target. Italy and Netherlands experienced mergers of some very large financial services firms, such as the US$88bn merger of Intesa and San Paolo in January 2007,
Chapter 2 / Historical overview of mergers and acquisitions activity


The UK also has a much longer history of merger transactions, and shares many similarities with the US in terms of governmental laissez-faire attitude to takeovers, importance of the stock market as a source of corporate finance, corporate governance and ownership structure. In the areas of privatization, takeover regulation and economic liberalization the UK has been a pacesetter. As Europe’s prime centre for investment banking, the City of London plays a major role in influencing deal-making structures and in the financing of takeovers in Europe. For these reasons, we now focus on the historic M&A experience of the UK.

### Historical overview of takeover activity in the UK

Active merger movement in the UK can be traced to the 1960s, although two mini merger booms happened in the 1890s and the 1920s. Figure 2.4 presents the aggregate value of domestic takeovers and divestitures involving only UK companies from 1964 to 1992. There are clearly peaks of takeover activity in 1968, 1972 and 1989 in terms of value. When allowance is made for the inflationary increase in company values, the peaks in those three years are unmistakable. There is a striking parallel in the incidence and timing of the 1960s and 1980s waves in the US and the UK.

The first, second and third waves

There was very little takeover activity between 1945 and the late 1950s in the UK, a period of post-war reconstruction. It then picked up and accelerated into a wave in the second half of the 1960s. After hitting a peak in 1968, the wave receded, only to surge again in the early 1970s to hit a second peak in 1972. The third merger wave was in the period 1984–89. The nominal value of the mergers in 1968 was £1.95bn. This increased to £2.5bn in 1972 and reached a dizzying £27bn in 1989. The average deal values at these peaks were £2m, £2m and £20.4m. The peaks of 1968 and 1972 were of a similar scale. However, the average deal value in 1989 was ten times the average size of a deal in 1968 or 1972, and the total value of acquisitions, at

### Table 2.2 M&A deals in 2006 and 2007 in major EU states plus Switzerland

<table>
<thead>
<tr>
<th>Member state</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Value (US$bn)</td>
</tr>
<tr>
<td>UK</td>
<td>1247</td>
<td>269</td>
</tr>
<tr>
<td>Netherlands</td>
<td>250</td>
<td>14</td>
</tr>
<tr>
<td>Italy</td>
<td>282</td>
<td>54</td>
</tr>
<tr>
<td>Germany</td>
<td>699</td>
<td>79</td>
</tr>
<tr>
<td>France</td>
<td>731</td>
<td>113</td>
</tr>
<tr>
<td>Spain</td>
<td>432</td>
<td>71</td>
</tr>
<tr>
<td>Switzerland</td>
<td>140</td>
<td>15</td>
</tr>
<tr>
<td>Sweden</td>
<td>271</td>
<td>28</td>
</tr>
<tr>
<td>Finland</td>
<td>127</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: Mergers & Acquisitions, Table on M&A in major overseas markets outside the US, February 2008.
Historical overview of takeover activity in the UK

1990 prices, was twice the size of the earlier peaks. The second half of the 1980s thus represents a qualitatively different period from the earlier periods of high takeover activity.

**Main characteristics of the first two UK merger waves**

The first wave, peaking in 1968, was fuelled largely by horizontal mergers. This characteristic differentiates the UK wave from the US wave of the same period. The latter represented a shift from the monopolistic and oligopolistic mergers of the first two waves to conglomerate mergers. It was noted earlier that one of the possible reasons for this shift was a more rigorous enforcement of the antitrust rules following the Celler–Kefauver Act of 1950. The 1960s’ wave in the UK is intriguing, since it followed closely the passing of the Monopolies and Mergers Act and the creation of the Monopolies and Mergers Commission (MMC) to enforce that Act in 1965. While the incipient nature of the antitrust regime might explain the unchecked incidence of horizontal mergers, there is an alternative reason for the paradox.

Under the Labour government of 1964 a new industrial policy was adopted to strengthen UK companies into ‘national champions’ that could take on competitors on world markets. The Industrial Reorganization Corporation (IRC) was the newly created instrument for bringing about this transformation. The IRC actively promoted and midwifed the merger of firms in the same lines of business\(^\text{21}\). The mergers sponsored by the IRC generally escaped antitrust scrutiny by the MMC\(^\text{22}\). Thus, during the first merger wave, the UK was ‘hunting with the hounds and running with the hares’, which may explain the paradox of a new antitrust regime accompanied by a massive horizontal merger boom. This shows how government industrial policy dictated merger activity in the past.

The second wave, which peaked in 1972, was also characterized by horizontal mergers but on a slightly smaller scale. There was also a greater incidence of conglomerate mergers. While horizontal mergers accounted for 89% of assets involved in mergers considered by the

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**Figure 2.4** UK merger waves during 1964–92

Mergers Panel of the MMC during 1965–69, in the following wave, 1970–74, the corresponding figure was 65%. Diversifying mergers during the first wave accounted for 7% by value of the same merger sample, but they accounted for 27% during the second wave. Thus there is a perceptible shift towards diversifying mergers in the second wave. The first merger wave may also have contributed to an increase in market concentration and aggregate concentration in the UK, although the relation between merger activity and market concentration is not empirically conclusive. Despite a large proportion of the second wave mergers being horizontal, their impact on merging firms’ market power was very marginal.

Main characteristics of the 1980s wave

As noted earlier, this wave was of tidal proportions compared with the previous two. As in the US, this wave coincided with a stock market bull run from the recession of 1980–81 to the market crash in 1987. The merger boom did not screech to an immediate halt and, carried by momentum, peaked only in 1989. The 1980s wave enveloped massive restructuring not only in the manufacturing industries but also in the financial services sector.

The Big Bang deregulation of the financial services sector in the City of London heralded the arrival of US investment banks, which brought not only their huge capital-raising capabilities but also their investment banking expertise and techniques in the areas of mergers and acquisitions advisory work, corporate restructuring, risk management, securities trading and stockbroking. The impact of the Big Bang on the old City of London firms was little short of cataclysmic, with most of the British merchant banks, brokerage houses and securities firms being systematically swallowed up, initially by American and subsequently by continental European companies. The City of London (‘the City’), offering an immensely attractive venue for foreign banks to display their investment banking prowess, represents ‘Wimbledonization’.

The expertise in hostile takeover tactics and defences was transplanted to the City by the newly arrived American investment banks, leading to more aggressive hostile bids than in the past, although hostile bids had been part of the UK scene from the late 1960s. Some of the predatory tactics of the US raiders were also tried in the UK. New financing techniques, such as highly leveraged buyouts (LBOs), were also imported from the US into the UK takeover scene, although on a smaller scale. While the predators were on the prowl, many incumbent managements of their current or potential targets scrambled and unscrambled their businesses as a defence against these raiders.

The UK corporations and institutional investors, like their US counterparts, were undergoing a renewal of faith in shareholder value management – or at least that was the mantra and the rhetoric behind the 1980s’ takeover wave. The resulting battle cry was return to specialization or ‘sticking to the knitting’, which led to divestitures on an unprecedented scale, as shown in Figure 2.5b.

The fourth merger wave

In the 1990s the UK experienced its fourth merger wave, as shown in Figure 2.5. For comparison with the US and EU merger waves the value of deals is expressed in constant 2007 US dollars. The fifth UK wave shares many of the characteristics of the merger wave of that period in the US, as well as the characteristics of the 1990s wave in the EU. Many new sectors in the UK were privatized, such as water, electricity and gas. Further deregulation of the telecom industry took place, increasing pressure on British Telecom, the previous monopoly, to restructure. Many firms undertook divestitures, such as ICI, which demerged into ICI and
Zeneca, which then went on to merge with the Swedish pharmaceutical firm Astra to form AstraZeneca. Vodafone, born out of a demerger from Racal Electronics, has now become the largest mobile telephone company in the world after acquiring Airtouch in the US and Mannesmann in Germany. Thus, as in the US, the UK also experienced high-level divestiture activity as part of the merger boom.

**The millennial merger wave**

Figure 2.5a shows the number and value of acquisitions and divestitures during 1984–2007. For comparison the level of the UK stock market proxied by the FTSE All-Share Index is also
shown. There is close movement of the merger waves and the stock market levels, as observed in the case of the US and EU merger waves above. The 1980s and 1990s waves are fairly comparable in terms of deal numbers, but in terms of value the 1980s wave is hugely dominated by the 1990s wave, indicating that the average size of acquisitions is considerably larger in the latter period. Again, as in the US and the EU, the new millennium sees a revival of acquisitions from the crash of 2001, but it hasn’t achieved the same peak level as the 1990s wave. Thus in all three regions the 1990s merger wave is the largest in history. The millennial wave, while smaller than this wave, still substantially dominates all pre-1990 merger waves (see Figures 2.2a and 2.3a above). Thus there seems to be a step change in acquisition activity after the 1980s.

Figure 2.5b shows that divestiture activity in the UK has also occurred in waves. In terms of value of divestitures three waves are distinct. These waves happen around the same time as the acquisition waves, with the correlation between the two in terms of numbers (value) being 0.85 (0.79). But divestiture activity seems to be maintained at higher levels than acquisitions following the peaks. For example, after the fall off the acquisition peak in 1999, divestitures peak in value in 2000, and the decline from that peak is much gentler than in the case of acquisitions (see Figures 2.5a and 2.5b). This suggests that divestitures may be pursued even when acquisition activity has abated.

**Mergers in emerging markets**

Unlike the previous merger waves, the millennial wave has been reinforced by mergers, acquisitions and divestitures in major emerging markets. We focus here on merger activity in Brazil, the Russian Federation, India and China, the so called BRIC countries. These countries have experienced very strong economic growth rates in the last decade, accompanied by greater openness to foreign direct investment and, in particular, equity ownership of domestic companies by foreign corporations as well as by private equity firms. The private sector has played a major role in achieving high growth rates in these countries, which also undertook substantial privatization of previously state-owned enterprises. These privatized enterprises with enormous financial resources have engaged in domestic as well as foreign acquisitions.

New industries sprang up, such as mobile telecoms, and these have seen a number of cross-border M & A. The spectacular growth rates of many of these countries increased demand for infrastructure and the products of companies selling to infrastructure projects. As a result some industries once regarded as sunset industries, such as steel and cement, have found new vitality and manifested numerous cross-border mergers. The takeover trail of Mittal has swamped well-established steel makers in Europe (e.g. Arcelor), in the US, in Central and Eastern Europe (CEE), and in Asia. Many large companies from BRIC countries made bold forays into the developed countries and acquired companies in steel, (e.g. Tata Steel’s $12bn acquisition in 2007 of Corus of UK-Netherlands after beating a rival bid from CSN, a Brazilian steel maker); in automobiles, e.g. Tata Motors’ acquisition of Jaguar and Land Rover in the UK for $2.3bn in 2008; and in information technology sectors, e.g. Lenovo’s $1.8bn acquisition of the personal computer business of IBM in 2004.

These examples demonstrate that many firms in BRIC countries have grown in size, resources and capabilities, including distinct technological capabilities, that have fuelled their ambitions and widened their strategic vision to become global players, e.g. Russian gas giant Gazprom’s acquisitions in the CEE and seeking targets in the US. The cumulative outcome of these forces is the arrival of these countries as significant players on the world M & A scene. Table 2.3 provides the statistics on takeover activity in BRIC countries in 2005 to 2007. The major sectors experiencing these restructuring activities included automotive, financial services, oil and gas, and minerals.
Why do merger waves happen?

Overview of the merger waves

Our survey of the merger waves around the world shows that while the early waves were influenced by conditions in the individual countries, and by firms seeking to alter their competitive position vis-à-vis their domestic rivals, the waves of the 1980s, 1990s and 2000s were characterized by similar trends in different countries, by increasing globalization of product and capital markets, by similarity of approaches to government’s role in industry and regulation and corporate governance, and by shareholder value as an important determining factor in corporate decisions. The increasing importance of cross-border M & A (e.g. see Table 2.1) also reflects the strategies of companies to cope with the institutional changes in the EU, such as the Single Market and the Eurozone with a single currency, as well as the need to compete globally for markets, technologies and capabilities. Thus corporate M & A strategies seem to have evolved in response to these environmental changes as well as to changes affecting individual industries. There are, however, different perspectives on the causes of merger waves.

Why do merger waves happen?

Figures 2.2, 2.3 and 2.5 above show that merger waves seem to parallel the stock market movements. The correlation coefficients between stock market level and value of acquisitions in the same year (and between stock market level in a year and value of acquisitions in the following year) respectively are very high: 0.88 (0.94) for the US, 0.92 (0.86) for the EU, and 0.81 (0.79) for the UK. Thus merger waves occur during periods of high stock market valuation. High valuation of their stock may induce companies to use it as a payment currency and acquire target companies on the cheap if the latter are relatively undervalued. Thus high merger activity may reflect this opportunistic behaviour of managers rather than the economic rationale of acquisitions. High valuation may also increase the scope for high valuation errors that may lead target firms to overestimate potential synergies and accept takeover bids, thereby increasing the momentum of the waves.

In recent years alternative theories of merger waves have emerged and been subjected to empirical tests. These can be broadly divided into rational economic models and behavioural models. Rational economic, also called neoclassical, models, assume that managers, in making acquisitions, are driven by the objective of maximizing the long-term value of their companies. Financial markets are assumed to be rational and to price up fairly the stock of firms that make value-creating acquisitions. By contrast, behavioral models impute opportunism to these managers, for example capitalizing on their stock’s overvaluation at times of irrationally high stock market valuation. In the rest of this chapter we review these theories, their implications for merger waves, and the available empirical evidence in their support.

Table 2.3 M & A deals in 2005–2007 in BRIC countries

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th></th>
<th>2006</th>
<th></th>
<th>2007</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Value (US$bn)</td>
<td>Number</td>
<td>Value (US$bn)</td>
<td>Number</td>
<td>Value (US$bn)</td>
</tr>
<tr>
<td>Brazil</td>
<td>75</td>
<td>9</td>
<td>112</td>
<td>21</td>
<td>266</td>
<td>31</td>
</tr>
<tr>
<td>Russia</td>
<td>138</td>
<td>31</td>
<td>202</td>
<td>17</td>
<td>298</td>
<td>68</td>
</tr>
<tr>
<td>India</td>
<td>161</td>
<td>10</td>
<td>216</td>
<td>16</td>
<td>213</td>
<td>21</td>
</tr>
<tr>
<td>China</td>
<td>171</td>
<td>11</td>
<td>199</td>
<td>15</td>
<td>295</td>
<td>22</td>
</tr>
</tbody>
</table>

Source: Mergers & Acquisitions, Table on M & A in major overseas markets outside the US, February 2008.
Rational economic models of merger waves

The Q theory

Michael Gort developed the economic disturbance theory of merger waves. According to this model merger waves occur when a rise in general economic activity creates a disequilibrium in product markets. Some investors hold a more positive expectation of future demand than others, and value target firms higher. Mergers result from attempts to take advantage of such valuation differences. Once some leading firms make merger moves, their competitors follow suit and pursue ‘me-too’ mergers for fear of being left behind. Thus the momentum for a wave develops. Gort’s model is consistent with the incidence of merger waves during periods of strong economic growth and rising stock markets in the US, the EU and the rest of the world.

In the same tradition, Boyan Jovanovic and Peter Rousseau formulate their Q-theory of merger waves and argue that ‘mergers are a channel through which capital flows to better projects and better management’. Thus the function of mergers is to ensure that corporate assets are redepolyed to more efficient firms run by more competent managers, leading to higher value creation. Efficient use of assets is measured by the ratio of the market value of the firm that owns the assets to the replacement cost of such assets. This ratio is known as the Q ratio, with a higher value signifying more efficient use of assets. Thus the model predicts that high-Q firms will acquire low-Q firms (‘high buys low’). This requires that firms have widely varying valuations of corporate assets. Such large inter-firm dispersion in valuation increases the incentives for mergers that reallocate corporate assets from low- to high-Q firms.

Such valuation dispersion is therefore a characteristic of merger waves that are essentially reallocation waves. While identifying two interesting characteristics of such waves – wide valuation dispersion and ‘high buys low’ – the Q-theory does not explain why valuation differences arise in concentrated time periods. We still need to identify the triggers not just of mergers but of merger waves. It is plausible that some economic disturbance or other acts as the triggers. We therefore need to understand the nature of these disturbances, and where they originate.

Environmental analysis of merger waves

While economic disturbances may partly account for merger waves, these disturbances and the merger waves may both be subject to wider influences. It is also plausible that an incipient merger wave itself creates new, or reinforces existing, economic disequilibrium. We have noted that many contextual factors also change just prior to or during these merger waves. In some cases firms undertake mergers in anticipation of changes of great import. For example, many European firms carried out mergers in the late 1980s in anticipation of the Single Market in the EU from 1992 so as to position themselves to competitive advantage in the new market. As a result, the growth in intra-EU mergers was much faster than the growth in purely national mergers. Thus disturbances that trigger, or provide conditions for, large-scale merger activity can be traced to a wider range of sources.

A framework to explain merger waves is the PEST model of the environment, incorporating political, economic, social and technical (PEST) dimensions. For example, the technological breakthroughs of the 1890s in mass production and transportation and the information technology breakthroughs of the 1990s provided the impetus for a number of mergers. Changes in tax regimes or government policy changes in pension provision for citizens are examples of changes in contextual factors that may provide firms with the opportunity to develop new sources of competitive advantage through mergers and acquisitions. Mergers of investment banks and commercial banks in the US during the 1990s were encouraged by a less stringent...
application of and finally the repeal of the Glass–Steagall Act, which had prevented such consolidation for more than 60 years.

The new rules adopted in 2001 by Germany to give relief from capital gains tax for banks such as Deutsche Bank and insurers such as Allianz when they unwind their investments in German companies were expected to lead to considerable restructuring of German companies through acquisitions, since a major disincentive to such liquidation had been removed. The increasing proportion of income spent by Europeans on leisure activities such as travel reflects a lifestyle change, and has spurred a number of mergers in the travel industry in the 1990s. The privatization of electricity in the UK in the 1980s attracted a number of US utility firms to acquire UK utilities as a way of diversifying out of the more restrictive regulatory regime in the US. Similarly, water privatization in the UK attracted French utility firms to acquire UK targets.

In the second merger wave of the 1920s in the US, political and regulatory factors influenced the direction of mergers away from monopolies to oligopolies, since popular disquiet over the monopolies created during the first wave led to stringent new antimonopoly laws and their trust-busting enforcement. New management models such as the multidivisional form (M-form) of management enabled managers to acquire unrelated businesses. Managerial preference for growth during the 1960s and the new management tools probably spurred the conglomerate growth of the 1960s. In the 1980s, with a more relaxed antitrust regime, political factors receded, but economic factors and social factors such as globalization, shareholder activism and emphasis on shareholder value provided the impetus for the fourth merger wave in the US. Finally, political and ideological trends towards deregulation and privatization in member states of the EU and attempts at economic integration at both the regional and global levels impacted on the M & A scene. The phenomenal development of information technology and the convergence of technologies in Internet communication, media and telecommunication contributed to the ‘new economy’ mergers.

In the EU, in addition to the above technological and political factors, sociological factors such as the ageing profile of the populations and their longevity have led governments to change their policies on pension provision for their citizens. The move away from state provision for retirement benefits to private provision by individuals created new opportunities for financial services firms to sell their existing products in new markets, or to design new products to suit new customers. This in turn triggered an avalanche of mergers in the financial services sector, both nationally and across borders.

Environmental factors may have both direct and indirect influences on corporate investment decisions. The increasing concern over global warming and carbon dioxide emissions has led to greater awareness of the carbon footprints of individual and corporate activity. The emergence of carbon trading, which allows high polluters to buy carbon permits from low polluters, provides an economic solution to the problem of excessive carbon emission. More environmentally friendly cars, such as hybrid cars that run on both gas and electricity, manifest corporate responses to the pressure to minimize carbon emissions. Such pressures towards socially responsible corporate behaviour can alter the incentives to shift to new technologies, and encourage firms to access them through corporate mergers or strategic alliances.

**Impact of industry changes on M & A activity**

The PEST environmental analysis and the Gort model suggest that different industries may be affected differently by the forces generating disturbances. If these disturbances alter the competitive structure of an industry by, for example, lowering entry barriers or opening new markets for the industry’s products, or by increasing the cost of operations through burdensome
regulations, firms already operating in an industry need to cope with these challenges to their competitive position. Thus disturbances that have industry-wide impact also tend to trigger industry-wide competitive moves in a jockeying for a new competitive equilibrium.

While technology-based competitive changes may often be initiated by firms themselves when they create new technologies, political, economic and social changes are largely exogenous to individual firms. Changes in PEST dimensions can often confer first-mover advantages on firms that can anticipate these changes, or read the implications of these changes correctly. Thus merger decisions of firms are designed to cope with both the direct impact of PEST factors and the indirect impact of these factors through changes in the industry structure.

**Industry clustering of mergers**

One of the natural forces of change in an industry is the product life cycle of that industry, such as agricultural products or clothing. As these products become commoditized, there is fierce price competition with the industry characterized by excess capacity, and firms have to merge to ‘take out’ the excess capacity. Excess capacity may exist in several forms: in production capacity, in R & D, in marketing and distribution channels or in managerial expertise. For example, the automobile industry suffered from excess production capacity in the 1990s. The pharmaceutical industry had an excess of R & D capacity in the same period, and commercial banks had too many branches. The need to reduce this capacity drove many mergers in the 1980s and 1990s, such as the merger of Daimler-Benz with Chrysler in 1998, the merger of Union Bank of Switzerland with Swiss Banking Corporation in 1997, and the merger of Synthelabo SA with Sanofi SA in France in 1999 (see Chapter 5 for further discussion of such consolidating mergers).

In other industries mergers may be triggered by other forces, such as deregulation or the convergence of technologies. For example, deregulation and privatization have affected industries such as power, water, airports and telecommunications, leading to a surge in mergers in these industries. Technological changes drove new business models in the financial services industry, such as banking, insurance and investment management, and in the media and entertainment industries. Financial innovation such as junk bonds has facilitated the restructuring of mature industries with fairly predictable cash flows, such as oil and gas or food and drinks, a necessary condition for high-leverage financing. In the new millennium the development of credit derivatives has allowed the spread of credit risk and encouraged banks to accept higher levels of leverage in corporate acquisition deals, at least until the explosion of the sub-prime crisis in 2007 and financial meltdown in 2008.

The European Single Market has had an impact on the manufacturing industries, whereas European Monetary Union and the euro have impacted more strongly on the financial services sector. The removal of restrictions on interstate banking in the US allowed the consolidation of regional banks into much larger national banks, for example the West Coast-based Bank of America merger with the southern Nations Bank. Thus mergers and acquisitions in different industries are triggered by different ‘industry shocks’. The collapse of banks in the wake of the credit crisis led to the takeover of failed banks by stronger banks, such as the Bank of America takeover of Merrill Lynch and the JP Morgan Chase takeover of Bear Stearns in the US, and the Lloyds Bank takeover of HBOS in the UK.

**Evidence for industry shocks causing merger waves**

**US evidence**

Harford tests the industry shock theory of merger waves at the industry level using recent US data from 1981 to 2000. He also examines partial acquisitions, e.g. acquisitions of
subsidiaries rather than whole firms. Merger activity in successive 24-month periods is examined, and benchmarked against expected activity in such periods generated by a simulation model. Harford finds:

- **35 waves in 28 industries**, seven of which have two distinct waves;
- the **average number of bids** experienced by any of these industries in a 24-month period is 7.8; but
- in a similar period during a merger wave it is 34.3!

Table 2.4, extracted from Harford, provides examples of industry shocks that influence takeover activity. These industry shocks arise from deregulation (air transport, broadcasting, utilities), political events (shipping), changing consumer tastes (candy and soda) and economic factors (healthcare), Internet technology (banking and computers), consistent with the PEST model.

The PEST framework suggests that the various factors can not only directly trigger merger waves but also indirectly facilitate them. One such facilitating factor is the availability of financing. In periods of high capital market liquidity, acquisitions, especially those paid for with cash rather than the acquirer’s stock, are more likely. Harford argues that lack of liquidity may impede, delay or shorten merger waves. This is particularly relevant to partial firm acquisitions, since they are mostly financed with cash. Thus merger waves occur in periods of high liquidity. Using a variety of tests, and low commercial and industrial loan rate spread above the Federal Reserve funds rate as a proxy for liquidity, Harford finds strong support for his hypothesis. He also finds that deregulatory events, economic shocks and the combination of economic shocks and high liquidity in the previous year increase the likelihood of merger waves. The correlation between industry-specific waves and aggregate economy-wide waves is very high (correlation coefficient of 0.85). Thus industry-level merger waves drive the
economy-wide merger waves. The corollary of this evidence is that while high liquidity – an economy-wide phenomenon – can facilitate mergers, the basic drivers are essentially industry-specific changes in competitive structure, and supply and demand side shocks.

Mitchell and Mulherin provide broadly similar evidence for the 1980s. They find significant differences among industries in both rate and time-series clustering of mergers. The inter-industry patterns are directly related to the economic shocks borne by the industries, and show distinct timing effects. Generally, 50% of takeovers in a given industry cluster within two years. In a following study, Mitchell and Mulherin observe industry clustering of both acquisitions and divestitures during the 1990s. Among all the sample industries, 29% of the member firms are acquired. The average level of divestitures in all sample industries is 21%. Thus divestiture intensity, while significant, is on average less than acquisition intensity in the 1990s.

**Evidence from the EU**

In the light of the increasing globalization of markets and products from the 1990s, one would expect a similar industry clustering in countries outside the US. Indeed, we find some striking similarities in the level of M & A activity in the US and the EU during 2006–07, as shown in Table 2.5. The level of industry aggregation in the table (at the one-digit level, the broadest industry grouping) may perhaps accentuate industry clustering. Nevertheless, we find broadly similar M & A patterns across the US and the EU. The main sectors affected by M & A within each region, as well as between regions, are:

- hotels, personal, business and recreational services (SIC 7);
- glass, plastics etc. (SIC 3);
- finance, insurance and real estate (SIC 6); and
- food, textiles, paper etc. (SIC 2).

This pattern suggests that industry-level clusters may be driving aggregate merger waves not only within a region but also globally through cross-border merger clusters. In other industries,

**Table 2.5 Sectoral and geographical breakdown of M & A operations with a US or EU target, 2006–07 (%)**

<table>
<thead>
<tr>
<th>Sector SIC</th>
<th>Intra-US</th>
<th>Extra-US (US as target)</th>
<th>Intra-EU</th>
<th>Extra-EU (EU as target)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 Agriculture, forestry, and fisheries</td>
<td>0.6</td>
<td>0.3</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>1 Mining and construction</td>
<td>7.7</td>
<td>12.4</td>
<td>4.4</td>
<td>3.7</td>
</tr>
<tr>
<td>2 Food, textiles, paper, chemicals, etc.</td>
<td>9.2</td>
<td>12.3</td>
<td>11.2</td>
<td>10.2</td>
</tr>
<tr>
<td>3 Glass, plastics, metals, machinery, computers, transport equipment, etc.</td>
<td>16.7</td>
<td>21.1</td>
<td>11.6</td>
<td>20.8</td>
</tr>
<tr>
<td>4 Network industries</td>
<td>9.8</td>
<td>6.7</td>
<td>10.8</td>
<td>7.8</td>
</tr>
<tr>
<td>5 Wholesale and retail trade</td>
<td>7.1</td>
<td>3.3</td>
<td>10.4</td>
<td>6.7</td>
</tr>
<tr>
<td>6 Finance, insurance, and real estate</td>
<td>19.0</td>
<td>14.3</td>
<td>20.8</td>
<td>22.1</td>
</tr>
<tr>
<td>7 Hotels, personal, business and recreational services, etc.</td>
<td>21.4</td>
<td>21.0</td>
<td>20.3</td>
<td>20.4</td>
</tr>
<tr>
<td>8 Health, legal, educational, social, engineering and management</td>
<td>8.6</td>
<td>8.6</td>
<td>9.8</td>
<td>7.7</td>
</tr>
<tr>
<td>9 Public administration</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

All deals completed and acquirers hold > 50% of target shares after transaction; only deals with disclosed transaction values included; EU = 27 current members plus Switzerland; deals categorized according to announcement year. 

such as wholesale and retail trade (SIC 5) and network industries (SIC 4), firms are concerned more with consolidation within each region than with cross-region clustering.

**Evidence from the UK**
In the UK, similar industry clustering of mergers in response to industry shocks has been observed. Powell and Yawson report, for their sample of about 1300 UK firms during 1986–2000, 947 acquisitions and 562 divestitures. Acquisitions exhibit significant clustering in the second half of the 1980s and 1990s. They also cluster by industry. For example, over half of all takeovers in speciality chemicals, electricity and computer services take place in a two-year period. Interestingly, divestitures do not exhibit clustering in time, but cluster by industry, for example in builders’ merchants, electricity, and clothing and footwear in a two-year period.

At the industry level, with an average of 18 firms in each industry, the median number of acquisitions over the sample period is 10, but for divestitures it is only 3. Thus acquisition intensity is greater than divestiture intensity, a pattern also observed in the US by Mulherin and Mitchell (see footnote 38). The study also shows that divestitures happen more evenly over time than takeovers. For example, the median annual value of takeovers as a percentage of the value of all sample takeovers is 2.6, but this level of takeover activity is exceeded only in 1988–89 and 1995–2000. By contrast, the corresponding figures for divestitures are 4.3% and years 1993–2000. Not only do divestitures become more important in value in the 1990s, but they also become a more regular feature of corporate restructuring. Unlike divestitures, takeovers seem to be more episodic and in the nature of sudden and large responses to discontinuous shocks.

Schoenberg and Reeves observe industry clustering of M & A among 200 industry sectors in the UK during 1990–95. They find that deregulation is the single most important discriminator between industries with high and low acquisition activity. In insurance, national restrictions on underwriting by foreign companies were removed as part of the 1992 Single European Market programme. The resulting trend towards a single insurance market saw 18 UK insurance firms acquired by continental European companies, together with 41 acquisitions among UK competitors. In the electricity distribution industry, of the 12 regional electricity companies (RECs) privatized in 1990, eight were acquired by overseas investors and three by other British utilities; only one remained independent. In contrast, some US studies have not found deregulation on its own a significant determinant of takeover waves.

In an analysis of all mergers and acquisitions in UK two-digit industries during the period 1988–2006 reported by SDC Platinum, a Thomson Reuters Financial product, we find 21 industries with identifiable merger waves. Figure 2.6 shows them for some of these industries. The bars represent the number of acquisitions in successive two-year periods. These figures suggest that the duration or amplitude of merger waves is not uniform across these industries. In pre-packaged software the wave is much sharper and shorter than in retail trade – eating and drinking places. Thus different intensities of shocks occur in different industries, or different strategic responses to industry shocks are adopted by firms in those industries.

As noted above in our discussion of industry waves in the US, Harford observes that an economy-wide merger wave is an aggregation of industry-wide merger waves. A similar conclusion holds for the UK, as shown in Figure 2.7, where the bars represent the total number of mergers in 21 industries experiencing merger waves as illustrated in Figure 2.6. The line curve in Figure 2.7 is the sum of these industry mergers. This aggregate merger wave is similar to that in Figure 2.5a, although the latter includes all industries, whereas this figure represents only 21 two-digit industries with distinct merger waves. While industry-level merger waves may have different spans, their peaks occur in fair temporal proximity. Thus economy-wide merger waves seem to be driven essentially by industry-level merger waves, although industry-level merger
**Figure 2.6** Merger waves in UK industries: (a) retail trade – eating and drinking places; (b) hotels and casinos; (c) prepackaged software.

Source: SDC Platinum: A Thomson Reuters Financial Product
waves are not perfectly synchronized (see Figure 2.6). Thus in seeking to understand aggregate merger waves we need to understand industry shocks and how firms respond to these.

**Behavioural models of merger waves**

In contrast to the rational models discussed above, behavioural models assume some inefficiency in capital markets, reflected in overvaluation of corporate stock. Andrei Shleifer and Robert Vishny argue that smart corporate managers perceiving these inefficiencies take advantage of them through acquisitions. In periods of high stock market misvaluation of companies, companies can use their overvalued stock to acquire other companies: that is, they exchange their overvalued stock for the real assets of the acquired company. An incentive for acquirers to do so is the fear that when overvaluation is corrected their stock would decline in value unless they convert their stock into real assets. With conversion of overvalued stock into real assets, any subsequent correction of overvaluation would harm the acquirer less than if it had not made the acquisition. An implication of this is that acquirers that exploit overvaluation will outperform otherwise similar companies that do not, when the overvaluation is corrected.

Since, during these periods of overvaluation, the target firms’ stock is also likely to be overvalued, the implication of this model is that bidders’ stock is more overvalued than the targets’. This phenomenon is consistent with the ‘high buys low’ strategy of the Q-theory. However, cash financing of acquisitions seems inconsistent with the desire to exploit stock overvaluation. An interesting question is why target managers accept the overvalued stock of bidders. Shleifer and Vishny hypothesize that target managers do so out of selfish motives, that is, to cash out their accumulated stock and stock options. Thus target managers also exhibit opportunism.

Other implications of the model are that:

- managerial opportunism will be more evident in a stock exchange than in cash-financed takeovers;
- post-acquisition, target managers will sell their stock in the acquirer;
- targets are less overvalued than bidders; and
- long-run returns to stock acquirers are greater than to similar acquirers who acquire for cash, or to similarly overvalued non-acquirers.
Ang and Cheng find support for the overvaluation hypothesis and its many implications with US data consisting of more than 3000 mergers during 1981–2001\textsuperscript{47}. In particular, they report the following results:

- Overvalued acquirers opportunistically make stock acquisitions.
- Overvaluation is correlated with stock market returns.
- Cash acquirers are less overvalued than stock acquirers.
- Cash acquirers are not overvalued relative to targets but stock acquirers are: the median difference between acquirer’s overvaluation and target overvaluation is only 3\% (statistically insignificant) in cash deals, but it is a significant 7.5\% in the case of stock acquirers.

Ang and Cheng also report further results consistent with the behavioural model:

- Long-run performance up to three years of overvalued stock acquirers is superior to that of overvalued non-acquirers.
- Shareholders of overvalued acquirers are better off than those of overvalued non-acquirers\textsuperscript{48}.

However, not all stock acquirers are overvalued. In their sample, 330 out of 1574 stock acquirers are undervalued not overvalued. This suggests that the Shleifer and Vishny model does not explain all stock mergers.

Rhodes-Kropf and Viswanathan (RV) depart from Shleifer and Vishny (SV) by assuming that both bidder and target managers are rational value maximizers, and that targets may accept overvalued acquirer stock, not because of opportunism but because of limited information they have about the extent of overvaluation\textsuperscript{49}. RV’s model assumes market inefficiency in pricing corporate stock. In times of market-wide overvaluation there is a greater likelihood of target managers attributing any perceived overvaluation of the bidder stock to such market-wide overvaluation rather than to acquirer-specific overvaluation. These managers are unable to make accurate allowance for different sources of overvaluation, tend to overestimate the synergy between bidders and targets, and therefore will accept the bids. Thus high market valuation errors may go with high overestimation of synergy, giving rise to merger waves.

In a sequel to this model, Rhodes-Kropf, Robinson and Viswanathan (RRV) test its predictions empirically for a large sample of 4325 US mergers during 1997–2000. They decompose the error in valuation into market-wide errors, industry-wide errors and firm-specific errors. They estimate overvaluation using market-to-book value of equity (MB) as a valuation metric. The major findings of the study are:

- Overvaluation is much higher for merging than for non-merging firms, and mergers occur when both bidders and targets are overvalued.
- Acquiring firms are priced 20\% higher than targets.
- Firm-specific valuation error is much larger than market-wide error, suggesting an overestimation of merger synergy. About 60\% of the acquirer’s MB is due to firm-specific error, but almost none of the target’s is attributable to such error.
- Acquirers and targets cluster in sectors with high time-series sector error. They share a common misvaluation component. This suggests that industry shocks may not be the only factor explaining industry-level merger waves. These may occur because of overestimation of synergies in those sectors.
- Cash acquirers are less overvalued than stock acquirers.
- High firm-specific error makes acquisitions more probable by firms that use their stock as payment currency.
RRV conclude that

even when the merger is part of a merger wave that is being driven by neoclassical considerations, most merger activity is the work of misvalued firms . . . the vast majority of transactions (whether or not they occur during periods of economic shocks) involve highly overvalued bidders . . . Economic shocks could well be the fundamental drivers of merger activity, but misvaluation affects how these shocks are propagated through the economy. Misvaluation affects who buys whom as well as the method of payment.

These conclusions are broadly consistent with those from Ang and Cheng and from Harford discussed above. Corporate managers, even though driven by rational economic motives, may nevertheless time their acquisition moves to take advantage of overvaluation of their own firms and overestimation of potential merger synergies arising from market-wide overvaluation. Further support for the overvaluation model comes from Dong, Hirshleifer, Richardson and Teoh, who also empirically test the hypothesis with the US data for the 1980s and 1990s50.

It’s not all ‘high buys low’; ‘low buys high’ too

Time-series merger data throw up interesting patterns not explained by the Q-theory or the behavioural model and empirical tests reviewed above. One such is that low-valued firms buy high-valued targets, or firms buy others of similar valuation, i.e. ‘low buys low’. Rhodes-Kropf and Robinson provide evidence that in the US merger waves there is a significant proportion of high-Q firms merging with other high-Q firms as well as low-Q firms merging with other low-Q firms51. They call this type of mergers ‘like buys like’, and explain it on the basis of complementarity of the merging firms’ assets or resources. This is consistent with the resource-based view of corporate strategy and mergers. We review this study in more detail in Chapter 3 on alternative perspectives on mergers.

Strategic implications of industry clustering of M & A

While industry-level analysis of M & A is useful, we need to remember that industry as a construct is too static, and assumes that firms are constrained to operate within their current industry structures. We must also note the following caveats:

- Not all the shocks are exogenous. Some are generated by the firms in an industry in order to alter the industry structure so as to gain competitive advantage, e.g. technological innovation in products or processes.
- The relation between shocks and takeovers is not linear. While some firms react to shocks by undertaking takeovers, these takeovers themselves lead to further structural changes to which other firms may react, thereby amplifying or moderating the impact of the initial shock.
- Some firms acquire resources and capabilities through mergers that enable them to escape the current industry structure and enter or create new industries.
- Industry boundaries are also in some cases blurred, as in the case of the Internet and media, or banking and insurance (see case study below). Firms pole-vault industry boundaries: for example, AOL, the Internet provider, merged with Time Warner in 2000 to gain access to content in terms of movies and music, although this strategy was a colossal failure and destroyed enormous value for the companies’ shareholders.
Industry clustering patterns suggest that some industries undergo turbulent restructuring, but on average nearly half of the firms in an industry may participate in mergers within a short time period (see review of Mitchell and Mulherin, and Powell and Yawson studies above).

This industry clustering suggests copycat or ‘follow my leader’ moves. Some of these are countermoves to restore competitive equilibrium disturbed by the leader’s move. In a game theory context the first mover must anticipate this countermove and factor the implications of the countermove in fashioning its first move (see Chapter 3 on game theory). The competitive advantage from the first move may be just ephemeral. This is consistent with the poor post-acquisition value creation performance of many acquirers (see Chapter 4 for review of the related evidence).

Firms making copycat moves must consider whether it is the optimal strategy and the cost of being an ‘also-ran’. The pay-off to being a ‘fast second’ may also often be good.

While a vast majority of acquisitions are reallocating mergers, in which low-valued firms are taken over by high-valued firms, thereby enhancing operational efficiency, others exploit complementarity of resources to improve their competitive advantage and create value.

Value creation from mergers requires a matching of corporate strategy and financial strategy, since payment currency in mergers is a determinant of value created for the stakeholders.

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**CASE STUDY**

Pharmaceuticals suffer from the urge to merge

In recent years the pharmaceutical industry has been consolidating globally through a large number of mergers. Some of the mega deals in the last decade are listed in the table below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Target</th>
<th>Acquirer</th>
<th>Value (bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>Astra (UK)</td>
<td>Zeneca (UK)</td>
<td>40</td>
</tr>
<tr>
<td>1999</td>
<td>Warner-Lambert (US)</td>
<td>Pfizer (US)</td>
<td>112</td>
</tr>
<tr>
<td>1999</td>
<td>Hoechst (France)</td>
<td>Rhone-Poulenc (France)</td>
<td>34</td>
</tr>
<tr>
<td>1999</td>
<td>Pharmacia &amp; Upjohn (US)</td>
<td>Monsanto (US)</td>
<td>32</td>
</tr>
<tr>
<td>2000</td>
<td>SmithKline-Beecham (UK)</td>
<td>Glaxo Wellcome (UK)</td>
<td>80</td>
</tr>
<tr>
<td>2002</td>
<td>Pharmacia (US)</td>
<td>Pfizer (US)</td>
<td>60</td>
</tr>
<tr>
<td>2004</td>
<td>Aventis (France)</td>
<td>Sanofi-Synthelabo (France)</td>
<td>71</td>
</tr>
<tr>
<td>2008</td>
<td>Genentech (44%) (US)</td>
<td>Roche (Switzerland)</td>
<td>46</td>
</tr>
<tr>
<td>2009</td>
<td>Wyeth (US)</td>
<td>Pfizer (US)</td>
<td>68</td>
</tr>
<tr>
<td>2009</td>
<td>Schering-Plough (US)</td>
<td>Merck (US)</td>
<td>41</td>
</tr>
</tbody>
</table>

There have been numerous mid-size and small acquisitions as well. In addition to purely pharmaceutical acquisitions these firms have also acquired biotechnology firms, e.g. Roche acquiring Genentech, AstraZeneca acquired Cambridge Antibodies (see Chapter 22). Moreover in recent years many pharmaceutical companies have diversified into related businesses such as healthcare products in an attempt to reduce their dependence on prescription drugs. They have also diversified through acquisition into generics, over-the-counter drugs and healthcare systems. Some pharma companies have followed the strategy of acquiring much smaller rivals that can help fill their fast-drying product pipelines. Bristol-Myers Squibb’s acquisition of Imclone for $4.5bn in 2008 exemplifies such a strategy (called ‘string of pearls’ strategy).
What drives these consolidating and diversifying acquisitions by so many firms in the industry? We can identify many drivers that can be characterized as PEST factors:

- Political – pressure by publicly-funded healthcare systems in several European countries and healthcare management organizations in the US on pharma companies to lower drug prices; public perceptions that pharma companies put their profits before people and were selling drugs at too high prices for people to afford; more stringent regulation of clinical trials requiring longer trials and drug approval regimes; the healthcare reforms of the Obama administration are expected to put more pressure on prescription drug prices.

- Economic – tight budgetary constraints faced by several governments in financing their healthcare systems; the high cost of R & D; massive competition from me-too and copycat or generic producers selling unbranded drugs at considerably cheaper prices.

- Social – trend towards more healthcare products than curative drugs, for example nutritionals.

- Technological – the declining productivity of the drug discovery process at many of the big pharma companies.

- Legal – expiry or imminent expiry of patents on the blockbusters that have contributed high profits to pharma bottom lines in the past.

While these mergers seek to extract cost savings in various functional areas such as purchases, marketing, production, sales, etc., they are also aimed at improving the drug pipeline of the merging firms by improving their research productivity. There are also synergies in well established pharma firms acquiring newly formulated drugs from younger and smaller companies without the resources for prolonged drug trials, market and brand development and production infrastructure. Above all for many of the big pharma companies the imminent loss of patents would deal a serious blow to their profits and market valuation. They, therefore, desperately needed to replenish their pipelines with new blockbusters. One industry estimate put the value of patented drugs that would come off patent by 2011 at $60bn. Bristol-Myers Squibb faced the prospect that drugs accounting for 30% of its 2007 pharma revenue would lose protection by 2012.

The Merck-Schering Plough deal would double Merck’s late-stage drugs to 18 and transform its R & D. Since R & D and marketing costs account for a high proportion (35% to 40%) of total costs, savings in these areas would add to the profitability of the merging firms. Merck also estimated that it would reduce costs, with planned annual savings of $3.5bn from 2011.

Discussion questions

1. What are the different subsectors of the pharmaceutical industry?
2. What are the types of mergers that have taken place in the industry?
3. What are the drivers of the mergers that have happened?
4. What are the sources of value in these different types of mergers?

Overview and implications for practice

- This chapter provides an historic overview of trend in mergers and acquisitions over the last 120 years in the US, 45 years in the UK, and 25 years in the rest of the EU. Takeover activity exhibits distinct wave patterns in both the US and Europe. The US has had six waves, the UK five, and continental Europe three.
- Merger waves are no longer limited to the USA or Western Europe. In BRIC countries there has been a surge of M & A in recent years.
- A number of contextual developments accompany merger waves. High economic growth, recovery from an economic downturn, rising stock market and new technologies alter the competitive advantage of firms, or open up new markets and trigger mergers.
- The character of merger waves is also crucially dependent on political, technological, regulatory, institutional and demographic changes.
- While mergers in the first decades of the last century increased market power enormously, leading to stronger antitrust enforcement in later years, market concentration of the largest firms has not increased, and has even declined following the merger waves after the 1970s.
- Merger waves have also increased in intensity and frequency. The 1980s, 1990s and 2000s waves were of a considerably larger magnitude and followed each other more rapidly than the first three waves.
- Takeover activity is characterized by industry clustering. In certain industries, corporations, in a seeming imitation of lemmings, pursue M & A as if on an autopilot in fast-forward mode.
- With industry clustering, the first-mover firms may become winners, and ‘me-too’ followers end up as losers. However, ‘me-too’ followers may also gain from the errors of the first movers. Industry clustering throws up both opportunities and risks of failure.
- Merger waves may be triggered by rational economic motivations as well opportunistic behavioural motivations of corporate managers to exploit temporary stock market mis-pricing. It appears that both motivations may explain the past merger waves in the US.
- In the next chapter we provide alternative conceptual perspectives drawn from a variety of analytical traditions. This provides the framework to explain the context and rationale for mergers. The merger waves and industry clusters we have observed in this chapter may also be interpreted using that framework.

Review questions

2.1 What is meant by a merger wave?
2.2 What merger waves has the US experienced?
2.3 What are the major characteristics of these merger waves?
2.4 Do you think economic activity and stock market level cause merger waves? Why?
2.5 Are merger waves part of a global phenomenon?
2.6 How do the PEST factors affect merger activity?
2.7 What may be the reasons for industry clustering of mergers?
2.8 What is the significance of high divestiture activity during merger waves?

2.9 What is the significance of industry clusters in mergers for companies seeking competitive advantage?

2.10 Explain the rational economic theories of merger waves. What is the empirical evidence to support them?

2.11 Explain the behavioural theories of merger waves. What is the empirical evidence to support them?

Further reading


Notes and references


3. R. J. Gilson and B. S. Black, ibid., 15.


5. Gilson and Black, ibid., p. 18.

6. Gilson and Black, ibid., p. 23.

7. Gilson and Black, ibid., p. 18.


11. See S. Bhagat, A. Shleifer and R. W. Vishny, ‘Hostile takeovers in the 1980s: The return to corporate specialisation’, Brookings Papers on Economic Activity: Microeconomics, 1990, 1–72. Shleifer and Vishny, ibid., argue that rigorous antitrust enforcement in the 1960s caused US firms to diversify into unrelated lines of business. Matsusaka rebuts this argument with empirical evidence that diversifying acquisitions were made by small as well as large firms, with the former being less likely to face antitrust challenge. Further, in European countries such as Germany and the UK and in Canada, in the inter-war years, large firms undertook diversifying mergers although antitrust policy in these countries was less stringent than in the US. ‘The bulk of the evidence, then, is inconsistent with the antitrust hypothesis.’ See J. G. Matsusaka, ‘Did tough antitrust enforcement cause the diversification of American corporations?’, Journal of Financial and Quantitative Analysis, 31(2), 1996, 283–294.

12. A possible reason why the number of divestitures and their value tell different stories is that in 2000–2006 private equity firms became major players and bought divested businesses rather than whole firms, and some of these divestitures were very large (see Chapter 10 for a discussion of divestitures). This may also explain why divestitures increased in value in 2007 while mergers had slumped by then.
15. Hedge funds make investments to exploit anticipated market movements using a variety of investment styles and derivative instruments to hedge risk. They exploit volatility of asset price movements as well as timing. They also invest in special situations such as merger arbitrage (see Chapter 20) and distressed debt. They raise funds from financial institutions, pension funds, sovereign wealth funds and high net worth individuals. In 2007 hedge fund assets amounted to $1.9 trillions ($491bn in 2000) and fell to $1.4 trillions in 2008 (Casey Quirk-Bank of New York Mellon Thought Leadership series, The Hedge Fund of Tomorrow: Building an Enduring Firm, April 2009. Hedge funds are generally regarded as short-term opportunistic investors, although in the last few years their investment strategies have evolved to include long-term strategies such as LBOs. Hedge funds are unregulated, and receive management fees and performance fees in excess of some minimum yield to their investors, by the so-called 2/20 rule (2% of capital as management fee and 20% as performance fee). They have been blamed for contributing to the credit crisis in 2007–08.
18. See Table 2.3 of Sudi Sudarsanam, Creating Value from Mergers and Acquisitions: The Challenges (FT Prentice Hall, 2003).
20. Data for Figure 2.4 from ‘Acquisitions and mergers in the UK’, Central Statistical Office Bulletin, London, May 1993. Data up to 1969 include only listed companies. After 1969, figures include all industrial and commercial companies.
21. One of the most important examples of this state-sponsored cloning of corporate giants was GEC merging with two competitors, AEI and English Electric, and another was British Leyland, born of a merger of smaller automobile manufacturers. During 1965–69 the IRC sponsored approximately 50 horizontal mergers.
23. A. Hughes, ‘The impact of merger: A survey of empirical evidence for the UK’, in Fairburn and Kay (Eds), ibid., Table 1.4. A similar picture emerges, based on number of mergers.
24. Hughes, ibid., Tables 1.7 and 1.8. The average five-firm sales concentration ratio increased only marginally from 46% in 1970 to 47% in 1975, before falling to 46% in 1979. The 100-firm concentration ratio was even more stable at about 25% through 1968 to 1980.
26. Although Wimbledon in southwest London is the venue of the greatest of all tennis tournaments, the UK has produced very few champions over the years. The City of London is the world’s premier financial centre, but it is not dominated by home-grown British financial institutions.
27. As discussed in Chapters 18, 20 and 21, many US-style bid and defence strategies were not possible under the UK Takeover Code.
28. The correlations between stock market level and number of acquisitions in the current year (and between stock market level and acquisitions in the following year) are also very high: 0.81 (0.64) for the US; 0.92 (0.91) for the EU; and 0.84 (0.84) for the UK.
29. In the M & A literature there are other behavioural models, e.g. where corporate managers are irrational but the financial markets are rational value maximizers. A conjunction of irrational managers and irrational financial markets is also possible. These models are discussed in later chapters.
33. A variant of the PEST framework is PESTEL, i.e. political, economic, sociological, technical, environmental and legal. Since environmental and legal influences are likely to operate largely through the other four dimensions, we prefer the simpler framework.
34. A. Shleifer and R. W. Vishny, *ibid.*, discuss the contrasting influences that might have fuelled the 1960s and 1980s merger booms in the US. We discuss the M-form organizational structure further in Chapter 7 on diversifying acquisitions.

35. This suggests that when a firm in an industry becomes the target of an acquisition, it increases the probability that other firms in the same industry might also attract takeover bids. For evidence consistent with such an increase see M. H. Song and R. A. Walkling, ‘Abnormal returns to rivals of acquisition targets: A test of the “acquisition probability” hypothesis’, *Journal of Financial Economics*, 55, 2000, 143–171; A. Akhigbe, S. F. Borde and A. M. Whyte, ‘The source of gains to targets and their industry rivals: Evidence based on terminated merger proposals’, *Financial Management*, 29(4), 2000, 101–118.


39. J. H. Mulherin and A. L. Boone, ‘Comparing acquisitions and divestitures’, *Journal of Corporate Finance*, 2, 2000, 117–139. For example, 50% or more of the firms in banking, broadcasting/cable and petroleum are acquired during that period, whereas in household products, construction machinery, shoes, newspaper, semiconductor and homebuilding this is less than 10%. At least 40% of the firms in chemicals, petroleum, telecommunications, medical services and natural gas make divestitures, whereas there is no divestiture in banking in the Midwest, grocery stores, securities brokerage and toiletries/cosmetics.

40. R. Powell and A. Yawson, ‘Industry aspects of takeovers and divestitures: Evidence from the UK’, *Journal of Banking & Finance*, 29, 2005, 3015–3040. Clustering is assessed by number of acquisitions or divestitures and not value of these deals.

41. Powell and Yawson, *ibid.*, based on their Tables A1 and I. Supporting this conclusion is the greater volatility of the annual percentage value of takeovers (10.5%) than that of divestitures (6.9%) relative to the mean of 6.7% in each case (their Table 1). Numbers rounded to the nearest decimal place.


43. A merger wave is identified by first identifying the year with the highest number of mergers and then locating the beginning and end of the wave defined as the year with one third of the peak number or less. This algorithm is similar to the one used by K. Carow, R. Heron and T. Saxton, ‘Do early birds get the returns? An empirical investigation of early mover advantages in acquisitions’, *Strategic Management Journal*, 23, 2004, 781–794. The mergers are completed and involve UK firms as targets and acquirers who gain at least 50% stake in the targets from the merger. An initial sample of 25,591 deals is screened for this analysis.


45. If a bidder raises cash prior to the bid by selling its stock, say by a rights issue, such an issue can be construed as taking advantage of stock overvaluation. However, since equity issues are often made at a steep discount to the current stock price, and may involve underwriting costs, the degree of exploitation of market overvaluation is less than when a bidder uses its stock directly to make an acquisition.

46. Since in a tender offer in which the target shareholders are invited by the bidder to tender their shares directly to the bidder, target managers’ opportunism is likely to be constrained (see Chapter 20 on difference between mergers and tender offers). This constraint is even more binding if the tender offer is a hostile tender offer where target shareholders have even more power relative to their managers. This implies that in times of stock market overvaluation, tender offers and hostile tender offers should be less frequent than in normal times. There is evidence that during the 1990s the incidence of hostile tender offers in the US was much less than in the 1980s (see Holmstrom and Kaplan, *ibid.*). This model does not assume information asymmetry between bidders and target managers who knowingly accept bidders’ overvalued stock and therefore are not irrational.


48. J. S. Ang and Y. Cheng, *ibid*. Market value is compared with the expected value estimated by the residual income (RI) model incorporating expected return based on the Fama–French three-factor model and industry-relative market-to-book ratio (MB) (see Chapters 4 and 16 on these models respectively).
Median overvaluation for the whole sample is 36% (RI model) and 31% (MB model). Cash acquirers are overvalued by (median) 20% but stock acquirers by 40%, with the difference being significant. Median buy and hold return of overvalued acquirers is higher by 4% (around deal completion) and 5–6% (over one to three years post-acquisition) than those of overvalued non-acquirers (see Chapter 4 on this return). Overvaluation is greater in successful than in failed mergers, with the median difference between acquirer and target overvaluations 9% in successful and 0.6% in failed mergers. Since, generally, it is tender offers and hostile tender offers that fail, rather than mergers that are negotiated between bidder and target managers, this result is consistent with target managements’ opportunism being more constrained in failed bids (see footnote 41 above).

49. M. Rhodes-Kropf and S. Viswanathan, ‘Market valuation and merger waves’, *Journal of Finance*, 59(6), 2004, 2685–2717. The authors tease out a number of implications of their model, which they empirically test for in a follow-up paper discussed below.


CHAPTER 3

Alternative perspectives on mergers

Objectives

At the end of this chapter, the reader should be able to understand:

- the different perspectives on M & A, their focus and the major elements;
- the rationale for merger decisions under each perspective;
- the potential outcomes of merger decisions under each perspective;
- sources of value and risk in mergers; and
- M & A as a process rather than as a mere transaction.

Introduction

In the last chapter we traced M & A trends over the past 110 years and observed several peaks of activity. Takeover activity is also from time to time concentrated in certain industries, perhaps because of firms in those industries responding to exogenous factors and seeking to alter the competitive structure of their industries in their favour under the stimulus of these factors. The earliest wave we observed, the 1890s wave in the US, was described as merging for monopolies. Thus one possible framework to explain and predict the incidence of mergers is the economic perspective that covers monopoly power, economies of scale and scope, and relative transaction costs in markets and costs of internal organization.

We have also seen that technological changes often trigger corporate restructuring through mergers and acquisitions. This suggests that firms seek to alter the competitive structure of their markets through exploitation of technological resources and capabilities they have built up internally or acquired through M & A. We have also observed that although monopolistic mergers may have declined over the decades as a result of strict antitrust regimes, companies still carried out many related and unrelated or diversifying acquisitions. To explain these we need a corporate strategy perspective.

There are also other perspectives such as finance theory and managerial perspectives from which to view mergers and acquisitions. For example, the managerial perspective is useful in explaining the widespread evidence that most acquisitions do not generate value for their shareholders or other stakeholders. The finance perspective explains the conditions under which takeovers can provide discipline against the self-interested behaviour of top managers, and the relationship between takeovers as a disciplinary device and other corporate control mechanisms. Mergers occur in the context of their firms’ political structure, culture and social...
processes, and these may impact on the merger decision as well as on its effectiveness. An organizational perspective may explain the quality of acquisition decisions and some of the risks involved in the merger process. Human aspects of the merger process also need to be kept in view.

These alternative perspectives provide a much richer set of models than any single perspective, and may explain not only the rationale for corporate acquisition decisions but also the organizational context and the processes that condition the decisions. The alternative perspectives are not always mutually exclusive. Since a modern corporation, especially a medium- or large-sized firm, tends to be a multi-product firm, we assume this model of the firm in the following discussion. This allows us to incorporate economies of scope, transactional costs, diversification and some of the managerial motives for mergers and other elements as being germane to our discussion. We can also examine organizational complexity as a factor in the M & A process.

**The economic perspective on mergers**

The rationale for mergers under the economic perspective generally rests on their impact on the various costs faced by the firms, and on their market power. Costs may be reduced or market power augmented, allowing firms to enjoy higher profits than under competitive conditions. Thus firms merge in order to gain competitive advantage over their rivals through cost reduction or increased market power. In the following analysis we discuss the various cost concepts underlying the economic perspective and how mergers enable firms to reduce their costs. We also examine how mergers enhance market power.

A firm is regarded as a homogeneous decision-making unit concerned with maximizing its long-run profitability through achieving or sustaining competitive advantage over its rivals. The ability of the firm to create or maintain its competitive advantage depends on the competitive structure of the market in which it sells its output—monopoly, monopolistic, oligopolistic or competitive. The competitive tool that the firm selects will depend on this structure, and on the expected reaction of the firm’s rivals. In a competitive market selling a homogeneous product or service it has to compete on price, and can maintain its competitive advantage only by being the least-cost producer. In a situation of monopolistic competition it may differentiate its offerings sufficiently to avoid or minimize direct rivalry with other firms and achieve a degree of monopoly in a local market. In an oligopolistic structure the firm may avoid price rivalry and compete on non-price dimensions that again may have the effect of differentiating the product.

In the case of a single product firm competing in a single market, cost leadership may be achieved through economy of scale or vertical integration. Superior profitability may also be achieved through increase in market power, with the concomitant ability to dictate or influence the price and profits. We observed in Chapter 2 that the first merger wave in the US, between 1890 and 1905, was described as merging for monopoly, but subsequent antitrust laws reduced the opportunity for such mergers. Thus monopoly power is no longer a sustainable goal for mergers, albeit attractive for the merging firms.

**Economy of scale**

Where the firm is a multi-product firm selling a number of related or unrelated products, cost reduction may be achieved through both economy of scale and economy of scope. Economy of scale refers to the cost reduction in producing a product from increasing the scale of its
production in a given period. Since production costs may have a fixed component that is largely invariant to volume of production, e.g. rents, administrative costs, the average cost of production falls when these fixed costs are spread over a larger volume. This results in scale economies. A limit to scale economies exists when the production volume reaches the minimum efficient scale (MES). Average production cost does not fall with increasing volume beyond that level.

Similar scale economies may also exist in the case of non-production costs associated with marketing, selling, distribution, storage or after-sales service, provided they have a fixed cost component invariant to volume. Since, in a merger, the merging firms jointly produce and sell a larger volume of their product than each on its own, there is opportunity for scale economies in both production and non-production costs. For this reason, many mergers and acquisitions are often justified on this basis (see Exhibit 3.1).

Scale economies may, however, be limited for several reasons. Once the firm passes the minimum efficient scale there are no further efficiency gains. When the firm becomes very large, organizational control problems may lead to diseconomies of scale. Where large scale leads to substantial market power, antitrust regulations may come into play to check or roll back such power, e.g. the Clayton Act in the US or EU Merger Regulation (see Chapter 17 on antitrust regulation).

Economy of learning

A firm can reduce the costs of producing the same volume of output in successive production periods through the learning process. Such learning arises in the form of more efficient scheduling of production, minimizing wasteful use of materials, better teamwork, or avoidance of past mistakes. Japanese companies’ continuous improvement processes exemplify the application of learning economy to production. Initial learning costs are high, but as the cumulative output over time increases, the learning curve gets less steep and the marginal value of learning with each additional unit of production increases.

While scale economy is concerned with scale of output in a single period, learning economy is concerned with cumulative volume of the same product over several periods. Scale economy
requires the existence of fixed costs of production, but learning economy is not premised upon it; it is more about organizational capacity for learning. Mergers can bring about economy of learning through sharing of best practices based on accumulated knowledge and experience of the workforces of the merging firms, but the case for learning economy is perhaps much weaker than for scale economy as a rationale for mergers. After a merger the cumulative output of the merging firms’ products increases, but the learning opportunities may be more limited than when a firm increases its cumulative output on its own from one period to the next.

**Economy of scope**

Scale economy and learning economy are characteristic of a single product. Most modern firms are, however, multi-product firms. In spite of a high volume of divestitures in the last two decades, the largest 500 firms in the US and in the world remain significantly diversified. Thus it is appropriate to focus on multi-product firms. With multiple products, a firm can achieve scope economy. Scope economy exists when the total cost of producing and selling several products by the multi-product firm is less than the sum of the costs of producing and selling the same products by individual firms specializing in each of those products. Examples of economy of scope include costs of research and development, use of a single umbrella brand to sell several products, and selling several products through common distribution channels. Richard Branson’s Virgin group exemplifies the use of an umbrella brand, e.g. Virgin Atlantic Airways, Virgin Music, Virgin Cola and Virgin Media. The bancassurance model pursued by many banks and insurance companies in the 1990s provides another example, with insurance companies using banking networks to sell their insurance and asset management products.

Scope economy depends on the existence of certain capabilities and resources that have a common applicability across several products. How common a firm’s resources and capabilities are depends on the portfolio of products the firm is selling. Some products may share a common technological basis, some may share similar geographical markets or consumer groups, and some may share only managerial capabilities. The last provides a rationale for a firm making unrelated diversification.

Scope economy may also be manifested in the form of increased revenue and profits rather than unit cost reduction of the individual products in a multi-product firm. Thus it is effective use of existing common resources and capabilities that creates added value through increased volume and sales revenue, rather than through efficiency. Thus use of an umbrella brand or common marketing channels may serve to increase sales of existing or new products, and may provide the opportunity to sell them at a premium price, thereby increasing profitability. Selling two complementary products together, e.g. food and wine, increases the sales of both in a restaurant. Revenue enhancement through scope economies is often a strategic logic for mergers of firms selling related products, technologies or markets (see Exhibit 3.2).

In theory, scale, learning and scope economies are a function of size of the firm, i.e. 'big is beautiful and profitable', and give large firms a cost advantage over small firms. They give firms an incentive to grow. Since mergers are a quick way to increase firm size, firms may resort to these transactions to exploit scale, learning and scope economies. By the same token, acquirers often justify their acquisitions on the basis of these putative economies. We discuss the conditions for optimal exploitation of scale and scope economies through M & A in more detail in Chapters 5 to 7, along with the limits to such economies that often result in 'big is ugly'. Scope economies in unrelated mergers are discussed in Chapter 8.
Exhibit 3.2

Scope economy in a merger

Pearson plc, the UK firm that, *inter alia*, publishes the *Financial Times*, also produces several products for the education market, particularly the fast growing e-education market. It made several acquisitions and entered into alliances to expand its online product portfolio concerned with developing and distributing curriculum content. In August 2000 Pearson acquired the Minneapolis-based firm National Computer Systems (NCS) for $2.5bn. NCS provided software and Internet-based technologies for collecting, managing and interpreting education data, and was also leader in testing and assessment technology that had access to 40% of the US schools. The acquisition extended Pearson’s product range, and allowed the merged companies to tailor individual learning programmes that enabled students to learn from home with the participation of their parents, while cutting the cost of reaching a wider number of students. Pearson estimated that the acquisition would deliver annual cost savings of $50m by 2002.

Source: Adapted from A. O’Conner, ‘NCS could be transforming purchase for Pearson’, *Financial Times*, 1 August 2000

Transaction cost economies and vertical integration

A firm may enter into arm’s length transactions with its supplier to source its inputs or with a distributor to sell its output. Alternatively, it can set up production of those inputs or distribution of its outputs within its own organizational control. These alternatives represent the ‘buy or make’ decision of the firm. The make decision can be effected by acquisition of a supplier or a distributor, leading to a vertical merger or integration. Firms choose between the make and buy alternatives by evaluating the comparative transactional costs of dealing with independent parties in the market and internal organization.

Both the market relationship between buyer and seller and vertical integration of the two operations generate costs for both the transacting parties. In the case of the market relationship these costs include the return required by them for entering into the transaction, the cost of contracting, the cost of monitoring contract compliance, and the enforcement cost when either party breaches the contract. These costs may be difficult to estimate and even more difficult to recover in the event of a breach. The sources of these problems are varied, and rooted in the information asymmetry between the buyer and seller. In other cases, even a long-standing buyer–seller relationship could be strained by forces generated outside that relationship.

Until the late 1990s Marks and Spencer, once regarded as the flagship of the UK clothing retail market, had a close relationship with its UK-based suppliers. The suppliers, albeit independent, would tailor their clothing designs to the specifications supplied by M & S. The long and paternalistic relationship, however, precluded M & S from sourcing its supplies from cheaper markets overseas, whereas its high street competitors could. Moreover, the relationship also weakened the suppliers’ incentive to innovate and produce competitive designs. These suppliers had developed too much dependence on M & S. At the end of the 1990s M & S’s operating and stock market performance fell sharply, forcing it to start sourcing its merchandise from overseas to cut costs. This switching hurt M & S’s traditional suppliers a great deal, with many of them unable to survive.
An alternative to market relationship is to internalize the transaction through vertical integration. Thus an organizational solution is proposed for market failure. In the case of a conglomerate firm, Oliver Williamson also proposed that the firm plays an internal capital market role by allocating scarce capital resources to highest valued uses. The need for this internalization of the capital market function arises from the supposed failure of the external capital market, which also suffers from information asymmetry.

Firms can undertake mergers to bring about vertical integration of the adjacent stages from the inputs through production to retailing to the consumer. Firms can integrate vertically forwards or backwards through a merger. For example, an oil company owning refineries may acquire an exploration and production company to increase its access to oil to feed its refineries. Many Chinese steelmakers made vertical mergers to acquire captive iron ore mines, and Russian steel companies acquired small steel companies in Europe to gain technology and market access in 2006.

In addition to the cost reduction benefits of vertical integration, it can also give the firm a competitive advantage over its rivals that do not enjoy similar low-cost inputs or distribution channels. Thus it can also be used as an effective entry barrier. Vertical integration, however, is not free of problems. For example, the integrated supplier may sell only in-house and therefore not exploit possible scale economies. We discuss these potential problems in Chapter 6. Where a vertical merger encounters these problems it will not be an optimal decision, and it will fail to create value for its stakeholders. The 1980s and 1990s divestiture waves included many previously integrated operations, suggesting that the realized benefits did not exceed the costs of integration. The recent trend in large-scale outsourcing testifies to the excessive cost of integrated operations.

Industry analysis of competition

The above perspective describes the sources of economic value to the firm, but does not relate to the context of the firm’s efforts at value creation. This context is the competitive environment of the firm. What this environment is, and how firms compete within it, are matters of relevance to whether or not they can create value. An economic perspective that provides a framework to analyze mergers is the traditional structure–conduct–performance paradigm of industrial economics shown in Figure 3.1, and Michael Porter’s five forces model of industry competition as shown in Figure 3.2. In the SCP model industry structure plays a central role,
Industry analysis of competition

**Figure 3.2** Porter’s five forces model of competition

![Porter’s five forces model of competition](image)

**Source:** Adapted from M. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: The Free Press, 1998), Figure 1.1.

and shapes firm conduct and determines firm as well as average industry profit performance. This is depicted by the continuous arrows.

Porter defines industry competitive structure by the interaction of these five forces: current competitive rivalry, threat of new entrants, relative bargaining power of the buyers of firm’s output, relative bargaining power of the seller of the firm’s inputs, and threat of substitutes. The strength of each competitive force is determined by a number of factors, as illustrated in Table 3.1.

These five forces determine the average profitability of firms in the industry and hence its attractiveness. They are not of equal strength within the same industry or across industries. An assessment of market attractiveness depends in turn upon an assessment of the strength of

**Table 3.1** Determinants of strength of the five competitive forces

<table>
<thead>
<tr>
<th>Competitive force</th>
<th>Strengthened by</th>
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<tr>
<td><strong>New entrant</strong></td>
<td>Low level of entry barriers (e.g. scale economies, capital requirements, absolute cost advantages from learning, access to distribution channels)</td>
</tr>
<tr>
<td><strong>Product substitution</strong></td>
<td>Low relative price of substitute, buyer propensity to substitute, low (product) switching costs to buyers, superior performance of substitutes</td>
</tr>
<tr>
<td><strong>Supplier power</strong></td>
<td>High (supplier) switching costs to buyers, non-availability of substitutes, supplier concentration, ability to integrate forwards</td>
</tr>
<tr>
<td><strong>Buyer power</strong></td>
<td>Buyer concentration, low cost of switching to other sellers, ability to integrate backwards, buyer information</td>
</tr>
<tr>
<td><strong>Current rivalry</strong></td>
<td>Low industry growth, high fixed operating costs, excess capacity, low product differentiation, seller concentration</td>
</tr>
</tbody>
</table>