Mergers, Acquisitions, and Divestitures: Control and Audit Best Practices

APPENDIX IV

Annotated Bibliography

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Disclosure

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The Professional Practices Framework for Internal Auditing (PPF) was designed by The IIA Board of Directors’ Guidance Task Force to appropriately organize the full range of existing and developing practice guidance for the profession. Based on the definition of internal auditing, the PPF comprises Ethics and Standards, Practice Advisories, and Development and Practice Aids, and paves the way to world-class internal auditing.

This guidance fits into the Framework under the heading Development and Practice Aids.
SECTION 1

Corporate Strategy and Acquisition Strategy

This section reviews the literature dealing with corporate strategy in general and acquisition strategy in particular.


Study of how companies have created value through nonsynergistic acquisitions against the current wisdom of emphasizing synergistic acquisitions based on “sticking to the knitting.” 800 acquisitions are examined falling into “diversified public corporate acquirers” and “financial buyers” such as LBO firms.

Successful corporate and financial buyers adopt 7 key operating principles:
1. Insist on innovative operating strategies
2. Don’t do the deal if you can’t find the leader
3. Offer big incentives to top-level executives
4. Link compensation to changes in cash flow
5. Push the pace of change
6. Foster dynamic relationships among owners, managers, and the board
7. Hire the best acquirers, i.e. select the best deal makers with experience

Corporate acquirers pursue a different strategy for building their acquisition teams and rely less on outside advisers. Alternative approaches to developing acquisition capabilities are: evolve in-house; establish a separate subsidiary and outsource.

For a company to become a successful acquirer, executives must think in unorthodox and uncomfortable ways. Don’t look for growth only in high-growth industries.

Useful discussion of the sources of value creation in nonsynergistic acquisitions.


A firm can effectively leverage a profitable initial resource position represented by superior routines and its associated team-embodied skills by replicating these routines.

At the firm level, a routine in operation at a particular site can be conceived as a web of coordinating relationships connecting specific resources: without those resources it could not exist.


Competitive advantage is now regarded as deriving from unique and idiosyncratic organizational resources and capabilities rather than from industry/ market factors. Sustainable competitive advantage grows out of those valuable, rent-generating capabilities that cannot easily be imitated or substituted.
Quotes:
“Some members of (organization) will be unaware of which resources constitute sources of (competitive) advantage.”

“…sources of advantage buried in organizational effects.”

VRIO = Valuable, Rare, Inimitable and Organized to leverage that factor or competence.

Real advantage may lie in complementarities of human resource factors, organizational climate, organizational culture, employee empowerment and participation, informal communication etc.

Knowledge integration may be an important element in competitive advantage (Grant, 1996), which may be embedded in social relations and in the structure of these intellectual and social capital relations (Nahapiet and Ghoshal, 1998).


A review of the following models of competitive strategy: Industrial economics based Structure- Conduct – Performance, Strategic Groups with similar asset & resource configuration and competitive positioning, Cognitive Communities, Networks in Cooperation and Competition, Resource-based View (RBV) and Competence-based Competition (CBC).

Economic, cognitive and social forces can all influence the ways competitors are defined.

Quotes:
“Firms pursue cooperative agreements in order to gains fast access to new technologies or new markets, to benefit from economies of scale in joint research and/or production, to tap into sources of know-how located outside the boundaries of the firm, and to share the risks for, activities that are beyond the scope or capability of a single organization” (Powell, 1990).

“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. The rate and direction of a firm’s growth is influences by how management conceptualizes the firm’s resource base.”

“Dominant logic is the management’s mental schema as the way in which management conceptualizes the business and make critical resource allocation decisions”

“Core competencies are the outcome of collective learning in the organization which are communicated across boundaries within the organization to coordinate production skills and integrate multiple technologies. Companies, which successfully identify and cultivate their core competencies can use them to obtain a sustainable competitive advantage.

“Acquisitions impact on dominant logic since management must learn and adapt its dominant logic to the new industry conditions it faces on entry. Core competencies evolve over time and acquisitions can help this evolution. Resource differences can lead to different ways that firms attempt to enter new markets. Parental resources or lack of them can constrain subsidiary development.”

Case study of European pharma companies’ entry into the U.S. (Bogner et al, 1996).

This empirical paper develops a new methodology to resolve the paradox that, while in theory economy of scope and commonly shared strategic capabilities confer competitive advantage and should enhance performance of multi-business companies, empirical evidence linking composition of corporate business portfolios to firm performance has not been strong. The paper proposes measuring relatedness of various businesses based on the resource-based approach since the rationale for multi-business organizations lies in the sharing of strategic capabilities.

The authors measure relatedness based on intercategory technology flows. Using U.S. data the study reports a significant relation between relatedness and firm performance (3 year and 6 year ROA).

RBV is that strategic interrelationships among businesses have a direct positive effect on firm performance.

**Quotes:**

“Certain forms of managerial or technical knowledge play a particularly important part in creating a rationale for the multi-business firm.” (Winter, 1987)

“Because they are both valuable and difficult for competitors to copy, capabilities of this kind can serve as “strategic assets.”” (Barney, 1991)

“The systemic, tacit character of these capabilities helps to give them strategic importance.” (Teece)

Useful in highlighting the importance of resources as the source of competitive advantage and in providing empirical evidence that multi-business companies can be financially successful.


What is business policy, strategic analysis, creating strategy and applications and audit, references and recommended reading. Case study of Laker Airways.

**Quote:** “What should we be doing now to help us reach the position we want to be in five to ten years? Where are we now? Where do we want to be? What do we have to do in order to change from where we are now to where we want to be?”

Strategic analysis: Decide on the objectives, analyze the company, analyze the market, generate strategy alternatives, select the best strategy, consider the implementation plan, and sell it to the organization.

Strategist’s tool kit: Strategic fit, SWOT analysis, competitive strength rating, industry analysis, generic strategies, value chain, financial analysis, PESTEL analysis, market analysis.

PESTEL = political, economic, social, technological, environmental and legal.

Creating strategy: Inventing strategy alternatives. SWOT approach, generic strategies approach, competitive strategy approach, resources approach, idealized design approach, mindsets approach. Selecting the best strategy.

Useful framework for thinking about strategy development. This can be applied to acquisition strategy.
In the light of poor acquisition performance, mere application of numerical capital budgeting is not enough. Qualitative judgments also need to be taken into account. Explores the theoretical and rational basis to identify target firms. A takeover strategy is developed. A four-component strategy is presented.

Successful corporate and mergers strategy should consist of the following: identification and screening of target candidates; valuation and financial structure; negotiation and acquisition and assimilation and value creation. Exchange rate risk to be evaluated in cross-border mergers.

Brief and lacking detailed framework for merger strategy.

This study analyses 41 previous studies reporting estimates of shareholder wealth gains for bidders and targets. It uses the technique of meta-analysis to “aggregate” the results of these studies to arrive at overall conclusions treating the individual studies as experiments. A multi-factor regression model is estimated.

Bidders gain $\frac{1}{2}\%$ and targets gain 22% abnormal returns consistent with the individual studies.

Model explains a substantial portion of the variance on wealth gains reported by previous studies. Robust evidence that shareholders gains are lower in stock than in cash mergers for both bidders and targets; multiple and conglomerate bids have negative impact on bidding firm shareholder wealth. Targets gain more from tender offers than from mergers and regulatory changes in 1968 (Williams Act) and 1969 (tax reform act), which imposed additional costs on bidders.

No new insights over and above those of individual studies but these are confirmed.

Tests the hypotheses that related mergers lower systematic risk of the acquirer and that unrelated mergers would not change the systematic risk. The paper argues that related mergers reduce risk because they are more synergistic through specialization and market power increases, they are able to exploit capital and acquisitions markets’ imperfections and they are able to reduce the variability of their cash flows. Unrelated mergers may be unable to achieve risk reduction to the same degree.

Using monthly and daily stock returns, betas are estimated for both pre-and post-merger firms. The changes in beta for two groups – related and unrelated merger groups – are calculated. Changes compared and difference in changes tested for statistical significance. Results show that betas of firms undertaking related mergers decline significantly and more than for unrelated merging firms.

Quote: “On average, mergers may be value creating events because they can reduce systematic risk in a manner which stockholders cannot achieve on their own.” (p. 266)
Counter-intuitive arguments for reduction in risk following related mergers. Useful discussion of the sources of systematic risk in related and unrelated mergers.


Provides a conceptual framework and empirical methodology to assess value creation in acquisitions. Argues why related acquisitions may not outperform unrelated ones on average. Empirical results indicate that value is created in both related and unrelated acquisitions and related does not create more value.

*Quote:* Sources of value creation in related acquisitions are: increased market power, economies of scale and scope. Coinsurance and risk reduction may be sources of value in unrelated merger. “The strongest conclusion we can make a priori is that different types of acquisitions are associated with different sources of value creation.” (p. 106)

Useful presentation of sources of value in different acquisition types.


Review of M&A in the US defense industry, uses Tobin's Q *inter alia* to assess effectiveness and timing of strategic merger and consolidation decisions.

*Quotes:*

“Two important conclusions are made concerning the characteristics of the 1980s acquisition wave based on the sample of acquired business units from 1980 to 1984. First, the finding of positive market share predictions complements event studies that find net gains in shareholder wealth in acquisitions but adds to these findings because these predictions are explicitly the result of operational synergy that is made possible by the acquisition. Second, while previous research suggests that the ex post performance of acquired businesses in the second wave of acquisitions is better than the first, this research confirms this finding and explains part of the source of improved performance in terms of operational synergy.” (p. 20)

“Although firms in declining industries may not have good prospects within their own industry, they cannot enhance their value by diversifying to escape the unattractiveness of their own industry.” (p.113)

“Since the number of attractive targets within the industry is limited, firms should respond to industry decline by taking quick action. Unlike diversification, consolidation is bounded by the availability of potential targets. The most attractive of these targets may be expected to be acquired sooner. Firms that postpone action risk losing these attractive opportunities. Since there is a causal relationship between consolidation and performance, firms should measure the attractiveness of potential targets by identifying the opportunities for consolidation.” (p. 113)


This paper evaluates the implication of different management styles on the success or otherwise of mergers. It covers integration very well, although it is primarily focused at the USA. Some good points on how the integration process works.
Quotes:
“The findings of this study suggest that compatibility of management styles is important to superior performance in acquisitions characterized by both high and low levels of post-acquisition integration of operations.” (p. 291)

“An interesting finding of this study is that differences in management styles have a negative impact on acquisition performance even in acquisitions characterized by low post-acquisition integration.” (p. 291)


Acquisitions and joint ventures, U.S. and Japan. Joint ventures are preferred when Japanese firms are inexperienced in USA.

Quotes:
“There is, however, an alternative to joint ventures when markets for two or more inputs, held by two or more separate firms are simultaneously failing. That solution is the merging of the firms holding the complementary inputs.” (p. 2)


Review of innovation versus “control” in acquisitions. Larger organizations need more formal controls, which impact innovation.

Quote: “With increasing diversification it is necessary for managers to make trade-offs between strategic controls and financial controls. Consequently, in highly diversified firms, financial controls are emphasized. This emphasis is necessary because financial controls allow top-level managers to cope successfully with the amount of information that they must process. However, financial controls cause business unit managers to focus on the short term and to become more risk-averse, thereby reducing their commitment to innovation.” (p. 41)


Rewards paid to CEOs of acquiring firms of differently managed companies.

Three types of firm:
• Manager controlled
• Owner controlled
• Owner/manager controlled

Quotes:
“Indeed, if CEO rewards are frequently independent of economic performance ... we may be left with the specter of managers of publicly held firms possibly enlarging the size of their enterprises through acquisitions to increase their own rewards rather than to enhance firm value.” (p. 86)

“It is interesting to note that higher levels of outside board member ownership are positively related to
greater executive oversight for manager-controlled firms but not for the other forms of corporate control. Apparently, outside directors become more involved in corporate strategy in situations where they suspect agency conflicts.” (p. 91)

“Our results suggest that when corporate governance is limited, as is the case with manager-controlled firms, acquisitions seem to be motivated for their contribution to firm expansion which tends to positively impact CEO rewards. The interests of shareholders seem to be of paramount importance in owner-controlled firms and of least importance in manager-controlled firms.” (p. 91)


Re-tests agency theory, concluding that management theory is more robust. Role and actions of managers do not necessarily match agency theory rules.

Quotes:
“...we repeatedly find a negligible relationship between the monitoring efforts by principals and the strategic behavior of agents.” (p. 557)

“...agency theory's relevant domain for explaining managerial behavior does not appear to extend to those instances where managerial interests do not clearly conflict with those of shareholders. (p. 570)

“...we find no support for the standard agency theory predictions that management-controlled firms are associated with strategically inferior levels of diversification and acquisition types, lower levels of risk, and lower levels of returns than are firms with large block shareholders and/or firms with vigilant boards.” (p. 571)


Study of “fit.” Provides a model and makes good points about how to evaluate fit.

Quotes:
“The bottom line conclusion concerning this normative model and empirical test is that “fit” matters. It was not intuitively obvious that such disparate variables of environment, entrepreneurship, organicity and mission strategy could be used to determine how a firm is matched to its current situation. As environments become more demanding in the future, it appears safe to argue that fit will matter even more.” (p. 146)

Implications include prescriptive guidance to assist practitioners in diagnosing and correcting “misfit” for individual organizations. The initial instrument and subsequent refinement represent transfer of knowledge to top management teams from research findings. The guidance is: 1) Knowledge of how to manage, what variables to attend to; 2) A rough guide to prioritizing efforts (toward the most misfit first); and 3) A means of self-evaluating progress in fit efforts or as a means of evaluating consultants “improvement programs.” (p. 147)

Somewhat limited in scope, but probably a good basis for any model to produce.
Examination of diversification, including choice and implementation, based on the disparity between publicly available and internal data. Some good ideas about how diversification strategies can be managed. Unfortunately based on a very small and possibly subjective survey.

Quotes:
“…an external examination, based on publicly available data, of a diversified firm’s products, markets, manufacturing technologies and marketing and organizational arrangements permits only an assessment of potential relatedness among businesses. Due to difficulties associated with implementing diversification strategies, potential relatedness does not imply actual relatedness.” (p. 219)

“Organizational arrangements that promote sharing, such as incentive and control systems, may be so much at odds with those currently in place that firms may never attempt to install them.” (p. 221)

“…differences in the abilities of firms to implement corporate diversification strategies should impact not only the performance of firms but also their strategic choices. Firms with greater ability to implement related diversification strategies are likely to adopt such strategies and successfully realize the benefits such strategies offer. Conversely, firms lacking in such strategies ought to desist from undertaking related diversification.” (p. 229)

“Agreement” about strategic issues in mergers can be positive or negative, and may impact post-merger synergy. Uses a case study approach to review several behavioral issues in a post-deal hospital.

Quote: “…by integrating with the intent of bringing about homogeneity, the acquirer may end up destroying the differences that made the acquisition desirable in the first place.” (p. 261)

A review of cultural issues in merging companies. The conclusion is that cultural and people issues are key, but that culture clash in Europe is less noticeable than in the USA.

Quotes:
“In the globalizing world of the 1990s, managers of multinational firms face the challenge of finding a balance between the often conflicting demands of strategy and culture. Strategic demands, such as global-scale efficiencies and corporate-wide identity, pressures management to treat people at each subsidiary in a consistent manner, regardless of their respective normative expectations of 'how things ought to be'. At the same time, the unique cultural aspects of each subsidiary challenges management to accomplish their strategic demands without inducing perceptions of diminished relative standing.” (p. 609)

“Interestingly, the average merger in our sample revealed no evidence of the kind of cultural clash that is believed to characterize most U.S.-based mergers.” (p. 609)
Study of LBOs and their links to strategic decisions. Good analysis of performance of LBOs compared to linked firms.

Concludes that LBOs produce increased profits due to management incentives and that they do not grow and diversify as fast as comparable companies.

Quotes:
“The results of this study are consistent with previous studies, which have shown that LBOs increase operating profits.” (pp. 456-457)

“Strategic planning models have long fostered the idea that some lines of business of a diversified firm may be sources of profits while others may be ‘sinks’ which do not repay the cost of capital …The implication of the incentive-intensity hypothesis examined here is that managers in public firms may not be willing to divest such marginal operations, unless their incentives are transformed.” (p. 457)

“…this study finds that LBO firms had significantly lower rates of growth and diversification than comparable public firms during this time.” (p. 457)

M&A strategy in the telecommunications industry that identifies a few strategies for offensive and defensive approaches.

Quotes:
“Relatively few targets of any size and quality exist, and this makes them more valuable in absolute terms and as defensive ploys in the marketplace to inhibit other predators.” (p. 10)

“For these sort of activities, I think you have to analyze the market in terms of what I call The New Economics. This is what we really should be talking about. Understand this, and it’s unlikely that the huge mistakes you have been making will be replicated. At least to paraphrase what someone once said: you might still make mistakes, but at least they will be more interesting mistakes.” (p. 10)

There are four major elements of an acquisition strategy: strategic vision, operating strategy, systems integration and culture such that if one is missing in a particular M&A deal significant synergy can not be achieved.

Quotes:
“Acquirers can easily destroy value in the stand-alone businesses by attempting to gain synergies that have little chance of occurring.” (p. 42)

“Management’s vision of the acquisition is shared with suppliers, customers, lenders and employees as a framework for planning, discussions, decisions, and reactions to change.” (p. 43)
“Visions clue competitors in to the acquirer’s actual operating strategies. What better time for a competitor to launch an attack on a major market of an acquirer than on the announcement of a major acquisition?” (p. 43)

“Most acquisitions have no real operating strategy on the day the deal is completed.” (p. 44)


This paper explores the factors contributing to the failure of some highly publicized acquisitions.

Quotes:
“Diversification makes sense only when it adds greater value than can be realized by individual investors diversifying their own portfolios.” (Abstract, p. 9)

“There are three fundamental problems with portfolio planning models: they compare strategic business units only on two dimensions, making the implicit but probably erroneous assumptions that (1) these are the only factors that really matter, and (2) every unit can be compared fairly only on these bases. Second, they address each SBU as a stand-alone entity, ignoring common core competencies and internal synergies among operating units. Third, unless great care is exercised, the process becomes largely mechanical and an oversimplified graphical model takes to the place of the important contributions of CEO experience and judgment.” (p. 12)

“Rule number one is: Diversification makes sense only when it adds greater value than can be realized by individual investors diversifying their own portfolios.” (p. 13)

“Synergy must be created by (1) capitalizing on core competencies, such as R&D expertise and marketing skills, (2) sharing common infrastructures, such as production facilities, marketing channels, procurement processes, and the like, and (3) increasing market power by creating a stronger bargaining position vis-à-vis customers and suppliers.” (p. 14)


The study examines the stock market reaction to corporate divestments announced by potentially bankrupt as well as healthy UK firms and finds that this reaction is stronger and more positive for the divestments made by financially distressed firms.


This study provides evidence that the technological complexity is a significant influence on business survival and the nature of exit from an industry

Quotes:
“A co-operative framework between firms facilitates information and resource exchange and is likely to permit greater cross-organizational learning, particularly when key technological and marketing knowledge is dispersed among organizations.” (p. 68)

“Businesses commercializing high-complexity technologies face higher risks of dissolution than low-complexity businesses. They also face higher divestment risks, suggesting that even with failure, the
process of commercializing high-complexity technologies creates resources and capabilities that other firms may find valuable.” (p. 69)


Since 1992, M&A deals have been steadily rising and should be understood in terms of their impact on sustainable earnings which should therefore impact their valuation.

Quotes:
“Each acquisition must be measured for its impact on the building blocks of an earnings stream.” (p. 6)

“Some general rules of thumb should be kept in mind as you approach the merger market, whether you view yourself as a buyer or seller:

- Examine your own performance,
- Set the parameters for your future performance that are realistic,
- Detail the anticipated positive impact of an acquisition on your value, i.e. what’s your objective in doing the deal,
- Reduce your objectives to numbers,
- Be wary of objectives that cannot be reduced to numbers, get ranges of likely results; no one can give you the right answer,
- Be prepared to remain independent even if you think you want to sell,
- Set objectives recognizing that a decision to sell is generally the decision to make a major investment on behalf of your shareholders,
- Stay informed throughout the acquisition process,
- Be unemotional.” (p. 7)


Focused solely on cost estimation hypotheses regarding the divestiture of the Bell System.

Quotes:
“This huge divestiture was a unique event in American business and resulted in huge savings for consumers amounting to over 115.4 Billion USD.”

“There is, needless to say, an opposite set of accounts questioning these claims. Here, commentators generally begin the evidence of BOC cost inefficiency with the reduced rate of capital formation after the divestiture (rates of investment fell from 5.5 percent in the 1971-83 period to less than 2.7 percent in 1985-87), the substantial decline in R&D expenditures, which now average less than one-fourth their predivestiture rate…” (p. 62)


The government has recently begun to challenge the mergers proposed between non-profit and for-profit hospitals in the U.S. These M&A activities have been initiated in most cases due to sweeping market changes. Study focuses on California hospitals.
Quotes:
“The U.S. Department of Justice had propelled the claim that hospital ownership status has no effect on the relationship between price and market concentration. The purpose of this empirical study was to examine the motivations of for-profit and non-profit hospitals as they enter M&A activities. Most of the “output” in the US healthcare industry is from non-profit hospitals.”

“The assignment of property rights in the non-profit hospital turns it, in the limit, into something like a consumer co-operative. As a rough analogy, this is like the provision of life insurance through insurance companies organized as mutuals, in which any residual profits earned by the insurer are paid out to the policyholders.” (p. 440)

“Net price is the preferred measure in most research applications, and the analysis of list price has been criticized.” (p. 445)

“The merger of two for-profit hospitals, each with 25 percent of their county’s admissions, increases the merging hospitals’ net price by 5.8 percent.” (p. 452)

“This may be the reason why the estimated effect of merger on price is negative for non-profit hospitals.” (p. 458)


Study investigates the over 1,200 M&A transactions in the U.S. banking industry from 1970 through 1988.

Quotes:
“Acquiring institutions also benefited from faster ex-post capital growth when they acquired banking firms operating in more concentrated banking markets.” (Abstract)

“If markets are perfectly competitive and firms operating within them attempt to maximize shareholder wealth, one possible route toward shareholder wealth maximization, will be the acquisition of other firms perceived to offer increases in profitability, reductions in risk exposure, or other operating advantages.” (p. 334)

“A countervailing view of the motivations and gains of merger relies on agency theory, which suggests management’s optimization of utility does not necessarily correspond to shareholder wealth maximization.” (p. 345)

“The most notable differences centered on labor productivity where revenues generated per full-time equivalent employee averaged more than $5,000 higher in three of the five years before merger…” (p. 352)


A clear acquisition strategy requires careful planning in order to focus on good, scarce targets.
Quotes:
“The most aggressively courted targets include businesses with dominant positions in niche markets, branded consumer products, or desirable distribution systems. For strategic buyers, they can generate complimentary, add-on value to round out product lines, enhance growth, improve economies of scale, or supplement existing strengths and resources. Financial buyers may see them as suitable platforms for leveraged build-ups or as stand-alone investments.” (p. 20)

“Most companies have adequate staff for valuing deals and integrating acquisitions. But they lack the human capital and the time required to promptly pursue leads originating from operational staff and intermediaries and to stay abreast of companies that might be considered a sale.” (p. 25)


Study of 86 acquisitions in Canada that indicates small acquisitions can be very risky and in the end large acquisitions experience a dramatically higher success rates.

Quotes:
“The entrepreneurial company thrives on practices and management styles that are different from the bureaucratic one. Unless the right balance of autonomy and control between parent and acquisition can be struck, a good organizational fit remains elusive.” (p. 52)

“Horizontal extensions of the parent’s core business, whether in the same or different markets, are less risky than other kinds of acquisitions, as the business logic and required managerial capabilities remain the same.” (p. 54)


The risk manager plays a critical role in mergers and acquisitions and can highlight insurance and risk issues to management to be used throughout the M&A process.

Quotes:
“It is important to implement risk management and insurance programs after the deal is completed.” (Abstract)

“A risk manager should raise insurance and risk issues, offer solutions to those issues that fit in with the overall merger or acquisition strategy, and implement the best possible risk management and insurance program after the deal is completed.” (p. 24)

“An (insurance) broker can assist in presenting information on the target’s history, losses, risk exposures and any pending litigation.” (p. 24)
SECTION 2

Acquisition & Conglomerate Diversification

This section reviews the literature dealing with related and unrelated acquisition and conglomerate diversification.


In the U.S., large firms are remarkably well diversified. Multiple-line businesses are here to stay as a dominant feature of the economy.

The paper sets out the economic rationale for diversification. Three perspectives are examined:

- Market power – through cross-subsidy, mutual forbearance & reciprocal buying.
- Agency – through managers abusing their agent’s position, free cash flow.
- The Resource view – firm has unused managerial and organizational resources that are indivisible and inimitable allowing their profitable exploitation through diversification.

Empirical evidence: Diversification and profitability are negatively related. So are diversification and industry concentration. This evidence is more consistent with the agency view or the heterogeneity of resources view.

Evidence based on shareholder value gains from the US is consistent with diversification not being value enhancing. However, it appears that conglomerate diversification did better in 1960s than in the 1980s.

Overall, research shows that diversification is not a guaranteed route to success. There is substantial evidence that existing organizational capabilities, particularly in R & D and marketing, often guide diversified expansion.

*Quote:* “Firms do not diversify in a random fashion, but neither do they do so in a completely predictable way. There appears to be a pattern and logic to the diversification choice of most firms that is related to their base resources, even though the variety of configurations is very large.” (p. 174)


The paper tests the relation between net profit/ market capitalization and ownership, (i.e., stock ownership concentration and managerial ownership) and the degree of related/ unrelated diversification for US data from 1987. It finds that profitability is positively associates with both related and unrelated diversification.

The study does not examine the interaction between ownership and diversification to test for the agency relation.

Results are consistent with the view that success of diversification depends on the specific characteristics of the firm.
Theoretical arguments suggest that diversification can enhance or reduce value. There is no clear prediction about the overall effect of diversification.

The paper uses segmented data to estimate the valuation effect of diversification and to examine the potential sources of value gains or losses. It compares the sum of the stand-alone values of the segments of diversified companies to the actual values of those companies.

Diversified firms have values that average, during 1986-91, 13% to 15% below the sum of imputed values. This loss is less for related diversification. Value losses arise from overinvestment in segments with limited growth opportunities and from cross-subsidization of poorly performing division by better performing divisions.

Stand-alone values are estimated by using multipliers of assets, sales or earnings and the median of the narrowest industry grouping to which the division belongs.

A very thorough study with a large sample of the effects of diversification on firm value.

The current trend toward corporate focus reverses the diversification trend of the late 1960s and early 1970s. This article examines the value of diversification when many corporations started to diversify.

The study finds no evidence the diversified companies were at a premium over single segment firms during those periods. There was a large diversification discount during the 1960s but this discount declined to zero in the 1970s. Inside ownership was negatively related to diversification during 1960s.

Diversification is measured by the number of 2 digit SIC industries in which the sample firm operates.

Quotes:
“Overall, valuation results provide no evidence to indicate that diversification benefits shareholders.” (p. 1215)

“Further theoretical and empirical work is required to determine why the market values diversification differently over time and why diversification works for some firms and not for others.” (p. 1223)

“There have been wide swings in the market’s assessment of the cost of diversification. Some firms, e.g. General Electric, have successfully followed a diversification strategy while other have decided to de-diversify.”

A competent and carefully constructed empirical paper providing insight into the historic valuation of diversification.

The author finds evidence consistent with the view that managers consider personal risk when making decisions that affect firm risk. CEOs with more personal wealth vested in firm equity tend to diversify.
CEOs who specialize in the existing technology tend to buy firms with similar technology. Long serving CEOs tend to diversify. Firms with poor performance in existing lines of business move into new lines.

The study presents evidence on managers’ motives to reduce risk. This behavior has implications for firm strategy and for managerial compensation package.

Quote: “The evidence points to one potential cost associated with equity-based compensation. The accumulation of equity wealth while aligning effort incentives may make the manager more risk averse and thus misalign risk taking incentives.”

Interesting analysis of managerial compensation and diversification strategies.


In a sample of 326 U.S. acquisitions during 1975-87, three types of acquisitions have a systematically lower and predominantly negative announcement period returns to bidding firms. These returns are lower when their firms diversify or buy a rapidly growing target. The returns are also lower when the firm managers performed poorly before the acquisition. These results suggest that managerial objectives may drive acquisitions that reduce the value of bidding firms.

The paper tests the agency model of corporate diversification by examining the relation between value reducing acquisitions and managerial objectives e.g. growth and unrelated acquisition.

The paper shows that returns to unrelated acquisitions have declined substantially in the 1980s.

Quote: “Unrelated diversification is a bad idea from the point of view of the bidding firm’s shareholders in the 1980s. The negative return to acquisitions by poorly performing acquirers is evidence that bad acquisitions are a manifestation of agency problems.” (pp. 46-47)

The study confirms the negative link between diversification and shareholder value and suggests that diversification strategies need to be carefully evaluated before being undertaken.


The paper tests the propositions about the relation between strategy and style, the importance of the fit between a company’s style and its portfolio and how companies overcome the disadvantage of their particular style. When there is a fit between a company’s strategic management style and the needs of the business style can add value.

Quote: “Corporate management teams need to pay more attention to the alignment between their company’s management style and the characteristics of the businesses in their portfolio.”

Importance of the management style in the context of building the business portfolio highlighted with serious implications for acquisition strategy. Useful case studies included in this article.
The paper examines the effectiveness of strategic control style firms in managing a portfolio of businesses. Strategic control companies combine some of the characteristics of the other two management styles. Such companies give profit responsibility to managers under tight financial controls. They also are involved in business unit planning with the center reviewing and challenging business unit strategies and aiming to assess strategic as well as financial performance.

The onset of recession has sharpened the evidence that the effectiveness and the portfolio compatibility of a company’s management style are an important determinant of its success.

Companies very rarely introduce major change in management style except as a result of a crisis or top management change.

Quote: “It is necessary to recognize that management styles reflect deeply ingrained beliefs, biases and skills of the senior managers, which change only slowly, if at all.”

Strategic Control companies need to be cautious about their ability to manage a strategically diverse portfolio of businesses.

Interesting analysis of the strategic styles, acquisitions and demergers. Useful case studies.

Why are big companies, with impressive financial histories, legions of successful operating managers, deep pockets and all kinds of technical skill and know-how, unable to extract superior performance from any newly acquired business?

The answer is that corporate strategy must be built on parenting advantage – the idea being a better parent for a given business than other possible owners. Learning how to do this takes a long time.

Quote: “Proceed very slowly; learn how to experiment and understand your leverageable strengths without “betting the store.” Only consider major steps in the business when benefits outweigh costs.”

Or, do not diversify but concentrate on expanding the existing business.

Useful caveats for companies contemplating acquisitions.

The article addresses the problem of diversification in managing multi-divisional businesses. It argues that some analytical approaches have oversimplified complex relations. This can lead to risky diversification and the establishment of strategic business units inappropriate to corporate needs.

The paper advocates analysis of relations within a corporation through four portfolios – Product, Resources, Customers and Technology.
These enable the synergies to be identified and managed through the cultural and systems building processes which should focus around these.

**Quote:** “Appropriate organization structures for companies with synergy potential will encourage the realization of the shared economics.”

Highlights the importance of organizational structure in realizing expected synergy. Relevant to mergers and acquisitions where expected synergy drives the deal.


The valuation effect of diversification is examined for large samples of firms in Germany, Japan and the UK for 1992 and 1994. The authors find no significant diversification discount in Germany but a significant diversification discount of 10% in Japan and 15% in the UK. Concentrated ownership in the hands of insiders enhances the valuation effect of diversification in Germany but not in Japan or the UK. For Japan, only firms with strong links to an industrial group have a diversification discount. These findings suggest that international differences in corporate governance affect the impact of diversification on shareholder wealth.

A thorough study of the conglomerate discount. The three-country perspective sheds light on the diversity of experience of different countries and the possible reasons for it.

**Quote:** “The value of diversification is related to the institutional structure of a country. However, no consistent pattern emerges across countries.”


The paper models the internal power struggles that lead to distorted resource allocations decisions in diversified firms. This model predicts that if divisions are similar in resources and opportunities, funds will redirected from divisions with poor investment opportunities to those with better opportunities. In diversified firms the reverse flow may happen. For a panel of US diversified firms during 1980 to 1993, the authors find that diversified firms redirect resources to inefficient investments.

**Quote:** “Diversity in investment opportunities between segments within firms leads to distorted investment allocations… Diversified firms can trade at a premium if their diversity is low.” (p. 39)


The paper reports research into the relation between operational and strategic ‘relatedness’ and the success or failure of 26 diversification moves by large French industrial companies. No direct relation was found between operational relatedness and success. The ability to exploit competitive advantage through operational relatedness is linked with the success or failure of diversification. Managerial relatedness is also a condition of success.

Contributes to a better understanding of relatedness and develops a model of the diversification process. Two levels of relatedness need to be considered- operational (sharing of resources or transfer of operational skills between the value chain) and the managerial (applying particular managerial skills to the new business).
Worksheets to assess the competitive structures between businesses and the impact of operational relatedness on competitive position are presented. The components of the diversification process are also presented.

Useful research into diversification problems faced by French firms.
SECTION 3

Transactional Aspects of Mergers & Acquisitions

This section reviews the literature concerned with the transactional aspects of M & A deals.


The paper discusses the role of investment banks in M & A deals and the scope for conflicts of interests between these banks and their principals the bidders and targets. The large scope and complexity of current deals have made corporations highly dependent on professional advice from investment banks further diminishing the clients’ ability to judge or even question the investment banks’ performance.

The market for investment bank services is an oligopolistic market. The prevailing fee structure may create perverse incentives for banks to close deals that may not be in the interests of their principals. Recently there has been some switch from relationship to transactional banking further increasing banks’ incentive for opportunistic behavior.

The paper draws on the negotiation literature to provide guidelines for structuring the investment bank relation for the benefit of the principal:

- Reduce information asymmetry between your company and the bank.
- Explore alternative sources of advice.
- Develop long-term relation with the bank.
- Increase accountability of the bank i.e. fee structure is such that the bank participates in both gains and losses from the transactions they advise.

*Quote:* “The investment banks reaped higher fees as they negotiated higher acquisition prices regardless of the party (buyer or seller) they represented. This is especially troublesome for buying companies.”

Useful discussion of the causes of conflict of interest between banks and clients and remedies to overcome it.


The study compares acquisitions completed with and without investment bank advice over the 1981 to 1992 period. It finds that whether or not a bank is used depends on the complexity of the transactions (takeovers versus asset purchase), the acquirer’s prior acquisition experience and the degree if diversification of the target firm. Although acquisition announcement returns are lower for firms using investment banks, this difference can be explained by differences in transaction characteristics. The results suggest that transaction costs are the main determinant of investment bank choice, followed by contracting and asymmetric information costs.

*Quote:* “Work on the specific functions performed by investment banks during the acquisition process and on the impact they have on acquirer’s decision process is required to further advance our understanding of the role they play.”

Discussion of the various costs that arise in the relation between companies and their investment banks provides insights helpful in structuring the relation.
Agency theory suggests a conflict of interest between investment banks and their clients in merger negotiations. The study examines the association between investment bank compensation and the premium paid in mergers. Results show a positive relationship between premium and investment bank compensation for both target and bidder firms. This indicates alignment of interest between targets and their misalignment between bidders and their banks.

The results suggest that bidding firms do not design optimal contracts for investment bank fees.

_Quote_: “We should recognize that incorrect incentive contracts have a cost beyond the actual fee paid. Poorly aligned incentives can inflate the overall value of the deal, adding millions to the final price and diluting gains to the bidder shareholders.”

This study highlights the importance of understanding the nature of investment bank relationship and the need to design compensation contracts very carefully so as to minimize potential conflicts.

This study examines the shareholder wealth gains to acquirers advised by different banks. Including Goldman Sachs, Morgan Stanley, Shearson Lehman, Salomon Drexel Burnham and ‘others’. Abnormal returns over the period 3 days before to 3 days after the bid announcement day are calculated and compared for deals advised by different banks.

Drexel Burnham outperformed the other banks with the lowest premium paid to the target firms.

This result suggests that Drexel clients were able to minimize the agency conflict.

The paper discussed the role of investment banks in M & A deals and sets up two hypotheses; better merger and bargaining power. Better merger hypothesis is that high reputation banks broker superior value creating mergers. Bargaining power hypothesis is that high reputation banks have stronger bargaining power.

The study finds support for the better merger and not for the bargaining power hypothesis.

The study provides insight into the different ways investment banks can add value to the deal for their clients.

The role of fee contracts in the agency relation between investment banks and client firms in tender offers is investigated using a sample of offers between 1978-1986. Different fees have different payoffs that can be used by client firms to create incentives and by bankers to signal differences in their abilities. The
study tests the effectiveness of fee contracts in resolving agency problems. The evidence suggests that fee contracts are used as a tool by both firms and their banks. Contracts also influence tender offer outcomes.

The paper identifies 3 different fee contracts for targets:
• Share-based fees are either a linear or a step function of the number of shares purchased.
• Total value fees are linear functions of the value of a completed transaction.
• Incremental value fees specify a contingent fee to be paid only if a transaction takes place at a price greater than a benchmark price.

For bidders there are two types:
• Share based fees.
• Total value.

In addition there may be other incentive fees from targets or bidders.

This study enhances our understanding of the complexity of the relation between firms and their bank advisers in M & A deals. Firms should not rely merely on fee contracts to provide the right incentives for the optimal behavior of their advisers.


Empirical analysis reveals that investment banker advisory fees in tender offers average 1.29% of the value of a completed transaction, far below the levels often alluded to in the business press. Most fees are contingent upon offer outcome, with target fees typically contingent on transaction value and bidding firm fees on the number of shares purchased. Although these contingent contracts motivate investment bankers to satisfy some client objectives, many also create conflicts of interest between banker and the client firm. These incentive problems are apparent in offer evaluation, in hostile offers and in the price paid by bidding firms.

Quote: “The (fee) contracts motivate bankers to seek a high price. They also create potential conflicts of interest, however, between banker and client. These fees are used despite the existence of alternative contracts that would eliminate or substantially reduce the potential conflicts, suggesting either that our understanding of the contracting process between firm and investment banker in tender offers is incomplete or that the contracts can be improved.”


Many acquisitions fail to create value for shareholders. Among the reasons is the allegedly self-serving behavior of investment banks pushing their clients into dubious takeover deals. However, banks have incentives to act in their clients’ interest and preserve their reputational capital. We examine the impact of investment bank reputation in 1155 UK takeovers during 1985-94.

Bid period returns are highest when both bidder and target retain first tier banks and lowest when they both hire second tier banks. First tier banks craft better mergers. There is only weak support for the proposition that top banks add more value through their superior bargaining skills.

Use of first tier banks by target in hostile bids increases the probability of bid failure irrespective of bidder bank quality.
Quote: “Targets lose in hostile bids through inappropriate choice of bank adviser, rather than bidders win. Investment bank reputation thus makes a significant difference to takeover outcome as well as shareholder wealth.”

The study highlights the importance of the choice of investment banks that differ in their reputation and in their capabilities, which that reputation implies.


Companies involved in merger and acquisition deals are faced with a fundamental problem when they negotiate. Information is asymmetrical i.e. unequally distributed between buyer and seller. There are two, parallel outcomes. The buyer makes an adverse selection i.e. buys an inferior company. The seller cannot reveal all its information and true value. The seller has a credibility problem. The market for such goods may then become a market for lemons with bad goods driving out the good.

There are some solutions to the lemon problem:

• External verification of the value of the company e.g. certification by a reputed investment bank.
• Warranties and earnouts i.e. the purchase price is paid only after performance has been satisfactorily demonstrated.
• Prior dealings with the seller.
• Joint venture instead of outright takeover.

Quote: “Adverse selection and credible signaling problems are not a sign of failure but, rather, a consequence of the fundamental structure of the negotiation problem.”

The paper provides interesting analysis of evaluating acquisitions when complete information is not available.


This paper discusses the impact of the choice of accounting policy for mergers and acquisitions on the bid premium paid by the acquirers. In the U.S. setting the pooling and purchase accounting rules are compared. The study shows that bid premium is higher in acquisitions accounted for as pooling. It suggests that bidders raise their acquisition cost in order to obtain the benefits of pooling.

The study provides evidence that financing considerations in acquisitions are influenced by accounting considerations.


Lys and Vincent analyze the events surrounding the takeover with the focus on how AT&T took considerable trouble to structure the deal as a pooling of interest. NCR had set up barriers to reduce the chances of pooling and AT&T had to persuade NCR to have these dismantled.

A detailed analysis of how accounting policy considerations drove up the cost of acquisition. An insightful study.
In the 1980s the UK merger accounting rules allowed goodwill to be written off against reserves rather than amortized as in the U.S. This lax treatment was alleged to have given UK firms an advantage in making acquisitions in the U.S. UK companies could afford to pay higher premium for U.S. targets than U.S. bidders since goodwill would not hit the bottom line of the UK acquirers.

The study emphasizes that international accounting differences may influence the cost and hence the probability of success of takeover contests when the bidders can account for their acquisitions under different accounting regimes.

This study investigates how acquiring firm managers’ preferences for control rights motivate the payment for corporate acquisitions. The hypothesis is that managers of target firms who value influence in combined firms will prefer to receive stock. One reason top managers desire influence is to enhance their chances of retaining jobs in the combined firm. The results show a strong positive association between managerial ownership of target firms and the likelihood of acquisitions for stock. Managers of target firms are more likely to retain jobs in combined firms when they receive stock rather than cash.

**Quote:** “Incidence of acquisitions for stock is a positive function of managerial ownership in target firms and target managers are more likely to retain jobs when targets are acquired for stock rather than for cash.”

Important study focusing on control rights as a significant motivation for financing method. Has implications for structuring M & A deals.

This study examines the motives underlying the payment method in corporate acquisitions in the US. The findings support the view that the higher the acquirer’s growth opportunities, the more likely the acquirer is to use the stock to finance an acquisition. Acquirer managerial ownership is not related to the probability of stock financing over small and large ranges of ownership, but is negatively related over a middle range. In addition, the likelihood of stock financing increases with higher pre-acquisition returns experienced by the acquirer and the market in general. Stock financing is also less in tender offers and where the bidder’s cash position is strong and institutional and block shareholdings are high.

**Quote:** “Many reasons influence the method of payment in corporate acquisitions. These reasons include characteristics of the acquirer and target as well as the characteristics of the environment in which acquisitions takes place. Two of the most important characteristics are the mode of acquisition and the investment opportunity set faced by the acquiring firm.”

This study identifies a wide range of factors likely to influence the method of payment choice.
This study covering 2500 acquisitions in the UK and the U.S. over the period 1955-85 surveys theories of acquisition financing and the related empirical research, describes the financing patterns over a long period and presents evidence on the wealth gains to bidders and targets in cash and equity financed acquisitions.

The study sheds light on the changing patterns of acquisition financing in the UK and the U.S. A number of theories explaining the choice of financing including tax-based and agency theories are tested. It also provides evidence on the shareholder returns in the post merger period for both UK and U.S. acquirers.

Important results are:
• Target shareholders gain more from cash than from stock exchange acquisitions.
• In the UK shareholder gains for bidders are similar between cash and stock exchange offers but in the U.S. bidders gained more from cash offers.
• Post-merger returns to shareholders over two years are about zero in cash acquisitions but significantly negative in stock acquisitions.
• Tender offers generated higher shareholder value than mergers in the U.S. but tender offers were also more likely to be cash offers.
• Both type of offer and the medium of exchange are important in determining shareholder returns.

This is a major study covering a huge sample and a long time span with important insights into the impact of mode of acquisition and acquisition financing. It raises a number of unresolved issues for further research.

The paper develops a model in which the mode of acquisition conveys information concerning the value of the bidder. This signaling use of method of payment is constrained by the tax consequences in the US for both target shareholders in the form of capital gains tax and for bidders in the form of whether the acquisition is taxable or non taxable. The signaling model leads to predictions about the use of stock versus cash in US acquisitions. Data relate to the Tax Reforms Act of 1986.

This study also provides evidence that bidder shareholder returns are much higher in cash than in all stock or mixed offers.

Quote: “In the model, low valuation bidders choose an offer including at least 50% stock and high valuation bidders make cash offers. High valuation bidders offer cash to avoid issuing their own undervalued stock and low valuation bidders offer stock to avoid the capital gains tax penalty.”

This paper is one of a few which take explicit account of the tax impact on method of payment choice by bidders.

This paper uses UK data to test a number of theories of choice of payment method including tax effects, information asymmetry, bidder’s liquidity, investment opportunities, ownership structure and accounting policy choice between merger and acquisition accounting. The UK regime provided a rich choice of
accounting policies in the 1980s for acquirers and the paper examines the impact of accounting policy choice on method of payment.

While many non-accounting factors significantly influence payment method consistent with the previous studies e.g. Martin (1996) above, accounting policy is also an important variable.

Quote: “We find significant and substantial evidence that UK acquirers’ accounting policy choice influences their payment method choice.”


The paper adopts the L-G exchange ratio determination model to investigate the bargaining area in UK takeovers involving share for share exchanges. The model arrives at the ratio of exchange between the shares of the target and the bidder by a trade off between the expected post-merger valuation of the combined entity, i.e. the post-merger price earnings ratio and the exchange ratio. For a given PER the exchange ratio then determines whether the bidders and targets gain or lose.

The paper tests the L-G model using UK data.

Quote: “The advantage of the L-G model is that it may help to determine the boundaries for negotiation and reduce the number of abortive takeovers.”

The L-G model provides a good conceptualization of the relation between expectations about the value of a merger and the current negotiations for share exchange.


The paper investigates the relationship between market share of investment banks in the M & A advisory market and the contingent fee payments charged by the banks and the percentage of deals completed in the past by them. The author finds that it is unrelated to the performance of the acquirers advised by the bank, suggesting that the contingent fee structure in tender offers ensures that investment banks focus on completing the deal rather more than on creating value for their clients

The study further finds:
• First tier banks complete more tender offers than second tier or third tier banks but the completion rates are similar for mergers.
• Acquirers in tender offers advised by first tier banks earn higher announcement period excess returns than acquirers advised by second and third tier banks.
• In tender offers premium paid by acquirers is least with third tier banks but in mergers there is little difference across investment bank groups.
• In tender offers paying higher contingent fees can hurt the acquirers in the longer term.

Quote: “These findings contradict the assumption common in the literature that banks will not behave opportunistically.” (p. 323).
Many acquisitions fail to create value for shareholders. Among the reasons is the allegedly self-serving behavior of investment banks pushing their clients into dubious takeover deals. However, banks have the incentive to preserve their reputation and act in their clients’ best interests. The study investigates the impact of investment bank reputation (I tier and II tier based on *Acquisition Monthly* league table ranking) on shareholder gains for a sample of over 1100 UK takeovers during 1985-1994. The study finds:

- The bid period returns are highest when both bidders and target firms engage first tier banks and lowest when they both hire bottom tier banks thus supporting the superior merger hypothesis.
- Only weak support for superior returns on account of the greater bargaining skills of first tier banks.
- Use of first tier banks by targets in hostile bids increases the probability of failure.

*Quote:* “It is the targets which lose in hostile bids through inappropriate choice of bank adviser rather than the bidders win.”

The authors examine wealth changes for the debt and equity securities of firms involved in 260 pure stock for stock mergers in the U.S. over 1963-96. They test the hypothesis that in conglomerate mergers bondholders gain at the expense of stockholders due to risk reduction but find not evidence in support. They document significant net synergy gains in non-conglomerate mergers and not net gains in conglomerate mergers. Conglomerate bidding firm stockholders lose while all other security holders at least break even. Convertible security holders experience the largest gains due to mostly to the attached option values.

*Quote:* “Nonconglomerate mergers create more total wealth than do conglomerate mergers. Clearly, nonconglomerate stock-for-stock mergers create significant net new wealth for securityholders. Conglomerate mergers at best do not destroy value and there appear to be fewer actual inter-securityholder wealth redistribution than our theories would suggest.”

One of very few studies that have examined the impact of method of payment on different types of securityholders, including stock, debt and convertible securityholders.
SECTION 4

Corporate Divestitures and Demergers

This section reviews the literature on various forms of corporate divestments including sell-off, demerger (spin-off), and equity carve-out.


This paper examines the stockmarket reaction to corporate divestments by a large sample of UK companies and investigates some of the specific factors at work. Attention is focused on the different degrees of uncertainty in the divestment process and the relative size of the sell-off. Price disclosure has a decisive impact on stockmarket reaction. The paper also tests the hypothesis that divestment is a means of avoiding bankruptcy and finds that the abnormal return to divestor shareholders is inversely related to the degree of financial distress. This result is consistent with market approval for such ‘distress’ sales.

Quotes:
“Price disclosure appears to have more significance as an indicator if the economic importance of the divestment than as a signal about the likelihood of eventual consummation.” (p. 133)

“Financial strength of the divestor measured via the z-score construct is seen to have a negative relationship with excess return.” (p. 133)

The paper summarizes various theories of value creation through divestments. It investigates the impact of the transactional details of divestment announcements on stock market reaction.


The paper finds that asset sales lead to an improvement in the operating performance of the seller’s remaining assets in each of the three years following the asset sale. The improvement in the performance occurs primarily in firms that increase their focus. The improvement in operating performance is positively related to the seller’s stock return at divestiture announcement. These returns are greater for focus increasing sellers. There is also evidence that some of the seller’s gains results from a better fit between the divested asset and the buyer.

Specific results are:
• Increasing focus is a determinant of the seller’s stock price reaction.
• Returns are higher when the buyer is an LBO group which may improve operating performance through incentive and organizational structure changes.
• Returns are higher when seller is divesting a division unrelated to itself but related to the buyer.

Provides a good test of focus as the source of value gains in corporate strategy.

In the 1980’s a number of large corporations restructured their diversified businesses through divestitures. The paper hypothesizes that firms at intermediate levels of diversification following a mixed corporate strategy (i.e. related-linked) create organizational and control inefficiencies in managing both related and unrelated types of business units. Empirical evidence is provided in support.

Restructured firms were also found to move towards two different types of internal capital markets (related and unrelated). Most restructuring firms moved toward lower levels of diversification (i.e. related-constrained) but some sought more diversification (unrelated business).

Restructuring firms that changed their corporate strategy by reducing diversified scope increased their R & D intensity. The opposite was true of diversification increasing restructuring firms.

The results suggest partial substitution between diversification and R & D activity.

*Quote:* “Level and type of diversification become more efficient and effective in the post-restructuring period by moving away from the related linked strategy type. However, managers of restructuring firms, in general, are taking on more risk.” (p. 633)


The paper examines the relation between management turnover and divestitures of recently acquired divisions. The empirical results indicate that at the time of a management change, there is an increased probability of divesting an acquisition at a loss or one considered unprofitable by the press. This probability increases the same whether the change is an apparent age-65 retirement or a resignation.

Overall, the results suggest that management changes are important events that reverse poor prior investment decisions.

*Quote:* “The probability of divesting a poorly-performing acquisition rises following the departure of the CEO during whose tenure the acquisition was made. This result is consistent with managers (making) acquisitions that are not in the shareholders’ interest, with models in which managers are resistant to selling investments that prove to be mistakes and with models in which successor managers desire to sell assets solely to create losses that can be blamed on their predecessors.” (p. 160)

A good investigation of some of the conditions under which erroneous investment decisions can be reversed and the motives behind such reversal.


Presents preliminary evidence on stock market reaction to divestiture announcements by European firms from Germany, Sweden, France and the UK.

Sources of gains from sell-offs:
- Better fit with buyer than with seller.
- Undiversify to eliminate negative synergies.
• More specialized and focused management.
• Better managerial performance measurement and link to incentives.
• Increased management wage flexibility.
• More flexible management decisions and ability to exploit market opportunities.
• Reduction in bureaucracy.
• Tax/regulatory factors.
• Bondholder wealth expropriation.
• Opportunity for outsourcing.
• Merger motivation – unbundling after merger.
• Takeover defense – scorched earth, crown jewels.
• Raising cash.

The main results are:
• Stock price reaction is positive and continues for 60 days.
• Substantial information leakage in Continental countries.
• Stock price reaction depends on whether domestic subsidiaries (positive effect) or foreign subsidiaries (neutral effect) are sold.
• Relative size of the divested unit explains a considerable part of the variation in stock-price effects.

Useful comparison of international experience of divestments.


The authors analyze the impact of the motivation behind the sell-off and the use of the proceeds from the sale on the value of UK firms divesting assets during 1984-94. They find that managers do not create value when they:
• Divest in order to raise cash.
• Do not increase the focus of their business portfolio.
• Do not announce the motivation behind the sale.

For the 1990s sales, value increases for firms refocusing or divesting loss making assets. Returning the proceeds from the sale to shareholders or reducing leverage were also associated with value increases, whereas reinvesting the proceeds for growth had a negative impact in the 1980s but not in the 1990s.


The authors offer an information-based explanation for spin-offs. When the various divisions of a firm are spun off into several firms that have separate stock market listings, the number of traded securities increases. This makes the price system more informative. It improves the quality of the investment decisions made by managers and reduces uninformed investors’ uncertainty about the value of the divisions. Both effects serve to increase the sum total of the market values of the spun-off divisions above the market value of the original firm.

These conclusions do not mean that all assets of the firm should be divested. “Such a conclusion would of course be erroneous, for it ignores the costs of a spin-off:
• The difficulty of correctly appraising managerial performance, by precluding the diversification of the specific risk that makes such appraisal difficult.
• The hold-up problem in the case of complementary assets, for such assets should be owned by single firm rather than by separate firms. It is businesses that differ most from the main business of a firm that should be spun off.

Provides a theoretical rationale for spin-off decisions in terms of information leading to higher valuation.


The paper tests a prediction from the corporate focus literature that cross-industry spin-offs, where the continuing and spun-off units belong to different 2-digit SIC codes, create more value than own-industry spin-offs.

The results indicate significant value creation around announcements of cross-industry spin-offs only. There is significant improvement in operating performance for cross-industry spin-offs and none for own-industry cases. There is no strong evidence of bonding benefits i.e. from commitment by managers to avoid cross-subsidizing relatively poorly performing units.

The operating performance improvement is associated with the continuing rather than the spun-off entity consistent with the hypothesis that spin-offs create value by removing unrelated businesses and allowing managers to focus attention on the core operations they are best suited to manage.

Quote: “Our evidence supports the theory that increased corporate focus through spin-offs create value. We believe that this value creation arises primarily from performance improvements following the spin-off.” (p. 280)

Bonding is measured by frequency of new capital issues, increase in book leverage and increase in dividends. Performance improvements measured by return on assets. Interesting study of the sources of added value in spin-offs in particular and divestments in general.


The paper investigates the value created through spin-offs over 1965-88 by measuring the stock returns of spin-offs, their parent firms and parent-spin-off combinations for periods of upto three years following the spin-offs. The spin-offs generate significant positive abnormal returns for spin-offs, their parents and the parent-spin-off combinations.

Both the spin-offs and their parents experience unusually high incidence of takeovers and the abnormal performance is limited to firms involved in takeover activity. These findings suggest that spin-offs provide a low cost method of transferring control of corporate assets to bidders who will create greater value.

The study identifies taxable and nontaxable spin-offs and focuses analysis on 146 non-taxable spin-offs and their 141 parents.

Quotes:
“These returns suggest that spinoffs provide superior long term returns to investors. Furthermore, these findings contrast with the results reported for IPOs.” (p. 301)
“...the value created through spinoffs is attributable to the spinoffs and parents involved in takeover activity. Spinoffs create value primarily by providing an efficient method of transferring control of corporate assets for acquiring firms. By splitting companies into separate businesses, spinoffs establish pure plays in the market, allowing bidders who are able to create more value to avoid the expense of taking over whole entities.” (p. 310)


For a sample of about 450 companies the authors estimate a hazard function to determine the environmental and organizational factors precipitating the sell-off of divisional units. The sample focuses on 285 lines of business fully divested between 1975 and 1981, comparing them to retained lines.

The results are that sell off is more probable:
- The lower the profits of the line of business.
- The lower the company-wide profitability.
- The lower the market share, the lower the line’s R & D/ sales ratio.
- After change of CEO.
- If the unit had been acquired in a conglomerate acquisition previously.

The buyers of the sold off units tended to improve their profit performance but not enough to realize a normal return on their investments.


The paper examines the innovative corporate structure of Thermo Electron Corporation which holds controlling interests in 11 units taken public in equity carve-outs. Carve-outs subject units of the company to the scrutiny of the capital markets, allow the compensation contracts of unit managers to be based on market performance and shift capital acquisition and investment decisions from centralized control to unit managers. Thermo carve-outs substantially increase capital and R & D expenditures following carve-outs and generate significant value from their capital investments. Since the first carve-out in 1983, gains to shareholders have been substantially greater than industry and market benchmarks.

Quote: “Thermo Electron, a rather poorly-performing firm from its inception in the late 1950s to the first carve-out in 1983 has transformed into an organization that is proficient in utilizing capital markets, developing new technologies, decentralizing control and sustaining growth over time.” (p. 123)

Provides interesting insights into the relation between equity carve-outs and value creation and into the organizational changes that establish or strengthen this link.


The paper provides evidence that an equity carve-out is usually the first stage of a two-stage process either to dispose of parent interest in a subsidiary or eventually re-acquire the subsidiary’s publicly traded shares. Both the initial carve-out-announcement and subsequent sell-off announcement yield, on average, significantly positive abnormal returns to parent shareholders. In contrast, the parent’s price response to re-acquisition of subsidiary shares is, on average, insignificantly positive. Both sell-off and re-acquisition
announcements have a strong positive impact on subsidiary share prices. These gains are offset by the subsidiaries’ below-average performance preceding the second event.


The paper reviews research on corporate restructuring by examining representative studies of acquisitions, divestitures and management buy-outs. Three challenges in researching corporate restructuring are identified:

- Trading off theoretical abstraction for institutional detail.
- Defining strategically meaningful research questions.
- The pursuit of partial models versus development of a comprehensive theory of restructuring.

Important conclusions from the review of studies are:

- Managerial discretion and corporate governance especially board monitoring are important considerations in restructuring decisions;
- Divestments are about re-focusing or re-configuring the business portfolio and not just about getting rid of poor performers;
- LBOs are generally efficiently run. This suggests that public firms in mature industries may possess high levels of slack resources;
- Post-merger turbulence needs investigation as high levels of turnover and loss of morale have been identified in many anecdotal articles.

A comprehensive review of restructuring studies with important summary of unresolved issues.


The paper develops a model in which the success/failure of the division signals good news or no news respectively. The paper identifies sell-off divisions as “winners” or “losers” from WSJ articles and examines the stock price reaction to announcements of these sell-offs.

The stock price reaction to the loser sell-offs is indistinguishable from zero while the reaction to winners is statistically significant 2.5%. These results are strengthened when the sample includes companies announcing profits in their annual reports. Sell-off returns to winners are 3.4% whereas for the losers it is neutral.


The research examines 3 ways of corporate restructuring:

- Tracking stock – a class of parent company stock that tracks the earnings of a division or a subsidiary.
- Equity carve-out – IPO of a stake in a subsidiary with the parent keeping a majority ownership.
- Spin-off – entire ownership of a subsidiary is divested as a dividend to shareholders.

Sources of value:

- Increased coverage by analysts.
- Restructured subsidiaries attract new investors.
- Improved operating performance.
- Increased strategic flexibility.
Why parents hesitate: concern about stability, ability of spin-off to survive and potential takeover threat, added complexity since directors need to be responsive to more than one set of shareholders.

When to restructure: do parent and subs operate in different industries? Is the sub growing faster than parent? Do analysts seldom mention the sub’s future growth and earnings prospects? And are high performing managers or key technical staff being lost to smaller competitors?


A sample of 119 U.S. parents carrying out equity carve-out is analyzed. Their performance as well as that of the subsidiaries is examined. Parents who perform repeated carve-outs are separately analyzed. Four out of five sample firm executives are interviewed.

Quotes:
“How does carve-out promote growth? The answer lies in the changed relationship between the corporate center and the business unit and the effect this has in three important areas: corporate governance, human resources and finance.” (p. 167)

Carve-outs “foster many of the performance advantages found in independent agile businesses, but they do not forfeit the opportunity to profit from synergies among business units, or from the wisdom and experience of the executive centre.” (p. 171)

Corporate governance: Parent is more accountable for subsidiary to investors restricting room for cross-subsidising. More stock market scrutiny.

Human resources: higher motivation, more sensitive performance-incentive relation, more psychological payoff, more talent retention, better succession planning.

Finance: better funding of new ventures, new investors, new capital at more attractive prices. There are also tax and accounting considerations.

Why doesn’t everyone do equity carve-outs? While some parents do extremely well out of equity carve-outs others do less well. Carve-out may not suit every one. Problem areas are:
• Potential transfer pricing.
• Subsidiary prospects not good.
• Contractual agreements between carved out subsidiary and rest of group may be too complex to rework.
• Carve out duplicates administrative cost.
• Cost of subsidiary debt may rise without backing of parent assets.
• Carved out subsidiary may demand too much independence.
• Carve out is not a substitute for sell-off.


The paper investigates whether stock breakups such as spin-offs, equity carve-outs and targeted stock offerings increase specialist analyst coverage. It finds that breakups are accompanied by an increase in analyst coverage and by a significant increase in analyst turnover, particularly for the break up subsidiaries. There is a marked increase in analysts’ earnings forecast accuracy and in consensus among
analysts about their forecasts following the break up. Increases in analysts earnings forecast accuracy are greatest for firms that are successful in attracting new analysts following breakups.

There is weak evidence that increases in the sample firms’ market to book ratios after breakups are associated with improvements in analyst forecast accuracy.


This paper evaluates the conjecture that excess stock returns that have been documented around the announcement of corporate spin-offs represent, at least in part, the re-creation of value destroyed at the time of an earlier acquisition. We evaluate this question with a sample of spin-offs that originated as earlier acquisitions. At the time of the original acquisitions, on average, announcement period returns to the bidder and the combined bidder and target firm are negative and significant. Further, announcement period returns at the time of the spin-off are negatively and significantly correlated with acquisition announcement period returns.

The sample consists of 73 acquirers. The median time elapsed between acquisition and spin-off is 88 months, the maximum is 356 months and the minimum 9 months.

Quotes:
“Acquisitions that end up as spin-offs generate stock valuation losses at the time of the original acquisition.” (p. 477)

“…the results suggest that managers who undertake poor acquisitions can redeem themselves, at least partially, by subsequently divesting the unwise acquisition.” (p. 484)
SECTION 5

Takeover Patterns

This section reviews the literature dealing with takeover patterns: Impact of economic, industry and regulatory changes on takeover activity in general.


Studies the industry level patterns in takeover and restructuring activity and reports significant inter-industry patterns. These are also related to the economic shocks borne by the industries.


Methodology: Examine the frequencies of takeovers and restructuring in different industries and compare them. Variance analysis to determine whether these frequencies vary across industries. For comparison 46 CRSP industries are also analyzed. Time clustering in different industries examined. Broad and specific industry shocks and their impact of takeover activity examined. Broad industry shock is proxied by abnormal growth or decline in sales in the pre-sample period. Specific shocks include: deregulation, energy dependence, foreign competition and financial innovation. Regression of takeover activity on both broad and specific industry shocks.

Main results: Significant variation in takeover & restructuring activity among industries. Takeover and restructuring activity determined by industry shocks.

Good analysis of industry impact on takeover activity. Useful proxies for industry shocks but could be improved. Discussion of implications of the industry factor insightful. Impact on takeover gains to other industry firms, performance benchmark for post-acquisition analysis, timing of takeover waves.


Examines the impact of anti-takeover laws and devices on takeover activity and takeover premium and on the bargaining position of target firms.

See the section on Wealth Gains from Mergers for more details of this paper.


The study provides analysis of both mergers and acquisitions and partial sales of firms’ assets in the US. These are all components of the overall market for firm assets in manufacturing industries. Plant level transfers of ownership data from 1974 to 1992 are used.

The study tests the model that firms become focused when their prospects in their main industry improve and may remain unfocused if those prospects are not good. Industry shocks alter the value of their assets
to firms and create incentives for transfers to more productive uses. Conglomerate acquisitions may be consistent with profit maximizing motive given scarce managerial or organizational ability. During 1974-92, on average, 3.9% of large manufacturing plants changed ownership. During expansion years this rises to 6.2%. Mergers comprise only one half of the number of assets traded.

The study finds that assets are more likely to be sold when:
- The economy is expanding.
- They are less productive than industry benchmarks.
- The selling division is less productive.
- The selling firm has more productive divisions in other industries.

For mergers, the less productive firms tend to sell during industry expansion. Firms are more likely to buy when they are efficient and more likely to purchase assets in demand-expanding industries. Sellers and buyers of plants tend to be large conglomerates.

Quote: “Most transactions in the market for assets result in productivity gains. …Firms have differing ability to exploit assets and their comparative advantage is in their main industries.” (p. 2021)


The paper reviews the evidence on takeover waves of the 1960s and 1980s and discusses the implications of this evidence for corporate strategy, agency theory, capital market efficiency and antitrust policy. It concludes that antitrust policy played an important role in the two takeover waves.

The critical feature of the 1960s takeovers was unrelated diversification. The reasons for such conglomerate acquisitions included: managers’ reluctance to pay out free cash flows, belief in the relative efficiency of the internal capital market, need to enter growth businesses and, above all, strict antitrust enforcement that forced firms into unrelated diversification. But many of the unrelated acquisitions of the 60s were subsequently divested or performed poorly.

The 1980s merger activity was characterized by increase in average size of acquisition, more hostile bids and increased use of cash for acquisitions. This period also witnessed “bust-up” takeovers, MBOs and LBOs. The antitrust regime was more relaxed leading to more friendly related acquisitions.

Interesting and rigorous analysis of the two waves drawing on various models of corporate diversification. A good survey of the 1960s and 1980s takeovers.

Quotes:
“In the ‘60s conglomerates were created; in the ‘80s, many of them were destroyed. The ‘60s were a move to unrelated diversification; the 80’s were a move to consolidation and specialization. This round trip of the American corporation is an intriguing example of corporate evolution.” (p. 54)

“The fact that the market thought conglomerates were a good idea does not mean that they were.” (p. 58)

“There is no question that lax (antitrust) policy has led to some anticompetitive mergers such as those in the airline industry, but it is better to have a few monopolies than a lot of conglomerates.” (p. 59)

Acquisitions in the UK have shown a steadily rising trend and is concentrated in certain industry sectors. The study reports an empirical investigation of mergers in 200 UK industry sectors between 1991 and 1995. Two sources of deregulation in the UK are the UK’s privatization program and the European Union’s Single Market Program.

The study finds industry growth rate, concentration and deregulation as significant factors in triggering industry restructuring.

The study lacks rigorous definition of some of the explanatory variables used and requires a stronger conceptual framework for the empirical analysis.


The paper examines the factors contributing to merger waves in the U.S. over the last 100 years. It argues that each merger wave has been a response to distinctive economic and technological developments. The merger activities of the 1990s reflect global competition, technological change and deregulation. Where industry shocks have been strongest, M & A activities have been highest. Resources have been moved to more productive uses. Overall job growth in the U.S. between 1980 and 1997 has been substantial. Thus M & A activity does not necessarily contribute to overall job losses.

This paper provides an easy introduction to the factors that may have triggered the merger waves in the US. It also provides an overview of the value creation evidence for U.S. mergers.


This summarizes a round table discussion of the forces that would shape M & A in the 21st century. The participants are M & A practitioners. It identifies the drivers of 1990s M & A activity:

- Industry consolidations.
- Technological innovations.
- Globalization.
- Restructuring.
- Shareholder value creation.

These drivers should remain potent for the current decade as well. Companies will show greater willingness to place bets in technology in the full knowledge that all deals won’t work out. There will be an upsurge in cross-border deals and restructuring will create new players.

Provides in interesting crystal ball gazing by practitioners. Useful for firms engaged in M & A.

**Quotes:**

“It is good to have discipline, but a lot of companies that put numbers ahead of strategy were good at killing deals instead of doing deals.”

“No matter how boldly or swiftly the buyer is impelled to move, it can narrow the odds by thinking like an investor.”

“Companies are now recognizing that merger integration must be a core competency.”
SECTION 6
Predicting Takeover Targets

This section reviews the literature dealing with predicting takeover targets.


Examines the relation between managerial ownership and the probability of being a target firm. Impact of managerial ownership on target shareholder returns also examined.


Methodology: Univariate and multivariate analysis of relation between ownership and takeover likelihood. Logit model of takeover probability. Control variables including size, leverage, liquidity, valuation ratio, ROE, PER, institutional ownership and growth. Targets divided into contested and uncontested targets. Second analysis is regression of CARs over different event periods. Controlled for contested and successful outcome.

Main results: Targets have significantly smaller managerial ownership even after controlling for firm size and other financial and ownership characteristics. Ownership significantly smaller in contested offers but higher in successful offers. Target shareholder returns positively and significantly related to ownership in contested but successful acquisitions. Shareholder returns are significantly increased when management uses its shares to negotiate but not block acquisition.

Highlights: Interesting results based on the interaction among managerial ownership, contest and wealth gains. Ownership is used to increase premium and not block takeover. Ownership not modeled as a nonlinear variable.

See also Holl & Kyriazis, 1997 in Section on Hostile Acquisitions and Comment & Schwert, 1996 Placebo paper in Section on Wealth Gains.


Examines whether differences in board structure and ownership contribute to the incidence of hostile takeovers. Are these corporate governance devices substitutes or complements? Board effectiveness and hostile bids are related in analysis. Model also predicts the likelihood of hostile takeover.

(See Section on Hostile Acquisitions for further details).


Models the probability of friendly and hostile takeovers.

Sample: UK data. 411 target including 97 hostile and 314 friendly and 532 non-targets over 1984-91.

Main results: Characteristics of hostile and friendly targets differ. Time period is important. Industry characteristics also play a significant role. Significant predictor variables are size (negative). Prebid performance (ROCE) not significant except for hostile targets. Liquidity, leverage and free cash flow are the other significant variables.

Highlights: Useful differentiation between friendly and hostile targets. Explicit recognition of industry factors although justification for industry construct weak in the paper. Sample of hostile targets over (1984-91) is only 97 compared to my sample of 238 in 1983-89. Corporate governance variables not considered. Selection of variables not very rigorous. Interpretation of results are superficial. Tables lack clear explanation.
SECTION 7
Valuation for Mergers and Acquisitions

This section reviews the literature on valuation in general and valuation in the context of Mergers and Acquisitions.


This compares the market value of highly leveraged transactions (HLTs) to the discounted value of their corresponding cash flow forecasts. For a sample of 51 HLTs completed between 1983 and 1989 the valuations are within 10% of the market value. Paper compares different valuation models. By inverting the analysis the authors also calculate the risk premia implied by transaction values and forecasts cash flows and relating them to firm and industry betas, firm size and firm book-to-market.

Sample comprises MBOs and leveraged recapitalizations. Cash flow forecasts are used to estimate the cash flows to all capital providers. Discount rate, estimated with CAPM, is used to value cash flows and the terminal value.

Valuation techniques:
1. Discounted cash flow model = Compressed adjusted present value technique.
   Capital i.e. after-corporate tax- cash flows to both debt and equity are discounted at the discount rate for the all equity firm. CAPV has advantages over standard APV as well as the weighted average cost of capita (WACC) approach.

2. Valuation using comparable multiples i.e. value/ performance measure.
   EBITDA is used as the preferred performance measure.

Measuring capital cash flows:
• Definition 1: Net income + depreciation + amortisation – change in net working capital + interest (cash and non-cash) – capital expenditure + after tax asset sales.
• Definition 2: EBIT – corporate tax = (EBIT- interest) x tax rate + depreciation + amortisation – change in net working capital – capital expenditure + after-tax asset sales.

Estimating equity cost of capital:  CAPM is used:  \( R = \text{risk free rate} + \text{asset beta} \times \text{market risk premium} \).

Three different measures of beta or systematic risk are used:
1. Firm based.
2. Industry based.

Risk premium is arithmetic average return spread between the S & p 500 and long term Treasury bond rate. Alternatively, short term Treasury bill rate is used as the risk free rate.

Valuation results: The study provides evidence that discounted cash flow methods give reliable estimates of market value. Median estimates of discounted cash flows are within 10% of the market values of the completed transactions and perform at lease as well as valuation approaches using similar industries and companies.
Quote: “Little evidence exists that shows that discounted cash flows provide a reliable estimate of market value. This study provides evidence of a strong relation between the market value of HLTs and the discounted value of their corresponding cash flow forecasts.”


This explores the problem of capital investment appraisal. It argues that many of the problems in applying financial appraisal can be remedied by blending financial and strategic analysis. Identifies the piecemeal nature of three traditional approaches to investment appraisal – financial theory, strategic theory and organizational theory – and suggests ways of reconciling the three.

Financial evaluation focuses too much on a single project and treats investment decisions as a self-contained financial problem amenable to a well-structured set of analytical methods.

Strategic theory offers clues as to how the problem can be understood in a more holistic way through emphasizing the interdependencies and understanding the uncertainties on the value of the business strategy itself.

Organizational theory offers an account of why managers find the problem intractable in the management process but the extent to which this is caused by cognitive limitations of managers as individuals is not well explored.

The paper describes a value based management (VBM) approach at BP carried out in 4 phases and lists the lessons from that exercise.

The connections between strategic and financial appraisal through process, analytical and decision linkages are set out. Problem areas e.g. evaluating intangibles and how to identify and incorporate the operational and strategic linkages in these areas are exemplified.

Quote: “Issues that are of major concern to academics, e.g. determining the exact cost of capital, are far less important to managers in practice. Issues such as dealing with uncertainty, interdependencies and intangibles play a much more important role within managers’ perspectives than in the literature.”


Discuss how the value chain model of Michael Porter can be extended and introduces the contrived value chain model. While the natural value chain represents what has to be accomplished with the resources of the enterprise in order for it to succeed in its external strategy, the contrived value chain is how the resources of the enterprise are used to accomplish those things. Contrived value chain can change frequently e.g. when new technologies are introduced, or when assets are acquired, divested or reallocated.

Value chain analysis is applied to a clothing retailer to illustrate how a coherent approach performs well against five criteria:
- Portraying a vision that spans the enterprise.
- Internal integrity.
- External consistency.
- Unconstrained thinking about the way the business should be done.
• Customizing to the specific nuance of the enterprise.

*Quote:* “The notion of the natural value chain offers enterprise a useful framework for applying the principles of visioning, strategic alignment and business process engineering.”


At a time when strategic acquisitions predominate, many acquirers do a slipshod job of calculating terminal values in discounted cash flow analysis. Not only is the terminal value usually the largest component of a purchase price but a major barometer of whether the deal will fit the classic purpose of a strategic acquisition to create value over a long period of time.

The key to determining an appropriate price based on the target’s long-range prospects is gauging its competitive position in its product or service market and whether that power and attendant financial returns can be sustained over the long haul.

*Quote:* “Determining the largest part of most purchase prices requires complete understanding of the target’s competitive position in its market.”


What are some of the more important questions that should be resolved in planning and evaluating the risk in a successful merger or acquisitions? Motivation, price, what are we buying, what are they selling and the key criterion.

What are the motivations for the target? Is it the desire for expanded market position, growth through diversification, combined with the recognition of unique attributes that exist in the target firm? The purchaser will be at a disadvantage if it does not attempt to discern the target’s motivating forces.

Price – whether the price paid represents value received and, if so, under what circumstances. Often the ultimate buyer in contested bids pays substantially in excess of value received.

Due diligence – what are we buying and what are they selling? The due diligence can greatly reduce the risk of the deal and needs to cover:
• The business itself.
• Production, source of supply and research and development.
• Facilities.
• Marketing.
• Financial information.
• Intangibles, other assets.
• Contingent assets, liabilities.
• Business outlook, competition, etc.
• Management, employees, etc.
• Other.

*Quote:* “Important that the potential acquirer learn as much about the target’s business, history, products and markets, relationships with its customers and corporate culture before any plans to change the target operations.”
Current high bid activity suggests that target companies may be undervalued. Is there a value gap between market value of targets and the raiders’ projected value? Is there a gap between market value of the target and the value placed by its managers?

Examines the existence of value gaps by researching survey of stockbrokers’ valuations, survey of recent acquisitions and study of market values.

Finds evidence that on average bidders overpay but many acquirers are expected by the stock market to create value. (Cites Franks and Harris). By looking at market to book value and ROE tests whether market undervalues companies. Investors appear to concentrate on overall profitability rather than how individual business units contribute towards it. It seems sensible for managers to communicate to investors to increase awareness of undervalued assets. Market may also give too much weight to current performance.

Many value gaps may be due to poor or inappropriate corporate management!

Quote: “Lessons to managers: understand your share price, keep the market informed, don’t hide the assets, keep profitability up, don’t diversify beyond your management skills, pay attention to management controls and incentives, dispose of assets you cannot exploit.”

Introduces a value based strategic management process (VSM) to provide the link between business level product market focus and the corporate level concern for the stock market. Operating managers can learn to appreciate the direction and the extent of their business units’ impact on corporate value. Top management can incorporate value based performance measures to encourage key executives to act in the best interests of the shareholders.

Subjects covered are: takeover threat, conglomerate discount, VSM, valuation of business strategies, going concern residual values, DCF valuation and strategic choices, linking competitive and corporate strategies and, executive compensation and value based performance incentives.

Useful review of techniques for linking stock market valuation and corporate and business strategies. Similar in approach to Rappaport.

Valuing a software company is a challenging assignment for acquirers. Survival and growth of computer software companies, indeed most technology-driven firms, are based on the companies’ ability to convert intellectual property into marketable technology, products, and services. The valuation challenge includes a determination of whether that strategy, given the relentless advancement of technology and the plummeting price of technology, will be viable in the future.

Traditional approaches to valuation are the DCF and the stock market ‘pure play’ i.e. comparable company approach.
In the new software industry new value drivers have emerged:
• Patronage – relation and reputation of company with customers and the market place.
• Exploiting new opportunities – the business must focus on new relations, ventures, alliances, products and service.
• Market share and size.
• Employees – the value of a software company is more than ever represented in the intellectual capacity, creativity and energy of its employees.
• Flexibility – speed, creativity and the ability to mass-customize are valued over efficiency based on mass and scale.


Types of options in an acquisition can take three forms:
• Growth options, which provide the pursue future emerging markets.
• Flexibility options, which allow the exploitation of assets in alternative future applications.
• Divestiture options, which mitigate risk by enabling a company to unbundled.

Paper provides examples of options embedded in strategic acquisitions.

Quote: “If the value of a strategic option is ignored, companies may forgo valuable growth opportunities and even undermine their current competitive position.”


The ability to change tactical direction in response to new information can contribute to value increase. Investments with this characteristic are real options e.g. R & D, oil exploration, mining. International investment may also contain real options. It may begin with a small commitment that may be scaled upwards or curtailed, depending on the outturns achieved.

Paper reviews the literature on real options including several valuation models. It then discussed real operating options in foreign direct investments.

Quote: “The development of the theory of FDI will be inadequate without encompassing net present value inclusive of real operating options. They greatly enrich our comprehension of one of the most important areas of international business strategy.”

Useful in the evaluation of investments in general and foreign acquisitions in particular.


Presents real options and the determinants of the value of real options. Drawing upon the financial option model of Black and Scholes, the basic elements of real options are presented.

The six real option value drivers are:
• Present value of fixed costs (the exercise price).
• Time to expiry.
• Uncertainty of expected cash flows.
• Present value of expected cash flows.
• Risk free interest rate.
• Value loss over duration of option e.g. costs incurred in meeting competition, or in keeping the opportunity alive.

The simple net present value (NPV) and real option valuation are compared. Essentially, NPV can mislead when there is flexibility, i.e. flexibility to respond to uncertainty. Real option value recognizes the value of learning and waiting for the arrival of better and more relevant information. Real option model is more comprehensive than the NPV model.

Management of real options:
• Extend the option duration e.g. through entry barriers, ability to innovate.
• Reduce present value of fixed costs e.g. leverage economies of scale, economies of scope, economies of learning.
• Increase uncertainty of future cash flows e.g. extend opportunity to related markets, encourage complementary products, product innovation, product bundling.
• Increase present value of expected cash flows e.g. develop marketing strategies, develop alliance with low cost suppliers.
• Reduce value lost by waiting to exercise e.g. create implementation hurdles to competitors, lock up key resources.

Illustrates the use of real options by UK companies BP and Powergen.

Quote: “In an increasingly uncertain world, real options have broad applications as a management tool. They will change the way you value opportunities. They will change the way you create value – both reactively and proactively. And they will change the way you think.” (p. 22)


One of the objectives of the report is to increase awareness of the methods adopted by valuers in preparing intangible asset valuations. It emphasizes the importance of intangible asset valuation in many contexts including M & A.

The feasibility of valuation and various methodologies are discussed. Among these methodologies are:
• Market –based e.g. comparable market value.
• Economic-based e.g. net cash flow/ earnings, Brand contribution, Royalty.
• Hybrid – asset approach, premium PE ratio.

Examples of valuation of many intangibles provided: brands, publishing rights, intellectual property, and licenses. Comprehensive analysis of the issues surrounding intangible valuation.


Risk is the mirror image of opportunity. Change creates new opportunities as well as risks:
• Increasing globalization.
• Increase in intangible assets.
Describes how to build a business risk assessment process. ‘Business risk is the threat that an event or action will adversely affect an organization’s ability to achieve its business objectives and execute its strategies successfully’.

Identifying key business risks:
- Strategic – doing the wrong things.
- Operating – doing the right things the wrong way.
- Financial – losing financial resources or incurring unacceptable liabilities.
- Information – inaccurate information, unreliable systems and inaccurate or misleading reports.

Assessing impact and likelihood of occurrence and acting on the risk assessment are discussed.

Quote: “Audit committee members should use their understanding of business risks to focus their deliberations as well as their inquiries of management and auditors on the key financial and control issues facing the enterprise.”

The risk assessment framework relevant to assessing risk in M & A.


The author reports the results of a study carried out by Harbir Singh and Maurizio Zillo on acquisitions in the US Banking Industry since 1985. The researchers were able to find that an acquired company’s assets are not a crucial determinant of the performance of the merged company (they have been reflected in the price!). Any new value has to be created through the decisions managers make after the deal is done.

The real value of this article is the reference to the study by Singh and Zillo.


The author refers to a number of research reports.

Reasons why mergers fail, including:
1. Key talent leaves.
2. Overall productivity and individual performance fails.
3. Cultural fit is ignored.
4. Remaining employees are poorly managed.
5. Lack of direction during implementation.
6. Placement errors are made.
7. Employees communications are incomplete and infrequent.

Quote relevant to High-Tech mergers: “Developing a detailed people strategy and sticking to it before, during and after the deal allows high technology firms to maintain momentum and successfully achieve one of their key goals, the quest for rapid growth.” Art Geis, Hay Group (a leading expert on high technology M&A).

Forward thinking companies are actively involving HR managers in due diligence.

A large majority of HR managers (80%) who responded to the survey said they needed training in due diligence, the acquisition process, communications, strategic planning and a number of other issues.
SECTION 8

Hostile and Tender Offers

This section reviews the literature dealing with hostile takeovers and tender offers and defensive strategies in hostile bids


Rationale for a psychoanalytic approach. To develop a typology of hostile takeovers to understand takeover events beyond rational explanations. Understanding enhanced using a cultural studies perspective

Interpretation of text – meaning creation process – stories that are told in the press are not simply the statements or products of either individual actors or journalists. Rather, these stories interact with the audience’s imagination, intuition and associations as well as emotions.

Two characteristics of narrative are: narrative probability (how well the story hangs together) and narrative fidelity (how true does it ring).

Hostile takeover events create a “narrative thirst,” a need for explanation to reduce uncertainty and to provide an illusion of understanding and control. The anxiety is revealed in narratives as unconscious fantasies about the purposes of takeover events and these fantasies become reenacted by interpretive interactions of the readers with the text and may even develop into a collective social defense against the anxiety generated.

Thus a psychoanalytic approach to interpreting media reports of hostile takeover events facilitates a deeper understanding of the actual events for the actors involved as well as a better understanding of the anxieties and concerns they generate in a broader social context.

An interesting interdisciplinary approach to applying psychological insights to the hostile takeover phenomenon.


Examines whether differences in board structure and ownership contribute to the incidence of hostile takeovers. Are these corporate governance device substitutes or complements? Board effectiveness and hostile bids are related in analysis. Model also predicts the likelihood of hostile takeover. Main results: CEO ownership, affiliated director ownership, duality, unaffiliated outside director ownership, outside directors’ outside directorships all reduce likelihood of hostile bid. Unaffiliated blockholdings increase hostile bid likelihood. Effective board substitutes for hostile takeover and reduces its likelihood whereas block ownership complements and increases hostile bid chances.

Direct test of alternative corporate governance mechanisms. Interesting methodology to estimate bid probabilities when sampling is choice-based.
Study reports univariate and multivariate analysis of premium and abnormal returns, bid outcome and bid resistance. Managerial compensation is computed to include capital gains from shareholding, present value of golden parachute payments and present value of loss of income from losing job. Logit regressions to explain bid resistance and bid outcome are run. A variable to measure credibility of bid resistance is calculated as the product of bid resistance and insider ownership > 10%.

Managerial resistance negatively related to target managers’ wealth gains. Wealth changes positively relates to bid outcome. Abnormal returns to targets lower for hostile than for friendly tender offers. When offer premium is controlled for (why?). Offer premium higher in hostile offers especially premium revision.

Very good paper innovative in measuring wealth changes related to tender offers. Differentiates between hostile and friendly tender offers. Variable “credible resistance” interesting new one.

Investigates the impact of bid resistance on wealth gains of target firms and the probability of bid outcome, using a sample of UK data. 238 takeover targets of which 113 are hostile (85 from 1983-89 my sample period in the 1994 paper). Sample period: 1978-89.

Main results: Individually all defenses except use of law increase target shareholder wealth, consistent with hostile bids generating more wealth gains. When combined with other defenses dividend increase increases wealth (significant at only 10%, one tail test) and use of law reduces. Relative effect of each defense insignificant. It is the combination, which adds value. As regards bid outcome, all defenses lower the probability of bid success but white knight increases (not surprisingly). Relative contribution of each defense in the presence of other defenses insignificant. For the sample of only hostile bids use of law reduces and corporate restructuring increases the probability of bid success. Smaller targets relative to bidders get more gains. High pre-bid target valuation and toehold reduce wealth gains.

Interesting methodology to measure the marginal effect of individual defenses although its results are similar to a regression with all defenses thrown in. Wealth gains are maintained even after bid failure over months 3 to 26 after bid. This is consistent with the new information hypothesis.

Examines whether hostile takeovers can be distinguished from friendly ones based on accounting and stock performance. Are hostile takeovers disciplinary or do they just reflect the patterns of public disclosures of negotiations between firms.

Sample: U.S. data. 2048 offers for exchange listed firms over 1975-94.

Methodology: To test whether there are identifiable differences between offers characterized as hostile and those that are not. Four definitions of hostility used: Wall Street Journal or Dow Jones description, SDC definition, first publicized bid or successful bid is either unnegotiated tender offer or merger proposal that specifies a price (a bear hug) and 13D acquisition in previous 12 months or there are significant merger rumors.
Correlation among the four definitions, frequency of hostile bids by different definitions, probit model of prediction of hostility, probit model of predicting bid outcome with hostility as a predictor variable, regression model of pre-bid price run up on hostility, regression model of bid premium on hostility, probit model of multiple bids on hostility, regression model of bidder’s CAR on hostility

Main results: Most deals described as hostile in the press are not so in economic terms. Negotiations are however publicized early in hostile transactions. There is significant but not very high degree of correlation among the four definitions. In the prediction of hostile targets the most consistent predictor is target size - hostile bids more likely for larger targets and less likely for high market to book targets. Predictive ability of models depends on definition of hostility and bid period. Only one hostility definition (no 3) reduces probability of bid outcome. Gearing of target reduces and M/B increases chances of bid success but P/E reduces! Hostile bids less likely to succeed in 1985-89 and 1990-94 than in 1980-84. Impact of hostility definition on bid premium mixed across definitions. Multiple bids more likely to be associated with hostility.

Interesting focus on what is a hostile bid. A very comprehensive sample of US acquisitions with lots of statistics on bid characteristics. Useful results on the impact of these characteristics on bid hostility, outcome, bidder returns, bid premium. Compares three models of CARs with discussion of the impact of high bidder returns in the pre-bid period on estimates of post-acquisition performance. Market adjusted model does better than the market model by minimizing this bias.


The paper examines the disciplinary function of hostile takeovers in the UK in 1985-86. It reports evidence of high board turnover and significant levels of post-takeover restructuring. Large gains are anticipated in hostile bids as reflected in high bid premiums. However, there is little evidence of poor pre-bid performance suggesting the high board turnover does not derive from past managerial failure. Hostile takeovers do not therefore perform a disciplinary function. Rejection of bids appears to derive from opposition to post-takeover redeployment of assets and negotiation over the terms of bids.

Provides evidence on the importance of the role of hostile takeovers in corporate control and in improving corporate performance.


The outcome of a hostile takeover bid hinges on an interplay of the defensive strategies of targets and the offensive strategies of bidders. The study examines the determinants of outcome for a sample of 205 hostile bids for UK public company targets over 1983-89. The impact of a number of defensive strategies adopted by the targets, their ownership structure, which could aid or hinder the deployment of those strategies, and the method of payment selected by bidders is investigated. The paper describes the City Code on Takeovers and Mergers in the UK and its influence on the choice of defensive and offensive strategies.

The study finds outcome in hostile bids in the UK is significantly influenced by the use of certain defensive strategies, the presence of large institutional shareholders in targets, the size of targets and the method of payment chosen by the bidder. The results of the study are useful in devising effective strategies to frustrate or prosecute hostile bids.
SECTION 9

Post-Acquisition Performance

This section reviews the literature dealing with post-acquisition performance: Stock return, operating and other performance measures


Examines % and $ returns to various classes of merging firms’ securities. Among acquirers, common stockholders, common and preferred convertible stockholders gain. Acquiring firms’ convertible and nonconvertible debt holders and non-convertible preferred holders neither gains nor loses. Among the acquired firms, common convertible and non-convertible preferred and convertible debt holders gain. Only non-convertible debt holders do not gain or lose.

Main results: $ value of both acquired and acquiring firms and the combined firm increase.


Tests two hypotheses: superior bidders create more value and acquisition of underperforming target leads to more value creation. Post-merger performance is thus positively related to bidder’s pre-bid performance and negatively related to target’s pre-bid performance.


Methodology: Regression of industry adjusted excess of market to book value of total assets on bidder’s and target’s pre-bid performance. Excess value normalized by sales. Explanatory variables include industry adjusted pre-merger excess value, relative size (sales) of target to bidder, net debt to capital, pre-merger industry entropies (a measure of industry concentration), change in industry performance (excess value) from pre-bid to post-bid periods, industry adjusted return on capital.

Main results: Post-merger performance is negatively correlated with the acquiring firm’s pre-merger performance and uncorrelated with the acquired firm’s pre-merger performance.


Tests for long-term (3 year) returns to acquirers using robust methodology. Focuses on two types of acquirers: glamour and value acquirers. It also investigates the effect of different categories of payment methods – cash, equity and mixed offers.

Main results: Glamour acquirers significantly underperform value acquirers. Cash acquirers also outperform equity acquirers. For further review see section on wealth gains.
Examines the post-acquisition performance for the 50 largest US mergers.


Methodology: Compare industry adjusted measures of performance for various periods prior to and after the merger. Premerger measure is weighted average of target and acquirer measures the weights being the relative asset values of the two firms. Performance measures include: cash flow return on assets, cash flow margin on sales, asset turnover, employee growth rate, pension expense per employee. Investment performance measures: capital expenditure rate, asset sales, R&D rate. Relation between cashflow performance and stock returns also investigated. Impact of bid characteristics on cash flow returns also examined.

Main results: Cash flow return on assets improves after merger resulting from increases in asset productivity relative to their industries. These improvements are stronger in related mergers. Sample firms maintain their capital expenditure and R&D rates relative to their industries after the merger. Strong positive relation between bid period abnormal returns and operating cash flow improvement. Characteristics such as method of payment, hostility, relative size do not have any impact on post merger cash flows.

Highlights: New methodology for measuring postmerger operating performance. Focus on cash flow return on assets. Shows bid period aggregate abnormal returns to bidder and target combined 9% confirming overall value creation.

The result contradicts results from many previous studies reporting deterioration in post-merge performance. The study’s focus on the largest 50 acquirers limits its generalizability.

Replicates the Healy, Palepu and Ruback (1992) paper. Examines whether mergers lead to increase in operating cash flow adjusted for industry. Relates increase in operational gains to stock returns during bid period.

Sample: UK data. 38 takeovers during 1985 - 6.87.

Methodology: Estimate operational cashflows of the merging firms before merger and of the acquirer after the merger. Adjust for corresponding cash flows of the relevant industry. Regress post-acquisition industry adjusted cash flow on pre-merger cashflow. Intercept interpreted as abnormal merger induced operating gains. Regress bid period abnormal returns on estimated operating gains.

Main results: Post-acquisition operating cash flow higher than the pre-acquisition cash flow but not significantly related to the latter. The abnormal cash flow gain is about 3.3%. Bid period abnormal returns are significantly and positively related to operating gains.

Highlights: Small sample. Operational cash flow definition differs from Healy et al and includes adjustment for working capital changes. Not as comprehensive an analysis as Healy et al since many bid characteristics are investigated. Useful UK study.

Examines the paradox that event period returns show no negative returns (in the US) but long run returns are negative. Develops a new methodology for a more appropriate benchmark to measure long-term performance.


Methodology: Post acquisition performance (net income to sales) adjusted for what the companies would have achieved without the merger is evaluated over 1 year, 2 years and 4 to 6 years after acquisition. Value Line analysts’ forecast of net income to sales used as a measure of future performance in the absence of merger. Performance also adjusted for industry, size, time, gearing. Adjustment to net income also made for accounting policy differences and gearing differences. Bid period abnormal returns estimated and related to operating performance in a test of whether the stock market can foresee subsequent performance. Sample partitioned into horizontal, vertical and conglomerate mergers. Sample also partitioned into divesting acquirers and nondiving acquirers to assess impact of postacquisition divestment.

Main results: Over 1 year and 2 years post-acquisition performance is significantly worse than control firms and forecast performance. Over 4-6 years acquirers significantly outperform controls. This result is uniform across different categories. Conglomerates outperform related acquirers. Bid period abnormal returns positively related to long term post-acquisition performance.

Highlights: Innovative methodology to measure post-acquisition performance controlling for what the performance would have been in the absence of merger. Uses analysts’ forecasts in constructing benchmark for post-acquisition performance. Limitations: Only net income to sales is used as performance measure. No analysis of relation between operation performance and long-term stock return performance.


Examines whether hostile takeovers can be distinguished from friendly ones based on accounting and stock performance. Are hostile takeovers disciplinary or do they just reflect the patterns of public disclosures of negotiations between firms.

See Section on Hostile Deals for further details.


Acquisitive growth strategies continue to be popular in spite of increasing evidence that they do not enhance the financial performance of acquiring firms and may adversely affect innovation. However, some acquisitions are associated with both increases in financial performance and a strengthened commitment to R&D while others experience decreases in both. The paper describes 12 cases of acquisitions that had favorable and 12 cases with unfavorable outcomes.

The findings of the study are:

- Successful acquisitions were friendly and the firms showed resource complementarity.
- Successful acquirers had less than debt than the unsuccessful ones.
• Inadequate target evaluation contributed to failure.

**Quote:** “…our research strongly supports the notion that success or the lack thereof in acquisitions is likely the result of a configuration of variables rather than any one variable’s independent effects. Thus a more complex view of acquisitions may be necessary to accurately test and understand their success.”


Given the rising volume of M & A, many executives will be taking bets that will put their companies’ future at stake. The roundtable discusses M & A and its role in the new economy including the tradeoff between acquiring a company and growing organically, the changing shape of M & A strategy and the keys to successful integration.

Main comments made by the participants:
• Growth through acquisition has been a critical part of the success of many companies in the new economy.
• Cost reduction shouldn’t be the sole goal; the most successful companies will be those that can grow as well.
• Acquisitions aren’t always a workable way to get into a new geographic market. We have been struggling for the last ten years with how best to build a business in Japan. From a cultural perspective it would be difficult to acquire a company there.
• Diversification was the main reason for company failures in the 1960s, ’70s and even the ‘80s.
• It is difficult to acquire Internet and technology companies and integrate them.
• Merging a US and a European company is a particularly complicated process because of cultural differences, centralization, pay etc.
• Change imposed by mergers can reduce productivity.
• Planning for integration should start well before the acquisition.
• Integration raises a number of issues – employee fears and expectations, customer reactions, talent exodus, retention problem, tribalism of directors.

A very useful perspective on the problems of using acquisition as a strategy for growth and value creation.


The authors examine the impact of acquisitions on the subsequent innovation performance of acquiring firms in the chemicals industry. They distinguish between technological acquisitions and nontechnological acquisitions and develop a framework relating acquisitions to firm innovation performance.

Main results: Within technological acquisitions absolute size of the acquired firm’s knowledge base enhances innovation while the relative size reduces innovation output. The relatedness of acquired and acquiring knowledge bases does not have a linear impact of innovation output. A moderate level of relatedness is preferable to very close relatedness or too little. Nontechnological acquisitions have no impact on subsequent innovation output.
Quote: “…from the acquisition selection standpoint this research suggests that a balance on both size and relatedness of acquisitions is favored.” (p. 217)


The paper presents theory suggesting a tradeoff between growth by acquisition and managerial commitment to innovation. The model developed proposes that the acquisition process and the resulting conditions affect managerial commitment to innovation.

Main results: The extent to which acquisitions serve as a substitute for innovation, energy and attention required during negotiations, increased leverage, increased size and greater diversification may affect managers’ time and risk orientations. Then managers may reduce their commitment to innovation.

Quotes:
“…firms engaging in acquisition activity may reduce their commitment to innovation. Repeated (acquisition) activity further reduces managers’ commitment to innovation and may lead to acquisitions of firms in non-R&D intense industries, thereby avoiding innovation.” (p. 43)

“…acquisition process involves tradeoffs that should be recognized and evaluated carefully.” (p. 44)


Theory and prior results show that firm performance is initially positive but eventually levels off and becomes negative as international diversification increases. Product diversification moderate this relationship.

Main results: International diversification is negatively related to performance in non-diversified firms, positively related in product-diversified firms. International diversification is positively related to R&D intensity but less so in the presence of product diversification.

Quote: “…at some point, the complexity (of international diversification) overwhelms the positive benefits and performance begins to suffer.” (p. 789)


Previous research indicates that operating performance improves following corporate acquisitions relative to industry-median firms. Such performance results may be biased because acquiring firms undertake acquisitions following a period of superior performance and they are generally larger than industry median firms. The author measures performance using control firms matched on pre-acquisition performance and size and finds no evidence that operating performance improves. However, cash flows increase significantly following cash acquisitions but decline following stock exchange acquisitions.

Quotes:
“Improved performance (in cash acquisitions) appears to result from higher sales growth and does not seem to arise from cost reductions.” (p. 176)
“The results suggest that cash acquisitions succeed in better managing the assets of combined firms. I find no evidence that other stakeholders like suppliers or employees stand to lose in cash acquisitions.” (p. 176)

This is one of the few studies to investigate post-acquisition operating performance. It represents a methodological refinement over previous studies.


- The authors maintain that despite 30 years of evidence demonstrating that most acquisitions do not create value for the acquiring company, executives continue to make more deals and bigger deals every year. There are many reasons why value is not created, but many times it is simply because the acquiring company paid too much. Put another way, companies pay more than the acquisition is worth to them.

- Good examples are given in the paper, Quaker Oats acquisition of Snapple. Vodaphone acquisition of Air Touch.

- In the battle for Air Touch the market reacted negatively to Bell Atlantic modest premium and positively to Vodaphone high premium. The reason for that is that acquiring Air Touch created more valuable synergies for Vodaphone that it would be for Bell Atlantic.

- The authors discuss different definitions of value: Intrinsic, Market, Purchase and Synergy and how to calculate the latter value.

- Acquirers generally base their calculations on five types of synergies: cost savings, revenue enhancements, process improvements, and financial engineering and tax benefits.

- The rigor in carrying a post acquisition review is essential if organizations are to learn from their experience. Such discipline is the responsibility of executive managers and the Board of Directors. The authors relate the lack of such discipline to the absence or non- effectiveness of corporate governance.

Quote: “Ultimately, the key to success in buying another company is knowing the maximum price you can pay and then having the discipline not to pay a penny more.”


The authors rely on data selected in the 1980s to test hypotheses relating to the use – among others – by managers in target companies of income enhancing accounting. Policies. The results of the test were inconclusive. Interesting as a concept in our thinking.


The authors argue that the choice of the accounting treatment of M & A has an influence on the price paid for the target company viz. acquisition accounting vs. merging accounting. Medium value, any mention of this must take account of what is happening in the UK, U.S., Australia and NZ, re: the disappearance of merger accounting.
SECTION 10

Shareholder Wealth Performance in Mergers & Acquisitions

This section reviews the literature on, shareholders wealth performance surrounding bid announcements and post-acquisition performance.


Examines evidence with daily returns of the stock market reaction to the announcement and subsequent acceptance or rejection of merger proposals. Impact of target management resistance and failure of merger proposal on shareholder wealth is examined.

Sample period: 1971-77, Sample size: 72 completed and 80 cancelled merger proposals.

Methodology: Market model abnormal returns over the period of bid announcement to completion or cancellation. Event period -40 to +40 days. Both target and bidder returns reported. Completed and cancelled subsamples analyzed. Focuses on mergers not tender offers.

Main results: Target firms earn 34% abnormal returns over 10 days before announcement to 10 days after completion. When proposals cancelled it is 3.7% but when target vetoes proposal it is 11%. Bidder shareholders get -7.2% for completed and -5.5% in cancelled proposals. When targets resist, their gain is -3%.

Importance of target management approval in mergers in the US. Target management resistance does not destroy all initial value gains. When bid fails bidder shareholders lose less than when the proposal is accepted.


Measures the impact of acquisitions activity on firm value by differentiating between specific merger events and programs of acquisition activity. For a sample of conglomerate acquirers, announcements of acquisition programs generate significant positive abnormal returns. Significantly negative returns are associated with regulatory changes with impact on acquisition activity - Williams Act 1968, Tax Reform Act 1969 and APB opinions 16 and 17.


Main results: Acquisition programs generate positive abnormal returns. Regulatory changes have negative impact on these returns.

Conclusions: Important to look at programs and not just individual bids.

Methodology for assessing impact of regulatory changes. Summary of previous research using abnormal returns. References to tender offer studies.

Examines the effect of mergers on the wealth of bidding firms’ shareholders. Both merger program and individual mergers are examined. Impact of relative size and time period of the merger is also studied.

Sample: U.S. data. 214 mergers over 1963-79. 70 firms announcing merger programs following which follow up with up to 4 subsequent mergers. Sample period: 1963-79. Methodology: abnormal returns over control portfolios formed on ranking by beta. Also market model excess returns.

Main results: Both bidder and target returns examined. Firms engage in multiple mergers as part of merger program. Benefits of merger to bidders not capitalized at the announcement of the program. Individual mergers following program announcement also generate returns of comparable size irrespective of the order of the merger in the program. Larger the target the greater the benefit to the bidder.

Focus on merger program. Report positive returns to bidders.


Examines the events leading up to and including mergers and their impact on shareholder wealth. Cumulative abnormal $ returns are estimated. Tests three hypotheses: value maximizing investment; improved target management; and size-maximizing.

Sample size: 256 acquirers and 85 acquired firms. Sample period: 1969-74. Methodology: Mergers including those initiated, as tender offers are included. Abnormal $ returns estimated covering both initial announcement and merger approval dates. Assumed 60 months cover both. CAPM the benchmark model.

Main results: Acquiring firms lose $111.71m over -60,0 months and $27.6m over -4, 0 months. Acquired firms gain $19.7m over -4,0 months. Combined $ returns are $16.2m over -1,0. Acquiring firms suffer negative abnormal returns over 1,12 months post-merger. Acquired firms experience positive returns over the same period.

Main conclusions: Acquired firms suffer losses before merger consistent with the improved management hypothesis. Merger a negative NPV project for acquiring firms.

Use of $ abnormal returns. Combined $ returns to acquirer and acquired reported.


Examines the stock price reaction to purchase of stocks filed under Sch. 13D by 6 ‘raiders between 1977-82. Test two hypotheses:

1. These investors improve target management.
2. They systematically identify underpriced stocks.

Examines the post-buy activities of targets for 2 years.
Sample period: 1977-82. Sample size: 99 13d purchases by raiders and 155 by a random sample of other acquirers. For stock reaction to buyers: 72 buys by raiders and 30 by random buyers.

Methodology: Market model abnormal returns.

Main results: Stock purchases by raiders generate significant positive returns larger than for those by random buyers. Evidence inconsistent with raiding hypothesis. Some support for the improved target management hypothesis but no clear-cut evidence for the superior security analyst hypothesis.

Hostile partial acquisitions are value creating for both targets and acquirers.


Examines % and $ returns to various classes of merging firms’ securities.

Sample: US data. 132 mergers during 1962-80. 94 acquiring firms and 81 acquired firms with at least one traded senior security. Methodology: Market adjusted abnormal returns over event window -19 to +20 days. Separate estimates of abnormal returns for different types of securities. Shorter window for some securities. Both raw $ gains and $ abnormal gains are estimated.

Main results: Among acquirers, common stockholders, common and preferred convertible stockholders gain. Acquiring firms’ convertible and nonconvertible debt holders and non-convertible preferred holders neither gain nor lose. Among the acquired firms, common convertible and non-convertible preferred and convertible debt holders gain. Only non-convertible debt holders do not gain or lose.

Dollar value of both acquired and acquiring firms and the combined firm increase. Estimates of total wealth gains to all the firms’ securities reported. Reports positive wealth gains for acquirers. Wealth transfer hypotheses tested.


Examines the impact of sources of acquisition gains – underpricing by market and undermanagement - and target’s bargaining power as determinants of acquisition premium. Estimates potential value gain from the two sources from historic performance as well as abnormal returns in the immediate bid period.

Sample: US data. 77 acquisitions during 1975-80 including both cash for stock and stock for stock acquisitions. Methodology: Regression of observed premium on measures of undervaluation, undermanagement and bargaining position. Undervaluation is market to book relative to industry, undermanagement is ROE and earnings growth relative to industry. Bargaining power is proxied by multiple bidders and target’s antitakeover amendments. Abnormal returns over -20 to 100 days used as stock market estimate of potential gains from acquisition.

Main results: Significant support for the bargaining power hypothesis with multiple bidders and antitakeover amendments increasing premium. Very weak support for the undervaluation and undermanagement hypothesis.

Comment: Inclusion of antitakeover devices to explain bid premium. Attempt to measure ex ante the potential acquisition gains. Identifying 3 sources of gains including synergy (not explicitly tested for).

Reviews empirical evidence for support of various theories of motivation for takeovers. Studies reporting shareholder wealth gains to both bidder and target company firms are reviewed. Both % gains and $ gains are reviewed.

Seven distinct theories of takeovers outlined: Monopolies, (new) information synergy, elimination of inferior management, financial motivation, management self interest and hubris (bidders overvalue their targets and overpay. Theories not mutually exclusive.

Main results: Target shareholders gain significantly but results for bidders less conclusive. More difficult to ascribe price reaction to bid to takeover per se in the case of bidding firms. Simply by making a bid the bidder may disclose information about itself unrelated to the bid. Strong negative relation between returns to bidders and targets suggesting high bids are too high and wealth is transferred from bidder to target.

Outline of several theories and good overview of empirical evidence. Studies examining impact of diversification examined. The impact of bids on debt holders also reviewed. Good summary of the hubris hypothesis and review of evidence in support. Concludes that hubris cannot explain all the bidder’s wealth gains/losses.


Tests the shareholder wealth impact of corporate acquisitions including mergers, tender offers, partial acquisitions, private company acquisitions and asset acquisitions. Results are reported partitioned for these different types. Investigates whether corporate acquisitions benefit bidders while controlling for relative size and partial anticipation.

Sample size: 5172 domestic U.S. acquisitions

Sample period: 1966-84 (source: Mergers and Acquisitions).

Methodology: CARs over -3 to +3 days and cumulative abnormal $ returns.

Main results: Majority of corporate acquisitions benefits bidder shareholders. Result holds on controlling for relative size and partial anticipation. Large firms pay too much. No evidence that past poor acquisition increases subsequent takeover likelihood.

Large sample including a range of acquisition types. Test of wealth effects of series of acquisitions. Test of post-acquisition consequence for bad acquirers.


Examines the impact of antitakeover laws and devices on takeover activity and takeover premium and on the bargaining position of target firms.
Sample: 1584 poison pill rights issues between 1975-91. Sample includes firms not subject to takeovers and takeover targets. 669 takeover targets including tender offer targets. Sample period: 1977-91.

Poison pill adoption firms from 1983-91 included in the sample.

Methodology: Predicting takeover targets, hostile takeover targets, poison pill adopters, takeover premium. Mainly probit and ordinary regressions. Sensitivity tests for various factors.

Main results: No evidence of deterrence from control share or business combination laws. Weak evidence of deterrence by poison pills that are predictable. No economically meaningful degree of deterrence by poison pills. Takeover premium higher when targets protected by state antitakeover laws or by poison pills. Demise of takeovers in 1989 was caused by secular trends and not by antitakeover laws or poison pills adoptions.

Good review of evolution of antitakeover laws and poison pills. Interesting methodology to estimate the effect of antitakeover devices on takeover probability and takeover premium. Methodology to predict poison pill adopters. Model to predict takeover targets. Provides explanation for the demise of the 1980s takeover wave.


Examines the disciplining function of takeovers in the UK. Tests whether hostile takeovers correct for managerial failure. Post-acquisition assets sales and management turnover are examined as well indicators of pre-bid performance of targets to indicate underperformance.

Sample: 35 successful and 23 failed hostile bid targets remaining independent, 22 failed hostile bid targets subsequently acquired, 35 random sample of accepted (non-hostile) bids and a group of non-merging firms.

Sample period: 1985-86

Data source: AMDATA.

Methodology: Estimate bid premium, over bid month to completion, pre-bid performance in terms of abnormal returns, omission or cut of dividends, cash return on assets, market to book value. Compare the means across different categories of targets.


Direct test of the disciplinary model of hostile bids. Examines bid premium and premium revision in relation to motive for bid resistance.


Studies the relation between takeover premium and pre-announcement stock price run-up. Is there a substitution effect between the two? Issues raised are auction for firms and insider dealing.

Methodology: Market model abnormal returns. Parameters estimated over -379 to -127 trading days. Runup period -126 to 0 and markup period from 0 to 252 days. Regressions of markup returns on runup for both target and bidder. Abnormal share volume traded also examined.

Main results: Runup explains only a small part of premium, No relation between runup in the target price and bidder’s returns. No support for Roll’s hubris hypo. Substitution between runup and markup evident where there is evidence of insider trading.

Large sample of tender offers and mergers. Both target and bidder returns examined. Interesting information on a range of bid characteristics. Raises research issues about what determines takeover outcome and how runup affects relative bargaining by bidders and targets. How does target valuation by investment banks change when target share price changes? Has implications for the Grossman & Hart model of toehold. Runup is an added cost to the bidder and does not reduce the total premium.


Main results: Significant wealth losses to bidders over 24 months. Consistent across six models. Wide variation in performance between hostile vs friendly, methods of payment, conglo vs. non-conglo, multiple bidders.

Test of alternative methodologies to measure long-term abnormal returns.


Examines the relation between post-acquisition returns, mode of acquisition and method of payment,

Sample: U.S. data. 947 acquisitions both mergers and tender offers.

Sample period: 1970-89.

Methodology: long term abnormal returns against size and book to market benchmarks. Regression to estimate expected return for a given size and book to market is run. The estimated return serves as benchmark in calculating the abnormal return. 5-year post-acquisition returns are reported.

Main results: Tender offers mostly for cash. Mergers include large number of cash offers. Stock mergers perform the worst. Cash tender offers the best. Tender offer effect is larger than cash effect. More value gains from relatively smaller acquisitions in stock mergers and more from larger acquisitions in cash mergers. More from mid size acquisitions in cash tender offers.

Interesting methodology to adjust for size and book-to-market factors. Use of relative size of target as a variable to predict post-acquisition performance. Estimate long term returns to target shareholders assuming reinvestment of their cash sale proceeds.

Compares top management turnover in unacquired US during active and nonactive takeover periods and draws inferences concerning the disciplinary impact of takeovers.


Methodology: Test for the impact of takeover activity level on management turnover. Measure turnover of CEO, president and chair as well as just CEO in the 5-year periods. The hypothesis is that turnover is higher in periods of high takeover activity. In relating turnover to takeover activity, performance is controlled for. Logit regressions of turnover on performance and control variables.

Main results: Turnover is higher in active takeover periods. The negative link between performance and turnover is also stronger in active periods.

OP. income/assets as performance measure adjusted for both size and industry. Other measures of performance: stock return, market to book, cash flow. Relation between turnover and performance only sig. for some measures. Comparison between firms with and without top mgmt turnover. Estimates probability of turnover. Control variables are corporate governance variables.


Examines the post-acquisition abnormal returns to acquirers in the UK after controlling for size. Acquirers show zero abnormal returns.

Sample: 830 acquirers with size falling over post-acquisition periods.

Sample period: 1975-90.

Methodology: Arithmetic abnormal returns over size deciles. Rebalancing monthly but population assigned to size deciles annually. Both value weighted and equally weighted decile returns. Both means and % positive returns tested.

Main results: Hostile bid defined as first target resistance. Evidence that hostile bidders generate superior returns to friendly bidders.

Bid announcement period returns to bidder positive but not significant up to Bid month + 3. Value weighted returns higher than equally weighted returns. Abnormal equally weighted returns over 12, 24 and 36 months not significant but value weighted returns significant over 24 and 36 months. Large acquirers generate even better returns over 36 months. Post-acquisition performance varies over time.


The study integrates a number of hypotheses concerning the different sources of value creation in mergers and the impact of possible agency conflicts between shareholders and managers on the distribution of
wealth gains between target and acquirer shareholders. The authors study a UK sample of 429 mergers during 1980-90.

Main results: Operational, financial and managerial synergy contribute to value creation. Where the merging firms have complementary excess and shortage of growth opportunities and cash flow this imbalance creates value. Several ownership variables and control variables such as payment method also influence the wealth gains and their distribution.

**Quote:** “When highly rated firms acquire less highly rated targets, the acquiring firm shareholders experience wealth losses whereas target shareholders experience wealth gains. This result is consistent with acquiring managers acting out of hubris.” (p. 692)


Tests for long term returns to acquirers using robust methodology. Focuses on two types of acquirers: glamour and value acquirers.


Main results: Tender offerors outperform merger offerors. Glamour firms in mergers underperform value acquirers.

Boot strapping; classification of acquirers in to glamour and value acquirers. Analysis of tender offers and mergers.

(19) **McClenahen, John S. (Jan 18 1999).** How much value creation?, *Industry Week, Cleveland, Volume 248, Issue 2, pp. 9-9.*

The study reports on a ‘A.T. Kearney’ study of mergers between 1993 and 1996 in the Americas, Europe and Asia. The summary of the findings are that 58% of these mergers did not produce stock appreciation and dividend increases 25% better than the averages for their respective industries. Subsequent questioning of the companies indicates that 62% of mergers fail to create significant shareholder value.

The only real value of this article is the reference to Kearney’s study.
SECTION 11

Mergers & Acquisitions in Different Countries and Cross-border Mergers and Acquisitions

This section reviews the literature dealing with Mergers & Acquisitions in different countries.


Examines the relation between capital markets and corporate control in France, Germany and UK and the influence of regulation pertaining to rights of employees, managers and shareholders.

Sample: Sample of partial and full acquisitions in 3 countries. Statistics on hostile takeovers, buyouts, and buyins. Samples analyzed for executive dismissals.

Methodology: Examine statistics on ownership structures and ownership change transactions to identify the patterns of ownership change and relate such change to the legal, institutional and other factors. Compare executive turnover rates in the three countries and infer the impact of laws concerning employment.

Main results: Ownership changes reflect fundamental features of the three countries’ capital markets. In the UK correction of managerial failure associated with changes in ownership. In France and Germany corrections of managerial failure associated less with ownership changes. Hence low incidence of hostile takeovers in France and Germany. There is a tradeoff between correcting managerial failure and promoting investment.

Highlights: Comparative analysis of takeover patterns and their relation to underlying characteristics. Interesting statistics on takeover patterns. 3 short cases of takeovers in the 3 countries. Follow up discussion of the paper.


Japanese M & A in the US create statistically significant wealth gains for both Japanese bidders and US targets. Consistent with the literature on foreign direct investment and the market for corporate control, bidder-specific characteristics and exchange rate movements are useful in explaining the cross-sectional variation in bidder returns. Returns to Japanese bidders and to the portfolio of Japanese bidders and US targets increase with the bidder’s leverage, the bidder’s ties to financial institutions through borrowings and the depreciation of the dollar in relation to the Japanese yen.

The paper addresses the following issues: what drives Japanese mergers in the US? What are the wealth effects of Japanese bidders acquiring US firms and what explains the cross-sectional variation in these returns? Do Japanese bidders pay different premiums for their US targets than US bidders?


Provides useful insights into the motivations for the wealth consequences of cross-border mergers.

This paper examines the effect of regulation and taxation the characteristics of the M & A process in Belgium. Regulatory provisions are reflected in the fact that Belgian bidders own large toeholds in the target before they engage in takeover bids. Although these toeholds do not have to be disclosed, bidders do not earn any significant returns as a result of the takeover. It is also found that tax considerations are important when a firm chooses to pay with cash or with shares. Finally, it is found that in negotiated offers, the gain to target firms is negatively related to the toehold of the bidder and positively related to the number of shares controlled by large block holders.

Sample includes 86 tender offers and 82 mergers. For abnormal returns generated by the market model.

Provides a useful comparison of the regulatory differences between US and UK, and Belgium. Interesting insight into M & A in Belgium.


The paper examines shareholder wealth gains from domestic and foreign takeover announcements in the US chemical and retail industries. Contrary to results in several recent papers, these data indicate there is no significant difference in within industry mean takeover premia levels. There is evidence that the sensitivity of takeover premia levels to standard transaction characteristics does differ across buyers. Foreign buyers do pay more than domestic investors in hostile transactions, but pay less when there are rival bidders. The results indicate the market’s reaction to buyer nationality is closely tied to the transaction characteristics.

Sample: In chemicals (retail), number of domestic acquirers is 81 (213) and the number of foreign acquirers is 35 (55). Market model used to generate abnormal returns.

Transaction characteristics, more than, nationality determines the impact of cross-border mergers. The impact of foreign exchange and tax also considered but not important.


The authors test the synergy and internalization hypotheses for international acquisitions using a sample of foreign acquisitions of US firms during the period 1979-90. The major findings include: shareholders of US targets and foreign acquirers experienced significantly positive combined wealth gains, $68m on average. Shareholders of the US targets realized significant wealth gains regardless of the nationality of the acquirers. The Japanese acquisitions generated the largest net wealth gains, $398m on average, which was shared by both target shareholders (43%) and acquirers (57%).

Cross-border takeovers are generally synergy creating activities. Foreign acquirers benefited from the targets’ R & D capabilities, supporting the ‘reverse internationalization’ view.
M & A activity is increasing worldwide but so is the regulation of cross-border mergers. This scrutiny has added some obstacles to the process.

**Quote:** “If a merger doesn’t get completed in a timely fashion because of regulatory or bureaucratic inertia, it can break the deal. Markets change and regulators must be sensitive to that.” (p. 46)

Importance of companies being aware of the international M & A regulations highlighted.

This study examines shareholder value creation in 112 large cross-border acquisitions undertaken by U.S. firms between 1978 and 1990. It empirically tests the impact of relatedness and cultural distance on such wealth effects.

Findings suggest that cross-border acquisitions do not create value for acquiring firm shareholders. Results also indicate that, while the influence of acquisition relatedness on value creation is unclear, cultural fit has an important impact. Acquisitions characterized by high cultural distance were accompanied by lower wealth effects for acquiring firm shareholders.

Cross-border activity within Europe has increased fourfold over the last 5 years. But it is a high-risk form of corporate expansion since one in two purchases fail. The paper discussed the types of cross-border acquisitions British companies make, the acquisition processes they adopt and the major areas of unforeseen difficulties. It is based on a sample of 70 UK companies acquiring in Continental Europe.

The key lessons are the need for specialized integration skills. Post-acquisition difficulties are compounded by cultural differences and the need to facilitate the transition from family to professional management.

A survey of European companies undertaking cross-border acquisitions.

**Quotes:**

“This decade has seen a rapid increase in M & A transactions and a view, gaining in strength, that they do not always deliver their promised benefits.”

“... M & A is not an end in itself but is seen as a means to an end.”

“It would appear that M & A is better at achieving market share and presence than presenting economies of scale.”
“What is surprising was the percentage of respondents who did not know or did not say when asked what their expectations had been at the outset of the transaction.”

“A new human resources strategy was implemented in almost a third of the cases.”

“These findings show that corporate and management cultures should be considered right at the outset.”
SECTION 12

Post-merger Integration and Change Management

This section reviews the literature dealing with post-merger integration including information system (IS) integration. It also reviews the literature on change management in general and in the context of M & A.


A merger creates immense change management issues and merger integration actions should help mitigate the risks.

Change management dynamics brought about by a merger:

• Aggressive financial targets
• Short timeliness
• Intense public scrutiny
• Culture clashes
• Politics and positioning
• Communication issues
• How to grow
• Restructuring
• Reengineering
• Where to downsize
• Personnel retention problems
• Employee motivation issues

Change management concepts:

• Change fast.
• Establish defined and clear leadership.
• Clear and constant communication.
• Customer focus.
• Making tough decisions.
• Dealing with resistance.
• Focused initiatives.


Requires a methodical process of identifying obvious problems and uncovering hidden ones helps to create a more harmonious integration. Describes the author’s experience of advising an acquirer to integrate.

Various steps are involved:

• Ask target executives to list issues of primary concern to them.
• Recognize difference between acquirer and target executives by forming a group to systematically go through a checklist of potential conflicts.
• Identify potential areas of concern.
• Develop a viable corporate structure:
• Maximize unification of organization.
• Ensuring fastest possible response to external stimuli e.g. customer demands.
• Being recognized by the market place “as the smart way to do it.”
• Having employees see it so.
• Use existing personnel to the maximum.
• Get maximum internal flexibility and adaptability.
• Identify key people and retain as many key people as possible.
• Publicize the advantages of the merger.
Quote: “The most critical analysis the group had to do was to determine the ‘optimum future corporate organization structure.”


Using a sample of 96 acquisitions between 1980-84 this study concludes that departure of executive from acquired firms is harmful to post-acquisition performance. The negative effects of departures of CEO, President and Chairman seem the most severe. Acquisition relatedness did not moderate the effect of departure on performance. Providing one or more executives with top management team status in the combined firm leads to better post-acquisition performance.

The impact of executive departures on postacquisition performance is derived from the following models:
- Agency – target managers are incompetent so no effect.
- Strategic management – target managers are a critical resource for building competitive advantage.
- Executive succession – the context of departure important to determine performance effect.

Paper provides a summary of articles embodying the above theories. It controls for factors such as seniority of executive, pre-acquisition performance, status bestowal after acquisition, relatedness and change in acquired firm’s industry performance.

Quote: “Executives from an acquired firm are an intrinsic component of the acquired firm’s resource base and that their retention is an important determinant of postacquisition performance. Executives are important to postacquisition performance.”

There are strong economic motives for initiating acquisitions but there are also strong social processes at work that may seriously affect the outcomes.


This study tested the relationship between organizational turbulence as reported by 49 strategic business unit managers and the attitudes of 670 middle managers. The results indicate that turbulence clustered into four dimensions that were differentially related to managers’ attitudes. Incremental turbulence was negatively associated with satisfaction with job security. Financial restructuring, growth and organizational break up were positively associated with career loyalty.

Types of corporate turbulence:
- Operational reorganization/ significant cutbacks.
- Force reduction.
- Acquisition of new operations.
- Rapid growth.
- Voluntary terminations and early retirement.
- Sale or spin-off of operations.
- Merger.
- Acquired by another company.
- Recapitalization.
- Attempted takeover, merger or LBO.
- Hostile takeover.
• Across the board pay or benefit cuts.
• LBO.

Impact of these on career loyalty, organizational loyalty, job involvement and satisfaction with job security

**Quote**: “One avenue for retaining good manager is through pay. Another is through providing challenging jobs. Let the managers know they are good and provide lots of opportunities for their development.” (p. 177)


The most difficult aspect of major change has little to do with getting the right concept, core process redesign or even a team at the top. It lies in changing the people system – the skill and behavior of hundreds of employees down the line. It relies on the ability and attitudes of mid-level and frontline managers.

What distinguishes real change leaders (RCL): RCL skills include:
• Linchpin linkages among market place, top leadership aspirations and workforce capabilities.
• 360º impact by influencing people all around.
• Diverse range of approaches with ability to improve.
• Capacity to employ more than one style of leadership.

**Quote**: “RCL capabilities: commitment to a better way; courage to challenge existing power bases and norms; initiative to break through established boundaries; motivating themselves and others; caring about how people are treated; a sense of humor.”

Change calls for initiative, energy, momentum and leadership.


Enunciates five laws of change:
1. The law of constituent balance – need to maintain balance among groups.
2. The law of leverage – finding the right levers is critical to change management.
3. The law of momentum – liberate the energy to drive change.
4. The law of feedback and adjustment – change may itself opportunity.
5. The law of leadership - if change is to have credibility within an organization, it must be congruent with the actions of its leader.

**Quote**: “A change effort must build sources of energy as well as production results. A company must discover a pattern of change that builds momentum within an episode and that promotes the shared vision, confidence, leadership capacity and capabilities that will make the next episode possible.”


Corporate acquisitions have become key elements in strategic planning for many companies. Historically, strategic and organizational factors were emphasized in evaluating takeover candidates. Since company data and IT are as much management resources as financial and human resources, the IT fit should be explicitly considered in analysis of corporate acquisitions. Assessment of IT fit considers the IT
environments of the merging companies, the IT contribution each can bring to the merger and the role IT should play both in negotiating the acquisition price and in integrating the joining firms.

Provides illustrative case examples of IT related problems in acquisitions.

**Quote:** “Assessment of IT fit is an important factor in the evaluation of an acquisition. Such an assessment can help create realistic expectations about the acquisition and provide insights into the complexities of the integration effort.”


For companies choosing to grow by acquisition, many problems remain. In addition to cultural and human problems in integrating two organizations, one of the main reasons for poor post-acquisition performance in the recent merger wave of the late 1980s was the failure of organizations to consider fully the implications of merging together the harder Information Systems and Information Technologies.

Role of IS/IT in post-acquisition management:
- Proactive role – when IS/IT is the facilitator for other organizational change or when the acquisition of an organization’s IS/IT is the prime motivation underlying the deal.
- Reactive role – when IS/IT needs to change to accommodate other operational considerations.
- Positioning IS/IT in different types of acquisition integration modes – absorption, symbiosis.

Includes a survey of UK companies involved in M & A into the role of IS/IT in the process. Low response rate due to due diligence.

Due diligence carried out in less than 50% of the cases and was superficial.

Many acquirers believed IS/IT was important for their company.

**Quote:** “The lessons are simple – anticipate IS/IT needs, involve key staff, align and communicate objectives over the long term, plan long term and review the process, feeding back learning for the next event.” (p. 61)


IS compatibility can directly affect the benefits of an organization receives from a merger or acquisition. At the macro level, the degree of compatibility determines whether consolidating systems is feasible and cost effective. At the micro level, IS compatibility is closely tied to the benefits from the merger. Potential merger partners can assess whether their systems will mesh with an IS compatibility index.

Compatibility of the two organizations’ IS is often overlooked. Often the technical obstacles caused by incompatible IS are not encountered until after the transaction has been completed. These obstacles could negate some of the benefits expected from the merger.

Assessing compatibility through IS compatibility index (ISCI) which has the following components:
- Hardware.
- Systems software.
- Applications software.
- Programming language.
• Database architecture.
• Telecommunications software.
• Approach to systems development.
• IS strategy.
• Personnel resources.

ISCI can be applied at both the macro and micro level.

The ISCI is a tool that can help management effectively develop and evaluate the benefits of a potential merger or acquisition, to gauge the effort needed to achieve the stated benefits, and to develop a cost and time estimate for achievement.

**Quote:** “The compatibility of IS must be considered just as thoroughly as any strategic, operational, organisational or political issue.”


The role of IS in M & A becomes increasingly important as the need for speed of reaction and information is growing.

The study develops an integration model that describes the criteria for choosing different strategies for IS integration. A number of variables influencing IS integration are identified:

2. Company structure – retaining status quo, annexation (absorption) or merger of equals.
3. IS integration strategies – total integration, partial integration or no integration.
4. Situation variables – kind of acquired business, geographical location, IS status, relative size of the companies, previous computer architecture.
5. IS requirements – economies of scale, operative behavior standardization promoting similar company culture, report standardization/ data integration to promote inter-company integration by standardizing information management and data representation.

**Quote:** “IS integration in M & A depends on a mix of both technical and organizational factors that force the new asset designers to consider the impact of the strategic objectives of the transaction on the integration cost in terms of financial, information and human resources.” (p. 297)


M & A may disrupt the operations of the organizations involved. Major issues include the need to integrate personnel, business processes, information systems and diverse information technologies across the merging organizations. However, if carefully planned and properly managed, the merger/ acquisition and the resulting integration process can become an opportunity to strengthen the capabilities of the combined organization and place it in a better competitive position.

This paper uses the results of a field survey to examine the effects of post-merger systems integration on information systems integration on information systems area capabilities.

Corporations depend on there is to provide accurate, reliable and up-to-date information. To minimize the disruptive nature of integrating them, the acquirer and target’s technical architecture and organizational
infrastructure should be accessed prior to the acquisition and IS professionals should be fully involved in the entire process, including pre-merger discussions, so that integration problems can be identified early. However, merger discussions tend to be secret, high level, financially oriented and, in general, do not include IS professionals.

The process of quickly integrating systems is extremely complex and the lack of pre-merger IS integration planning delays the process. Immediate benefits expected from the merger are often not achieved because of unrealistic expectations relative to integration.

Positive outcomes from successful IS integration are many:
- Enhance competitive position.
- Enable critical business strategies.
- Integration of related technologies across organizational units.
- Corporate wide information accessibility.
- Provision of good quality information – accurate, useful, timely, etc.
- Operation of systems efficiently and effectively.
- Accurate end-user support.
- Recruitment and retention of qualified staff.
- Identification and assimilation of new technologies.

Quote: “Successful integration requires high quality merger as well as IS integration planning, positive support by executive management, high-quality communication to end-users and high level of end-user involvement in strategic decision making.” (p. 210)


Conclusive evidence that information technology contributes to a firm’s effectiveness is rare. This study tests the relationship between IS integration during mergers and acquisitions and their effectiveness.

There is a positive relation between IS integration and effectiveness only when IT intensity and organizational culture differences between the joining firms are controlled for. Study based on a questionnaire survey of 69 firms involved in M &As.

Quote: “Management of highly IT intensive firms should pay as much attention to issues of cultural fit during pre-merger search processes as they do to issues of potential synergy from IT integration. Integration of IT following mergers must proceed carefully in order to reap any anticipated synergies, because culture clash may damage the cooperation and commitment of the very group that may be instrumental in determining the success of the IS integration and ultimately the merger itself.” (p. 89)


Challenges in mergers:
- How to consolidate your operations while providing uninterrupted, superior levels of customer service?
- How to ensure retention of best customers and associates while introducing a series of changes in products, processes and responsibilities?
- How to quickly institutionalize a common culture while honoring the past traditions?
• How to help leaders internalize the significant changes they need to make while escalating the pace of change and raising performance levels?
• How to expand leaders’ perspectives and critical thinking to a more national focus without losing understanding of regional and local needs?

The strategies and tactics used to meet these challenges have not varied from one merger to another carried out by Nations Bank.

Quote: “The true heroes are on the front line. They are not the senior managers but the associates who are closest to the customer, the people driving the merger process.

Communicate, communicate, communicate – a single, unifying vision.

The acquiring bank is not necessarily better than the other. Mergers allow us to take the best of what each company has to offer and create an even stronger, more powerful organization.

Keep core values simple, integrate then into everything you do, communicate your strategy in constant, consistent and simple themes.


Technologically and culturally the IT operations are different species. Amoco has a large IT staff worldwide. BP, by contrast, has been on an outsourcing binge. Merger may lead to IT jobs being outsourced.

IT would be one of the various that would be looked at intensively in terms of overlap.

On the technology front the two companies greatest challenge lies in integrating the monstrous amount of seismic and other geophysical data.

Quote: “Both Amoco and BP said that neither has closely considered the IT impact of their marriage, or made decisions about the technologies on which the combined companies will run.”


Describes the integration problems facing Boeing in its merger with McDonnell Douglas. Boeing has to handle a mega outsourcing deal, juggle staff and plow through integration issues. It will also have to deal with MD’s outsourcing pact with IBM’s Integrated Systems Solutions Corp.

In the short term there will be no layoffs of IS staff and there will be tremendous demand for IS resources to help the two groups consolidate their respective IT infrastructures. Once that is completed there would be reductions.


When considering an acquisition, a firm should consider the quality of information and the IT environment in the target company. The availability of quality information is significant in determining the likelihood and the extent by which postacquisition results will deviate from the pre-acquisition
projections. A typical valuation analysis for an acquisition should include an Assessment of Information Resources in Acquisitions (AIRIA).

AIRIA provides systematic analysis of the acquisition and contributes to smooth operational integration. It indicates:

- The IT contribution that each firm brings to the combined firm.
- The ways the IT environment of the acquired firm complements, augments, diminishes or conflicts with the IT environment of the acquiring firm.
- The information that each brings to the acquisition.
- The role that IT should play in the negotiation of the acquisition.
- What lies ahead in the integration effort.


Summary: “Case-survey,” which develops a multi-disciplinary framework for M&A. Excellent insight.

Quotes:

“We believe synergy realization more directly captures what goes on in an acquisition than measures of financial performance. Further, to the extent that combination potential, organizational integration, and employee resistance are the key antecedents to M&A success, researchers must adopt dependent measures that have the potential to reflect their effects.” (p. 15)

“In contrast to virtually all previous studies on acquisition relatedness, which highlight the extent to which two merging firms are similar, we argue that strategic differences can create opportunities for synergistic complements by combining different operations that enhance the competitive position of the resulting entity.” (p. 15)

“Perhaps most importantly, [the findings] indicate that researchers should consider strategic, organizational, and HRM explanations for M&A success simultaneously.” (p. 18)


Summary: An essential text, which outlines the manner in which GE Capital manages M&A.

Quotes:

“GE Capital has been working to make acquisition integration a core capability.” (p. 166)

“At GE, integrity is not just embodied in a standard corporate-policy statement. It is a detailed requirement meant to ensure that every employee understands what constitutes proper and improper ways of conduction business.” (p. 172)


The authors carried out a study on 340 large acquisitions completed between 1984 and 1994 in the Canadian Insurance Industry. They examined four factors that might contribute to shareholder value:
strategic intent, price, synergies and post-merger management. Surprisingly, we found that only post-merger management has really made a difference in the success of the major deals of the last decade.

Quote: “In short, for most companies the deal is won or lost after the champagne corks have popped.”


The author uses different examples to amplify the way(s), which organizations can follow in dealing with the issue of IT. One example is to discard the acquiree’s system and expand across the acquirer’s system. Another example but in the opposite direction is GA and CU when the latter’s system was dropped and GA system with adopted by all.

The author refers extensively to a piece of research by KPMG on the subject. The person from KPMG, which she quotes, is Volker Schulze.

An example where problems were created as a result of the failure to tackle the IT issue is BMW and Rover where for 5 years their IS systems did not talk to each other except at the financial reporting level.

Another example is the Lloyds TSB where three years after the merger took place, the bank is still at the early stages of integrating its IT structure.

KPMG advises clients to go softly on the integration and to keep the systems running for a few years before they go for integration (A good example is SmithKline Beecham who merged in 1989 and are now talking about integration and the use of a sophisticated IT system).
SECTION 13

Internal Audit and Mergers, Acquisitions and Divestitures

This section reviews the literature dealing with internal audit and their interface with mergers, acquisitions and divestments.


Case dealing with the personal experience of Richard G. Haworth, CEO of Haworth, Inc., a multi-national office furniture manufacturer.

Quotes:
“A few of the major points we always think about are: company values and principles, managerial philosophies and practices, labor/management relations, attention to customer satisfaction, quality practices and systems, market share, manufacturing capabilities, distribution channels, stock value, debt, discounted cash flow, sales, company’s image in the market, product portfolio and pricing, geographic location.” (p. 36)

“Merger and acquisition advisory services generally fall into three groups: legal, financial and support (advise on transaction value and deal structure.” (p. 36)

“The next phase in the process entails analyzing a target company. Due diligence involves not only seeing how a company stacks up against your acquisition criteria, but delving into other areas as well, such as environmental practices, retiree benefits, product liabilities, assets, intellectual property, and the integrity of financial statements.” (p. 37)

“Data from the Hay Group, a consulting firm from Philadelphia, indicates that during the height of the M&A activity in the mid-1980s, up to one-third of all acquired firms were sold off within five years.” (p. 38)


The independence and objectivity of internal audit can contribute significantly to acquisitions activity.

Quotes:
“Internal audit can play a vital role in M&A.” (Abstract)

“Motives proposed by business strategists to justify this course of action include: 1) access to new products and markets, enabling rapid growth, 2) obtaining managerial and technical expertise, 3) eliminating competition, 4) economies of scale, 5) diversification reduces dependence on one “revenue stream,” and 6) protection of key supply sources and distribution outlets.” (p. 28)

“It is inevitable that few people will have access to sensitive information before any deal is struck, and the auditor’s role at the pre-acquisition stage will depend on the nature and extent of analysis and appraisal requested by senior management. But, once an acquisition is affected, IA should be closely involved in reviewing systems within the acquired company and establishing control by the holding company over the activities of the subsidiary.” (p. 28)
“Internal audit’s efforts are directed towards promoting the effectiveness of an organization’s internal controls, but it would be a daunting task to review the areas referred to within a short period, particularly at a time of acquisition when audit resources may be thinly stretched.” (p. 32)

“However, the internal audit department’s own strategic plan should ensure that most aspects of financial control and organizational effectiveness are investigated within a reasonable time-scale regardless of acquisitions activity.” (p. 32)

“Once a purchase is made, there is a need rapidly to establish effective control over a subsidiary’s activities.” (p. 32)


Finding related to E&Y’s survey of 259 companies.

Quote: “The depth and intensity of your due diligence process can vary from a cursory inquiry and investigation of only the most general and obvious areas, to an in-depth audit and verification of asset ownership, customer and supplier lists, reviews or audits of financial records, to procedures that are less financial and more legal in nature, like reviewing all of the company’s contracts and agreements.” (p. 55)


Covers:
• Introduction to managing organizational change – why is change important.
• What is “change,” organizations and their environments, triggers for change, managing change.
• Models of organizations and beliefs about change and organizational change.
• Strategies for change and criteria for change strategies.
• Tools for change – micro and macro change programs.
• Helping change happen – the change process and change management competencies, the change agent and consulting skills for internal auditors, resistance & adaptation to change.

Management’s role:
• What is to be changed? The problem > focus of change >solutions > structural, technical or people solutions. (p. 20)
• Leavitt’s Diamond linking Structure, Strategy, Technology and People. “Organisation is a set of interrelated systems whereby changing one impacts the rest.” (p. 20)
• Tools and techniques for bringing about changes in the Diamond. Bringing about strategic change, how do markets and strategies evolve. Characteristics of dynamic organizations.
• Move from stable equilibrium organizational paradigm to a new ‘far-from-equilibrium’ organization. (Stacey, 1993)
• The chaos model of organizational change. (p. 28)

Change management approaches – Top down versus Bottom up:
• Top down = leader as hero, vision, drive and ‘they are the problem’ attitude.
• Bottom up = leader as facilitator, awareness, release, ‘we’ need to change, reflection.

“Change cannot be managed but it must evolve.” (p. 30)
Pettigrew’s 5 factor model of change (pp. 32-33):
1. Environmental awareness.
2. How is change led? What is the process leading change?
3. Capability to link strategic and organisational change.
4. Human resource management in the change process.
5. Maintaining organisational coherence towards strategic direction.

Criteria for choosing a strategy of change: time available for change, extent of change, characteristics of the target of change and resources available. (Connor & Lake, p. 35)

TROPICS = time scale, resources, objectives, perceptions, interest, control and source. (McCalman and Paton, p. 36)

2 dimensional change strategy – level of change force intensity and level of resistance to change. (Strebel, p. 37)

Strategies of change – planned versus emergent, discrete versus continuous change.

Organizational development (OD) – characteristics, need to change behavior, cognitive or intellectual change versus behavioral change, creating self-reinforcing and self-sustaining change.

Rational-linear versus emergent models of change. Matching capabilities to the dynamic and uncertain environment of the organization.

Macro versus micro change programs – magnitude of change versus timescale: ‘going in for the quick fix’, tinkering, transformational or radical change and incremental/evolutionary change. (Sadler, p. 45)

Macro level changes – TQM, BPR, Investors in people, the learning organization.

Helping change happen – the change process and change management competencies.

Use of change agent – external advisor who helps management bring about change using an OD approach (p. 65). Internal auditor as a change agent.

Roles change agents:
• Expert providing specialist advice.
• Executive to manage or control the assignment.
• Researcher to gather, analyze and interpret information.
• Tutor to help clients arrive at their own informed decision.
• Educator to impart knowledge through formal methods.
• Conciliator to get groups/individuals in conflict to work together.
• Powerbroker to change the balance of power within client system.
• Synergist to enhance the effectiveness of work processes.
• Resistance and adaptation to change – the psychological aspects.
• Internal auditors – from due diligence to consulting role.

Quote: “There is an important distinction between change as a phenomenon and changing as a set of actions. Managing change is best understood as an active process, taking place over time with new changes and unforeseen events impinging on the process creating a need to rethink tactics and strategies.” (p. 10)

Suggests strategic-level audit, also strategic audit committee to evaluate performance. Very useful.

**Quote:** “Is it possible to create a formal mechanism within the existing governance process so that the board can exercise proactively its responsibility for strategic oversight? My answer is yes. The mechanism is a formal strategic-review process – a strategic audit – which imposes its own discipline on both the board and management, much as the financial audit process does.” (p. 101)


The author tells the story of how the internal auditors at one bank (National Bank Corp.) contributed to a recent merger.

- IA’s role is usually associated with due diligence work (process). However when a merger/acquisition has been agreed, due diligence becomes more of a fact-finding exercise than a critical step in the DM process.
- IA need to become part of the management team involved with the transition process. [If not invited, then they should put themselves forward.]
- Possible quotes: “In the Boatmen’s merger, most of the calculable savings came from leveraging existing audit resources to avoid costly consultancy fees, identify potential problems and prevent unnecessary expenditures as the two entities merged.”
- Nation’s Bank internal audit department found its role shifting from a traditional one of assessing the adequacy of existing controls to that of management advisor charged with developing new process flows and controls in the redesigned operations as well as gathering and reporting key performance information and monitoring operations stability during the transition.
- As plans for the merger progressed, IA partnered with the management’s stability team (contingency planning team). After the merger was announced, IA became goodwill ambassadors vis a vis Boatmen’s employees.
- IA was responsible for carrying out post-merger reviews.
- The author states that: “While it is difficult to estimate the value of IA services to the Bank, the IA department’s activities certainly helped management keep operations running smoothly.”


The author advocates that audit committees should play a role in M & A and leveraged buyouts.


The author describes in some detail the areas which the acquirer’s CPA will investigate as part of their due diligence audit. These areas include: cash, receivables, inventories, property, plant and equipment, other assets, contingencies, commitments, shareholders’ equity, and statement of operations. The author then details the other areas of advice like the accounting treatment of M&A, taxation.

Too old to be of any value except that the areas of due diligence look quite familiar with what accountants are doing/carrying out now.