MERGERS & ACQUISITIONS: MOTIVES AND VALUE CREATION

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ABSTRACT

Over the years, Mergers & Acquisitions (M&A) have become part of a potent strategy to accelerate value-creation, attracting trillions of dollars every year globally. Ironically, recent research points out that M&A have a negative, or at best negligible, positive effect. This is so, particularly for the acquirer, due to failure in realizing expected synergies, including growth in worker productivity, greater economic efficiency, and lower prices. Despite this, why are M&A so popular? Do M&A really create value? This paper puts the motives and value creation potential of M&A in perspective through a literature review of recent research on M&A, and identifies key aspects that can increase the success of M&A, particularly in current times of global economic slowdown.

Keywords: Mergers & Acqusitions, M&A, M&A motives, M&A Value creation

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I. GLOBAL M&A : GROWTH AND OUTLOOK

Today, as markets and business models continue to disrupt and become fiercely competitive, firms are increasingly resorting to inorganic methods of value-creation, such as mergers and acquisitions (M&A), to grow their business.

Since 2000, over 790,000 transactions have been announced globally, with a known value of over USD 57 trillion[1]. Trillions of dollars are invested in M&A every year. Table 1 provides a sample of M&A value and the number of deals done over the past 15 years across the globe.

Table 1: Sample of M&A value and deals in past 15 years[1]

Year	USD (trillions)	Number of Deals
2019	3.70	49849
2014	3.95	43190
2009	2.18	40710
2004	2.14	32953

Despite an environment marked by geopolitical and economic uncertainty, the global M&A outlook remains strong. According to a survey of 2,900 executives conducted in August and September 2019, 70% of which were CEOs, CFOs, and other C-level executives, spread across 45 countries and diverse industries, 52% respondents planned to actively pursue M&A in the next 12 months[2]. Arguably, in an uncertain environment, the speed with which companies need to adapt and transform cannot, in most cases, be achieved without M&A.

What are the motives underlying M&A, and do they generate value? The following sections put M&A motives and their value creation potential in perspective through a literature review of recent academic research on M&A. The following sections also identify key aspects that can increase the success of M&A in current times.

II. MOTIVES UNDERLYING M&A

What drives M&A? Industrial rationales, ranging from access to new resources, increase in marketing capability, and greater market share, to achieving economies of scale, and reducing risks, are some of the prime motives for M&A. Corporate governance rationales

1 IMAA Institute (imaa-institute.org), Merger and Acquisitions Statistics
2 EY Global Capital Confidence Barometer, October 2019, www.ey.com/CCB

such as rectification of internal inefficiencies, diseconomies of scale, information asymmetries, and capital market flaws (Motis, 2007) also drive M&A.

Studies by Vermeulen et. al. (2001) and Madhok (1997) show that the opportunity to acquire new capabilities and knowledge is a key motivation behind cross-border M&A. This is especially important in recent years when products are increasingly dependent on multiple technologies and one company alone cannot maintain sophistication in all such technologies. This is the resource-based view based on organizational learning perspectives (Mohammad F. Ahammad, 2010). Examples of resources that can be acquired via M&A include advanced managing skills, marketing skills, and technology. Shimizu et al. (2004) add on to this and state that often firms undertake M&A to exploit intangible assets such as brand names.

Currently, one of the main motives for integrations and M&A is the mutual synergy experienced by each firm. Synergy is achieved when two organizations interact and cooperate by combining their operations and activities such as R&D and marketing. M&A can help firms gain economies of scale due to larger scale of production (Jaideep Anand, 1998). Furthermore, they can pool their resources, by combining their research and equipment to come up with a unique product ensuring their long-run profitability.

Berkovitch and Narayanan (1993) list another M&A motive named agency. The agency motive suggests that managers of the acquiring firm may undertake M&A— even though it might seem illogical from an economic standpoint — due to the incentives to maximise their welfare at the cost of the shareholder's welfare (Elazar Berkovitch, 1993). Managers want a firm to grow for personal reasons and this growth is achieved through M&As. One reason why this occurs is that managers' salaries are often linked to the size of the firm. The bigger the firm, the higher is their salary. Another reason is the greater power and status they achieve as the firm grows. For example, the chances of being on the board of directors is achieved more easily by managers of large companies. To accomplish this, managers can undertake both domestic and cross-border M&A (Mohammad F. Ahammad, 2010).

Diversification occurs when a firm sells new products in new markets and aims to increase its risk-bearing economies of scale (Sudarsanam, 1995). This entails a particular type of acquisition in which the target company operates in an industry which is unrelated to the firm acquiring the company. Diversification allows the firm to access vital resources along with reducing the risks and costs of entering a foreign market.

Structurally, most of the M&A deals or integrations can be classified broadly into three main categories — *horizontal, vertical, and conglomerate*. The main motives behind a *vertical*

integration, i.e. an integration wherein a company wants to control parts of its supply chain by acquiring either a distributor (forward vertical integration) or a supplier (backward vertical integration), are to reduce the rivalry between manufacturers and retailers. This results in competitive pricing, eliminates double marginalization by removing double mark-ups within the supply chain, and leads to higher joint profits. It reduces the average cost of production through economies of scale, and increases the market power of the company. On the other hand, the major incentive for *horizontal integration,* or an integration between two firms at a similar stage in the supply chain, is acquiring a higher market concentration. This implies higher market power, leading to economies of scale and an increase in profits of the firms. And, for a *conglomerate integration,* or an integration between two firms producing totally unrelated products, the main incentive is the increased risk bearing capacity achieved by the firm.

III. DO M&A CREATE VALUE?

In a 2011 BCG report, over 26,000 mergers since 1988 were analyzed; a majority of the acquisitions of public companies by other public companies destroyed value for the acquirer. A number of researches have concluded that M&A deals tend to leave the acquiring firm's shareholder worse off than if the company had not bothered making the deal at all. However, Alexandridis et. al. (2017) assess the value-creation from M&A deals made post-2009 and derive a contrasting conclusion. They claim that post the 2008 financial crisis, acquiring firms employed efficient investment allocation strategies, leading to lower degree of under/over investment. According to their research, an average acquirer experienced a 2.54% return post 2009, which corresponds to a $62.3 million gain for its shareholders.

Christensen et.al. (2011), in a Harvard Business Review article, show that M&A have had a high failure rate of 70% to 90% because executives have often made mistakes in matching M&A targets with the strategic purposes of the deals in question. They assert that executives have often failed to distinguish between deals that had the potential to improve current operations as compared to those that could have been transformative for the company's growth. As a result, acquirers often falter by paying the wrong price and integrating the acquisition incorrectly. However, Bradley et. al. (2018), in another article published in the Harvard Business Review, challenged the statistic used by the researchers earlier and asserted that the myth of a 75% failure rate for M&A has long been dispelled. These authors claimed that the statistic used in the 2011 research was related to the announcement effect (i.e. the impact of transaction announcements on the share prices of companies involved), which failed to capture the reality of corporate value creation.

Measuring the success or failure of M&A is not an exact science (Rehm et. al., 2012). For publicly listed companies, a typical assessment of the potential value of the deal entails analyzing the short-term market reaction through a comparison of share prices of the acquirer and the target before and after the announcement of the deal. This is based on the efficient-market hypothesis where the value-creation expectations of the deal are reflected in the share prices. In the short term, the changes in the share prices of the companies involved in the deal can be largely attributed to the announcement of the transaction, also known as announcement effect. However, this approach is quite heavily dependent on the timing of comparison. Werner Rehm and Andy West (2016) assert that although announcement effects are useful short-term measures of market sentiment, they are poor indicators of long-term value creation. They considered the announcement effect an unreliable indicator of long-term value creation, since the value creation implied in the announcement effect and the excess total return to shareholders (TRS) two or more years post the deal did not demonstrate significant correlation. Furthermore, this effect usually highlights shareholders' predictions of the acquirer's ability to realize the synergies, but does not actually measure the value change on account of the deal.

Keeping the limitations of the study of announcement effects in mind, Rehm et al. (2012) studied the excess total returns to shareholders (TRS) of the world's top 1,000 non-banking companies which have completed 15,000 deals over the past decade. Their study involved assigning companies to subsectors and tracking the difference between a company's TRS and an index that tracks the subsector. In order to avoid the issues resulting from the collapse of the dotcom/technology bubble in the early 2000s, their analysis used 11-year excess TRS. Their research implies that companies with the right capabilities, across industries, tend to be more successful by making smaller acquisitions, whilst in the case of large deals, success is determined by industry structure, along with company's capabilities and leadership.

However, measuring the success of M&A in the long term also has various caveats. In the long term, measuring the effect of a single activity is quite challenging. A company would make various changes over a decade, such as changes in management, multiple M&A deals, simple expansion of current operations and so on. Due to these additional changes, it is difficult to check the ceteris paribus effect (holding all other things constant) of a single M&A deal after a couple of years.

Measuring the outcome of M&A is also difficult as there is no universally accepted method that is used by all firms to check their improvement. Some prefer to look at changes in earnings-per-share, while some look at return-on-investment (ROI).

Apart from focusing on a methodology to measure success, Rehm et al. (2012) suggested that a growth strategy built around programmatic M&A entailing a series of small deals can be less risky than not indulging in M&A. Kengelbach et al. (2019) investigates the relationship between the economic conditions when the M&A took place, and the M&A value creation. Their study uses a Relative Total Shareholder Return (RTSR) index to analyze the outcome of deals consummated in a strong economy and a weak economy. The index compares short-term performance at the time of deal announcement (in terms of Cumulative Abnormal Return), and one and two years after the announcement (in terms of RTSR). Notably, the results indicate that two years post acquisition, the RTSR for the acquirer is significantly higher and positive for deals done in a weak economy, as compared to those done in a strong economy.

IV. CONCLUSION

As markets and business models continue to disrupt and become fiercely competitive, firms are increasingly resorting to inorganic methods of growth, such as mergers and acquisitions (M&A), to enhance stakeholders' value.

Empirical evidence suggests that M&A are typically undertaken for a variety of motives including access to new resources, increase in marketing capability, greater market share, achieving economies of scale, diversification, reducing risks, rectification of internal inefficiencies and capital market imperfections, reducing/eliminating agency problems, and acquiring new capabilities and knowledge.

However, M&A do sometimes burden the acquiring/resultant firm with diseconomies of scale, cultural clashes between the firms, distraction from the main focus of the firm, decreased shareholder returns, and deterioration in the quality of the final product or service delivered by the merged firms. Sometimes, managers may undertake M&A for personal gains at the expense of the shareholders.

While there is ambiguity around the value creation potential of M&A from the acquiring firm's standpoint, largely emanating from the measures adopted to evaluate value creation, M&A when done programmatically, can have a greater risk-adjusted probability of success (Rehm et. al., 2012).

Kengelbach et al. (2019) show that the acquirer's Relative Total Shareholder Return for deals done in a weak economy is significantly higher, as compared to the RTSR for deals done in a strong economy, two years after the acquisition. Taking a cue from this, organizations could

consider M&A as a potent growth strategy in today's times of global economic slowdown. Current economic conditions could potentially offer attractive value creation opportunities through M&A.

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