Mergers and Acquisitions: A Conceptual Review

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Abstract

From the last few decades, maximum studies focused to understand the importance of going into the deal of Mergers & Acquisitions (M&A). The current study examined the motivation to recognize either the assumed benefits of the deal of Mergers and Acquisitions have posted increase or not. The current study calculated whether the deal is beneficial or harmful for the organizations who want to enter into the deal of M&A. The study scrutinizes the issues by using the perspective of history, waves, motives and methods to determine Merger and acquisition value. The study focuses on the current Literature available on M&A from the recent past to portray unlike the methods used to gauge performance of M&A. Although field of M&A research is far too broad and more complex to be covered in a review paper, therefore, the study attempts to start covering some historical and background issues such as History, waves in M&A, Methods of measuring deals and M&A motives.

Keywords: Mergers and Acquisitions, Performance, Value
1. Introduction

The main objective of every organization is to get maximum profit every year to increase the wealth of shareholders by giving them high dividends. Every organization adopts different techniques and tools to maximize its profit and can be able to survive in the fast growing market. There exists certain event for which every organization has to respond spontaneously in order to get maximum gains like entering into new markets, launching new products, increasing portfolio etc. The firms then require financial resources to achieve their objectives as quickly as possible to enjoy a certain monopoly in the market. These events and transactions create a huge amount of problems for those firms and organizations that lack or fail to arrange finance to meet the requirements of the growing market. The small or less profit oriented organizations left with no option except to quit from the market or else merged with or acquired by sound/good financial firms. Mergers and acquisitions are very easy and the only option for small or less profit making organizations to stay and survive in the emerging market. Mergers and acquisitions are a global business strategy that enables firms to enter into new potential markets or to a new business area.

Merger and acquisition are not the same terminologies but often it is used interchangeably. In acquisition one organization purchase a part or whole another organization. While in merger two or more than two organizations constitute one organization (Alao 2010). Merger is the legal activity in which two or more organizations combine and only one firm survive as a legal entity (Horne and John 2004). As per the definition of Georgios (2011) in a merger, two or more firms approach together and become a single firm in acquisition big and financially sound firm purchase the small firm. Khan (2011) presented a definition of merger as two or more firms close together and form one or more firms. Durga, Rao and Kumar (2013) defined mergers and acquisitions as activities involving takeovers, corporate restructuring, or corporate control that changes in ownership structure of firms.

The main objective of the firm behind entering into the deal of merger and acquisition is to work with other companies that can be more beneficial as compared to work alone in a market. Due to merger and acquisition the return on equity and shareholders wealth increases and it decreases any related expenses (operating cost) for the firm as well (Georgios and Georgios 2011). For survival in the fast efficient market, Maximization of shareholders wealth is the next important objective of merger and acquisition. The management of the firm is also in favor of merger and acquisition as their authorities will be increased and they can achieve both short term and long term objectives of the firm (Gattoufi et al, 2009).

Merger and acquisition is a very important tool for the expansion of business in different countries and the researchers from all over the world are taking interest to work in this field (Goyal and Joshi 2011). If we go into the history of Merger and Acquisition, M & A were started from the United States back in the eighteen century. In Europe, the M & A begins in nineteen century (Focarelli, Panetta and Salleo 2002). Maximum research on M & A has been done in the United States and Europe market. Comparatively little research work had been done on M & A in the developing countries like Pakistan, India, Malaysia and Bangladesh etc.
For the last three decades, firms have been intensively used Mergers and Acquisition (M & A) as a strategic tool for corporate restructuring. Initially, this consolidation trend was limited to developed countries, especially the US and UK. However, afterwards developing countries started to follow the same pattern. The growth of the trend can be judged from the fact that in the US only the last decade of the twentieth century witnessed a threefold increase in the number of M&A whereas, a fivefold increase has been reported in terms of value (Coopland, 2005).

2. Different Waves in Mergers

In the existing literature on mergers and acquisitions, it has appeared in five distinct waves, which are as follows:

2.1 First Wave

The first wave started from 1897 and lasts until 1904. In the recorded period, M&A started to grow in those firms and Organizations who want to get benefit from their manufacturing, as being a single seller in the market, like railroads, light & Power, etc. The discussed period appeared on screens as horizontal mergers and happened in the profound industries (Fatima and Shehzad, 2014). Maximum of the deals that were started in the first period of M&A proved to be unsuccessful as the deals failed to accomplish the set goals and objectives.

2.2 Second Wave

The second period of M&A started from 1916 and lasted until 1929. The core objective in this period was to enter businesses into the deal of mergers and acquisitions that want to enjoy oligopoly and not monopoly. The Hi-tech expansion as the progress of railroads and transportation took place in the said time period. This M&A wave was horizontal or conglomerate (Golubov & Petmezas, 2013). Firms and organizations that have entered into the deal of M&A were the key producers of Ore and mineral, food items, oil & fuel, transport and chemical etc. Banks played a serious role in assisting the deals of M&A. Banks like Investment banks granted loans to the investors on easy installments. The wave proved to be crumbled of the share market in 1929.

2.3 Third Wave

The third wave of merger happened in 1965 and ended in 1969. Most of the deals were conglomerated in nature. The deals of Mergers and acquisitions were mainly backed from the capital of owners and banks appeared to be off screen. The wave started to move towards the end as consolidation of unlike firms and organizations stated to post unsatisfying results in 1968 (Fatima and Shehzad, 2014).

2.4 Fourth Wave

The fourth wave of mergers (1981-89) was exceptional in terms of noteworthy role of hostile mergers. Hostile mergers had turned out to be a tolerable type of business extension by the 1980s. The business invasion had achieved the rank, as highly beneficial speculative action. Furthermore! Organizations and speculative affiliations initiated to take over firms and
treated it as mean of taking benefit from lofty profits in short span. Takeovers in the current wave were either believed to be friendly or hostile. It was mainly depended on the response of the board of directors of the target firm. If the board of directors endorsed the takeover, it was well thought-out to be a friendly one, and if the board of directors opposed the deal, the takeover was supposed to be a hostile. According to Golubov & Petmezas (2013), the merger that was initiated between the oil and gas, pharmaceutical, banking and airlines are basically recorded in the fourth wave.

2.5 Fifth Wave

The wave started from 1992 and lasted until 2000. The wave gets its inspiration from the worldwide increased and boom in the share market and consequently happened deregulation. This wave took place in banks and telecom segments. The deals were backed by equity capital to a certain extent as compared to debt finance (Kouser & Saba, 2011).

2.6 Sixth Wave

The sixth merger wave (2003-2007) was described by merging in the metals, oil & gas, Utilities telecoms banking and Health care centers. This wave was fuelled by expanding globalization and support by the Government of specific nations like France, Italy, and Russia to make solid national and worldwide champions. Private equity buyers assumed an indispensable part, representing a quarter of the general takeover movement, empowered by the accessibility of credit that businesses were readied to give at low interest rate. Cash financed deals were significantly more pervasive over this period (Alexandridis, 2012)

3. Methods Used in Mergers and Acquisitions

The performance of Mergers and acquisitions are determined by different methods, therefore, the current study covers some of the techniques that are oftenly used in existing literature.

3.1 Accounting Return

Accounting Returns studies involve the analysis of the accounting performance of the joint entity measured in terms of Return on Assets or Return on Equity; two to three years post acquisition. Accounting studies typically contrast results for the sample firms with control firms to discount any industry wide phenomenon (Krishnakumar & Sethi, 2012).

Furthermore, Ruback, and Palepu (1992) added to the expansion of accounting returns and in the methodology of gauging operating performance. The study illustrated that most preceding studies had analyzed the performance of stock prices and consequently capital appreciation could be due to market inefficiency and mispricing. In addition, the study used an operating cash flow, which has been adjusted against industry standard returns to judge performance for a period of five years post M&A. Healy, Palepu and Ruback, (1992) calculated the post-acquisition operating performance of fifty mergers between U.S. public firms. Their study computed a return metric of cash flows classified as sales less CGS, and marketing and admin expenses, along with depreciation and goodwill expenses to give a return metric that is equivalent crosswise. By not including the cause of depreciation, interest exp, goodwill, and taxes, methodology are unaltered for accounting of M&A or for financing the merger. The
pre-acquisition accounting data for the target and acquirer firms preceding to merger was figured to attain pre-merger performance of the combined entity (Krishnakumar & Sethi, 2012).

3.2 Event Studies

Event Study is the most well-liked tactic and method adopted by researchers. Zollo, and Degenhard, (2007) studied 87 research articles on acquisition performance from top Management and Finance Journals between 1970 and 2006, and establish that 41% depicted the short-term event study method, while 16% used the long term event study method.

This methodology has its beginning in 1930’s. A detailed portrayal of the methodology which is the basis of most of the up to date event studies has been provided by MacKinlay (1997). First the normal returns for the chosen firm in relation to the market are estimated using a regression equation (1).

\[ R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \] ……………………………..(1)

where, \( R_{it} \) is expected return on the firm.
\( R_{mt} \) is return on the market portfolio
\( \alpha_i \) is intercept term
\( \beta_i \) is sensitivity of the return on the firm to market returns
\( \varepsilon_{it} \) is zero mean disturbance term

Normally daily returns are used for inference and not monthly returns. The researcher has an option of the time lines to be used for estimating the normal returns before the event (the announcement date) (Woznik, 2013).

In our assessment, we originate that the estimation period used was classically a 200 day period for about -250 to -50 days before the event. However, the researchers, Anand and Singh (1997); Singh and Montogomery (1987) employed an event window of -800 to -551 days before the event. They used this method to confiscate any effect of rumors in the market before the actual event announcement.

Having anticipated the normal returns for a firm, the market model is then employed to conclude the cumulative abnormal return for organization just about the event announcement.

Hayward (2003), Wang and Xie (2007), Masulis, Moshifique and Boetang (2009), Krishnan, Krishnan and Lefanowicz (2009), Anand and Singh (1997), Pangarkar and Lie (2004), Hayward (2002, 2003) has illustrated the short term event window up to -5 to + 5 days. While Chatterjee, (1986) has calculated long term abnormal returns up to 50 days post the event announcement. Similarly, another study has depicted the long term event window up to 100 days post acquisition (Singh and Montgomery, 1987).
3.3 Economic Value Added

Economic Value Added is another method to investigate the M&A. Therefore, Sirower, and O’Byrne, (1998) verify the expected level of annual operating performance expressed in terms of Economic Value Added (EVA) to validate the acquisition. This measure developed by Stern Stewart & Co involves measuring a firm’s financial performance by deducting cost of capital from operating profits. EVA provides a useful yardstick to measure actual versus expected acquisition performance (Sirower and O’Byrne, 1998). Their study computed the pre-acquisition values of both companies and the acquisition premium to decide the prospect stage of yearly operating performance essential to validate the investment. Their study narrated yearly expected increase in EVA, for the acquirer and target to disembark at a performance benchmark. Sirower and O’Byrne (1998) intended the actual EVA improvement and compared the dissimilarity between the real EVA improvements to performance yardstick with Market Abnormal Returns. Their study found a high correlation between the market abnormal returns and the EVA Performance benchmark return. The methodology shows what the joint business must bring about if it operates in the best interest of shareholders.

3.4 Residual Income Approach

Guest, Bild and Runsten (2010), noticed that both the event study methodology and the accounting returns methodology had limitations that did not determine the true fundamental valuation of an acquisition. Their approach is similar to the EVA approach. Their study proposed an alternate approach which they called the residual income approach, wherein researchers contrasted the fundamental value of acquirers prior to acquisition with the elementary post-acquisition value

The pre acquisition fundamental value of the firm is defined as:

\[ V_{pre} = \frac{E_{-1}(DPS_{0,1,2})}{(1+r_e)} + \frac{E_{-1}(BPS_{0,1,2})}{(1+r_e)^2} + \frac{E_{-1}(EPS_1 - r_e BPS_0)}{(1+r_e)^3} + \frac{E_{-1}(EPS_2 - r_e BPS_1)}{(1+r_e)^4} + \frac{E_{-1}(EPS_3 - r_e BPS_2)}{(1+r_e)^5} \]

- \( V_{pre} \) - Value of acquirer pre acquisition
- \( E_{-1}(DPS_{0,1,2}) \) - Expectation of dividend per share in the year of M&A, one year following acquisition and two years following M&A.
- \( E_{-1}(BPS_{0,1,2}) \) – Expectation of book value per share in the year of M&A, one year following and two years following M&A.
- \( r_e \) - Cost of Equity

The first two terms of the equation (i) are the anticipation of dividend per share and book-value per share in consolidation year. Third and fourth term of equation (i) portrays the expected residual income in year 1 and 2 post consolidation and the last term denotes the expectation of terminal value.

While the value post acquisition is defined as:
\[ V_{\text{post}} = \frac{\text{DPS}_0}{1 + r_e} + \frac{\text{BPS}_0}{1 + r_e} + \frac{\text{EPS}_1 - r_e \cdot \text{BPS}_0}{(1 + r_e)^2} + \frac{\text{EPS}_2 - r_e \cdot \text{BPS}_1}{(1 + r_e)^3} + \frac{\text{EPS}_3 - r_e \cdot \text{BPS}_2}{(1 + r_e)^4} \]

\( V_{\text{post}} \) - Value of acquirer post acquisition

\( (DPS_{0,1,2}) \) - Dividend per share in the year of M&A, one year following acquisition and two years following M&A.

\( (BPS_{0,1,2}) \) – Book value per share in the year of M&A, one year following acquisition and two years following M&A.

\( r_e \) – Cost of Equity

The first two terms of the equation (ii) signify the dividend per share and book-value per share in consolidation year. Third and fourth term of equation (ii) describes the residual income in year one and two and the last term denotes terminal value.

The difference between \( V_{\text{post}} \) and \( V_{\text{pre}} \) is the fundamental value created or lost by the acquisition.

### 3.5 Data Envelopment Analysis

As latest study, Rasiah, Ming and Hamid (2014), have used the Data Envelopment technique to weight performance. Data envelopment analysis (DEA) is a linear programming technique more common in operations research for comparing the relative efficiency of decision making units (Krishnakumar & Sethi 2012). An efficiency of each unit is calculated in terms of a ratio of output to input variables. An efficiency frontier is computed consisting of the most efficient firms; each unit is then compared to the efficiency frontier. Kwoka and Pollitt (2010), used this practice to probe the efficiency of mergers that took place in the United states electric-power distribution segment. Their study measured the consequences of mergers on firm cost efficiency, measured in terms of the sum of the operating expenses plus current capital expenditure. Every firm was then matched up to a blend of supreme practice firms which could generate at least as much of each output as the less competent firm but with the smallest amount of contributions. Their sample included 73 utilities of which twelve were purchased, twenty were sellers, and the remaining forty-one were control firms having no concern with mergers during the study period.

### 3.6 Questionnaire Method

A questionnaire method has been used usually where objective methods of assessing performance are not obtainable, for example, in the case of acquisition of petite divisions or private acquisitions (Datta and Grant, 1990). Their study has advocated about the use of a questionnaire method for studying performance and argued that both accounting and market measures are musculously influenced by external variables, hence separating the impact of acquisitions from other events becomes very thorny and complex. In case the acquiring firm is multidivisional or acquired firm is very small, then these measures would not be able to
spot the acquisition performance. Their study has also affirmed that abnormal returns reveal the performance expectation, not definite or genuine outcome.

Questionnaire may be directed either to managers of the acquiring company. Similarly, the results are supported by several researchers like Datta, and Grant (1990), Cannella and Hambrick (1993) and Reus and Lamont (2009), managers of the acquired company or to outside experts such as a Stock Market forecaster or analysts (Cannella, and Hambrick, 1993).

3.7 Innovative Performance

The innovative performance practice measures the impact of acquisitions on novelty or modernism as measured by the patenting frequency of the acquiring firm. Ahuja and Katila, (2001), figured innovation performance as a measure to point out success of technological acquisition. The study observes the effect of M&A on the succeeding novelty act of acquiring firms in the chemical sector. Their study has chosen a section of firms worldwide from chemical industry, free of their M&A, and outlined the acquisition performance of these firms.

3.8 Case Study Approach

A few but key researchers and practitioners have selected a case study approach wherein they have intended a small sample of acquisitions to figure out the factors that have guided to success or breakdown in a particular state of affairs. For example, Appelbaum and Roberts (2009), deliberated the role of cultural fit, direction and leadership in the triumph and failure of ten M&A situations.

4. Motives behind Mergers and Acquisitions

The current study elaborates some of the key and essential motives behind the deal of M&A. Some of them are as follows:

4.1 Synergy Motive

The widespread goal of all mergers and acquisitions is to hunt synergy gains. Synergy is accomplished when the value of the combination of the two firms is superior to sum of the two stand-alone values (Jensen and Ruback 1983, Bradley 1988). This effect is often portrayed as 1+1=3.

Synergy gains can be Operational or Financial. They may take the shape of Cost reduction and perfection in operational efficiency; revenue improvements due to optimization of distribution network e.g. cross selling, a boost in market power e.g. abolition of competitors or a range of financial advantages like tax efficiency and leverage (Seth, 1990a, 1990b).

Cost reduction is a usual source of synergies and can be accomplished from economies of scale and scope; get rid of duplicate facilities or alternatives and increased bargaining power against dealer or supplier (Fatima and Shehzad, 2014).

Revenue enhancement, another often cited cause of synergy (Krishnakumar & Sethi 2012).
It happens when the merged entity gets superior sales or growth level than the two stand-alone corporations. This can happen only due to sleeker product offerings, e.g. complimentary commodities and improved distribution work.

Diversification is another frequently quoted basis of synergy in mergers e.g. diversified organizations may generate so called internal capital markets, which permits the allocation of funds between divisions without resistance and inefficiency (Travlos and Doukas, 1988). Their study proposed that M&A of overseas organizations serves diversification medium which facilitate acquirer in expanding its borders.

Corporate Governance can be an additional supply of synergy as effectiveness of governance mechanism varies between firms. Wang and Xie, (2009), demonstrate that ‘Corporate governance transfers’ influence merger synergies which are then divided between the merging firms. This source turns out to be even more vital in global acquisitions, as corporate governance principles vary significantly across unlike markets. Bris and Cabolis, (2008), explain how dissimilarities in corporate governance across the country can be reason for cross border mergers.

Financial synergy is an additional source which stimulates firms to merge such as Tax consideration. Scholes and Wolfson, (1990) exhibit the outcome of US tax reforms of 1980s on M&A market. Also Hayn, (1989) explains that managers with admittance to spare cash favor in engaging favorite projects and unbeneficial or unsuccessful acquisitions instead of giving back to shareholders. This is sign of agency conflict between owners and managers.

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4.2 Agency Motive:

Under the agency motive, managers may get acquisitions against the attention of the shareholders. E.g. Amihud and Lev, (1981) depict that managers engage in conglomerate mergers in order to spread activities of the firm and smooth out earnings, thereby securing their jobs; though, this is against shareholders’ interest as they can diversify at their own at a very little cost.

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Firstly, executive’s payments is often connected to firm size, so that the managers have the first choice for growing the firm ever larger. As paying cash to shareholders lessens firm size and their discretion, managers tend to involve in negative NPV investments.

Secondly, it is simply more esteemed to head huge Organizations, CEOs in comparing to managers, who in fact believe in their abilities to build and craft value, are seeking more supremacy against shareholder interests. Thus prospects of lofty and towering remuneration and the kudos of running large firms push managers into making acquisitions even if the deal is unfavorable, harmful or unprofitable to the firm value.
4.3 Managerial Overconfidence (Hubris Hypothesis)

The merger wave was initially anticipated by Roll, 1986. The theory states that managers wrongly believe that they are quite better enough as compared to the rest of the management to control and supervise different firms. That is, they are arrogant and self-centered in their decision-making aptitude and conclude by paying more for target which turns the bidder firm to drop. Furthermore! It has been established that the hubris result is similar to the winner’s curse that occur in frequent value auctions where bidders pay more for the auctioned item. Here, the bidder that has highest bid would yield highest positive valuation error (reflecting his boldness) and is successful in winning the target. At the end, shareholders of the bidding firm lose from the deal because the market reacts to the blunder committed by the manager of the bidding firm.

Doukas and Petmezas, (2007) and Billet and Qian, (2008) conjecture that managers with overconfidence, sourced by self attribution bias, tend to attribute their preliminary success from previous corporate decisions to their own ability, and as a result carry out a worse deal later on which drastically underperform acquisitions initiated by non-overconfident managers.

4.4 Efficiency gains:

Farrell in 1990 and Shapiro in 2001 differentiated efficiencies as technical and synergy efficiency. They recorded technical efficiency as one that could be achieved by other ways than M&A. They concluded joint ventures, agreements, interior growth and licensing, as other ways of achieving efficiency than M&A. As per the study of instigators, technical efficiency communicates to the amendments that occur inside the combined manufacturing potential of the merging firms. In short, they can be increased by a redeployment of output across the merging entities or scale economies, provided the capital is portable. In long, they can be marked by starting investment on a mega scale. On the other side, synergy may be defined as efficiency attained through the close mixture of the merging firms and are intrinsically merger-oriented. Farrell and Shapiro (1990 and 2001).

5. Conclusion

Over the years several studies have been carried out to evaluate whether Mergers and Acquisitions have been value enhancing or destructive of organizations. The methods that have been used to analyze acquisition performance are varied. The objective of our study is to review the literature to study history of M&A, phases, Motives and different methods used for measuring performance; evaluate the benefits and shortcomings; investigate whether there have been new developments in the techniques used over the last few years. The study started reviewing the M&A literature with an aim to understand the relevant processes and synthesizing the research results for the benefit of managers and future researchers. The scope of the study thus was restricted to M&A history, phases, motives, and methods. To conclude, the current study shows that there are multiple methods of measuring acquisition performance, each with its merits and demerits. The selection of the method of measurement is crucial to the results drawn, hence should be selected with great care.
References


