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Mergers and Performance

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Much concern has been expressed about the economic consequences of the high rate of merger and acquisition (M&A) activity. The total value of M&As in the United States in 1998 was $1.3 trillion. This was almost double the level of activity of the previous year.

Is the accelerating rate of M&A activity a part of an economic bubble? Do shareholders of acquiring firms inevitably lose? Is M&A activity creating job losses and unemployment? These are some of the concerns that have been raised about M&A activity.

This paper presents five main messages: I. M&A activity is a response to major change forces. II. The change forces have increased the intensity of competition among business firms. III. Because of the increased intensity of competition, business firms have been required to adjust and to adopt many forms of restructuring activity. IV. At least 50% of M&A activity has improved returns to shareholders. The odds of succeeding in mergers increase when mergers are well conceived and implemented effectively. V. Increased M&A activity has been associated with outstanding performance in the U. S. economy.

I. Change Forces

Seven change forces are identified and listed in Table 1. Overriding all are technological changes which include computers, computer services, software, servers, and the many advances in information systems including the Internet. Improvements in communication and transportation have created a global economy. Nations have adopted international agreements

Table 1

The Seven Change Forces

1. Technological change
2. Globalization and freer trade
3. Deregulation
4. Economies of scale, scope, complementarity, need to catch up technologically
5. Changes in industry organization
6. Individual entrepreneurship
7. Rising stock prices, low interest rates, strong economic growth

such as the General Agreement on Trade and Tariffs (GATT) which have resulted in freer trade. The growing forces of competition have produced deregulation in major industries such as financial services, airlines, and medical services.

The next set of factors relates to efficiency of operations. Economies of scale spread the large fixed cost of investing in machinery or computer systems over a larger number of units. Economies of scope refer to cost reductions from operations in related activities. In the information industry, these would represent economies of activities in PC hardware, PC software, server hardware, server software, the Internet — and other related activities. Another efficiency gain is achieved by combining complementary activities — for example, combining a company strong in research with one strong in marketing. Mergers to catch up technologically are illustrated by the series of acquisitions by AT&T.

The fifth major force stimulating M&A and restructuring activities has been changes in industry organization. An example is the shift in the computer industry from vertically

integrated firms to a horizontal change of independent activities. Dell Computers, for example, has been very successful concentrating on PC sales with only limited activities in the many other segments of the value chain of the information industry.

The sixth major force is represented by individual entrepreneurship which has responded to opportunities and, in turn, created further dynamism in industrial activities. Examples are Bill Gates at Microsoft, Andrew Grove at Intel, Jack Welch at the General Electric Company, John Chambers at Cisco Systems, Bernie Ebbers at MCI WorldCom, among the many.

Finally, the economic and financial environments have been favorable for deal making. Strong economic growth, rising stock prices, and relatively low interest rates have favored internal growth as well as a range of M&A activities.

II. Increased Intensity of Competition

The new change forces have increased the intensity of competition. New competitive forces have emerged brought about by the impacts of the change forces. A more rapid pace of product introductions has occurred. Product life cycles are shorter. The technological requirements for all companies have increased. Growth in some industries has increased but declined in others. The forms and numbers of competitors have increased. Distribution methods have changed. Industry boundaries have become blurred.

The changes in the computer industry illustrate the new patterns of competition. Two central concepts of strategy developed by Michael Porter (1980, p. 4), the five forces framework and the value chain concept, require extensions. Porter's five forces driving industry competition are: rivalry among existing firms, the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, and the threat of substitute products or services. Grove (1996, p.

30) added a sixth force, the number and competence of complementors. Others would add a seventh — the degree of regulation by government authorities.

The computer industry is illustrative. Grove (p. 40) points out that when IBM reigned supreme in the computer industry in the 1970s, vertical integration dominated. IBM was strong in all aspects of the value chain including chips, hardware, operating systems, application software, sales and distribution, customer engineering, along with modification and maintenance facilities. But in the 1990s, the computer industry is only a segment of an expanded value chain of the information industry. A critical element of the information industry is high technology. The Morgan Stanley Dean Witter High-Tech 35 Index includes 12 technology segments, composed of electronics-based technology companies only. It excludes bio-technology, medical, test and instrumentation companies. Thus, the relevant value chain has at least 20 distinct nodes or segments each with intense competition. Change is so fast that firms must protect their vulnerability to change forces and intensified competition in all areas, from design and manufacturing through distribution. At the same time, each firm seeks to find attractive growth opportunities in the current domain of current and potential rivals. Competition has indeed become multidimensional. The dimensions of industries and segments are no longer well defined.

III. M&As and Restructuring

The changing environments and the new forms of competition have created new opportunities and threats for business firms. The change imperatives are strong. Firms must adjust to new forces of competition from all directions. Firms have been forced to adopt many forms of restructuring activity. M&As will be considered first, but it should be understood that they represent only one set of the many adjustment and restructuring responses.

Mergers vs. Internal Growth

Internal growth and mergers are not mutually exclusive activities. Indeed, they are mutually supportive and reinforcing. Growing, successful firms use many forms of M&As and restructuring based on opportunities and limitations. The characteristics and competitive structure of an industry will influence the strategies employed.

The factors and circumstances favoring M&As in part relate to industry characteristics. With excess capacity in an industry, horizontal mergers can be used to shut down some high-cost plants to reduce industry supply and to increase efficiency in the remaining firms. Also, a number of industries, formerly fragmented into many small-scale operations, have been rolled up into larger firms. The larger firms have been able to achieve efficiencies not achieved by the separate units. An example is the series of consolidation mergers in the waste management industry.

Some other advantages of M&As or external growth may also be noted. An acquisition enables the acquirer to obtain an organization already in place with an historical track record. Some surprises are still possible, but they can be mitigated to some degree by appropriate due diligence. An acquisition generally involves paying a premium, but the cost of acquiring a company may be determined in advance.

An acquisition may also represent obtaining a segment divested from another firm. The logic is that the segment can be managed better when added to the activities of the buying firm. Another important reason for M&As is to enhance the strength and breadth of the acquiring firm. For example, the phenomenal growth of Cisco Systems was achieved by acquisitions of companies with the technology and talent to expand capabilities.

Firms generally have internal development programs that are assisted by M&A activity. The existing capabilities of a firm influence the kinds of acquisition activity that will make business and economic sense. For example, in the years 1981-97, the General Electric Company made 509 acquisitions of $53 billion and made 310 divestitures of $16 billion. The central strategy was to seek to become the number one or two player in the product-market area of the strategic business unit. If unit managers were unable to achieve a leading position in the product-market area, the segment was divested.

The Many Forms of Restructuring

The discussion of internal vs. external growth of the preceding section does not convey the full story. Business firms have used a wide range of activities in seeking to exploit potential opportunities. Examples of the many forms are listed and briefly described below:

1. Expansion — A major objective of mergers, tender offers, and joint ventures is to achieve expansion and growth.
    a. Merger — Any transaction that forms one economic unit from two or more previous units.
    b. Tender offer — A method of making a takeover via a direct offer to target firm shareholders to buy their shares.
    c. Joint ventures — A combination of subsets of assets contributed by two (or more) business entities for a specific business purpose and a limited duration. Each of the venture partners continues to exist as a separate firm, and the joint venture represents a new business enterprise.

2. Sell-offs — General term for divestiture of part or all of a firm by any one of a number of means, e.g., sale, liquidation, spin-off, and so on.
   a. Spin-offs — A transaction in which a company distributes on a pro rata basis all of the shares it owns in a subsidiary to its own shareholders. Creates a new public company with (initially) the same proportional equity ownership as the parent company.
   b. Divestitures — Sale of a segment of a company (assets, a product line, a subsidiary) to a third party for cash and/or securities.
   c. Equity carve-outs — A transaction in which a parent firm offers some of a subsidiary's common stock to the general public, to bring in a cash infusion to the parent without loss of control.
3. Changes in Ownership Structure
   a. Exchange offer — A transaction which provides one class (or more) of securities with the right or option to exchange part or all of their holdings for a different class of the firm's securities, e.g., an exchange of common stock for debt. Enables a change in capital structure with no change in investment.
   b. Share repurchases — A public corporation buys its own shares (1) by tender offer, (2) on the open market, or (3) in negotiated buybacks.
   c. Going private — The transformation of a public corporation into a privately-held firm (often via a leveraged buyout or a management buyout).
   d. Leveraged buyout — The purchase of a company by a small group of investors, financed largely by debt. Usually entails going private.

e. Leveraged cash-outs — A defensive reorganization of the firm's capital structure in which outside shareholders receive a large one-time cash dividend, and inside shareholders receive new shares of stock instead.

f. Employee Stock Ownership Plans (ESOPs) — A defined contribution pension plan designed to invest primarily in the stock of the employer firm.

4. Restructuring — Changes in product-market participation, asset redeployment, financial engineering; changes in management systems to improve revenue growth and to achieve efficiency increases including cost reductions.

It is clear from the above list that the strategies include expansion, contraction, and efforts to improve the efficiency of operations. Joint ventures represent a flexible method of exploring new areas with partners whose capabilities are complementary. Joint ventures are particularly useful when one firm sells a segment to another. The joint venture can be used to have the seller transmit knowledge about the operation and the buyer to learn more about what is being acquired. A more informed basis for arriving at the sale price is thereby provided.

With regard to split-ups and spin-offs, a firm may improve motivations and performance by creating separate operations, when an activity does not fall into an effective organization structure of the parent. Similarly, leveraged buyouts, leveraged recapitalizations, share repurchases, and stock splits may be effective parts of a strategic program for enhancing shareholder values. Especially promising in this connection are cross-border transactions either in the form of joint ventures or mergers and acquisitions to achieve new products, new technologies, and new geographic markets.

IV. M&As and Company Performance

Are mergers good for shareholders? Shareholders of acquired firms benefit from the premiums paid by acquiring firms. The premiums paid over pre-merger market prices are mainly in the range of 25-35%, sometimes even higher. The premiums can be higher or lower depending upon what the target company has to offer and whether the gains are specific to the acquiring firm or would be of value to competing bidders as well. The subsequent five-year returns to the target shareholders as a part of a combined firm are positive, not greatly different from broad benchmarks such as the S&P 500, or narrower industry benchmarks.

The returns to acquiring firms are influenced by a number of factors. Many firms engage in a series of M&A activities over time. Thus, it is difficult to isolate the influence of a single acquisition event. If the time period over which the returns to the shareholders of acquiring firms includes a year or two before a specific acquisition, on average, acquiring firms earn at least their cost of capital. But studies also find that for the largest combinations during the period of strategic mergers, 1992-98, in at least two-thirds of the cases, value is increased. For a sample of 309 of the largest mergers during 1992-98, the initial market reactions represented a gain of $154 billion.

Even more significant, some acquirers have developed processes to achieve highly impressive track records. For example, Anslinger and Copeland (1996) found that samples of both corporate and financial buyers were able to achieve superior performance. For the period 1985-94, 10 active corporate acquirers achieved annualized returns in excess of the S&P 500 benchmark of 14.3%. A group of 13 financial buyers with capital of more than $16 billion achieved returns above 25% annually. Successful corporate and financial buyers utilized experienced (executives) acquirers, developed innovative operating strategies, and formulated

substantial performance incentives to the top executives of acquired firms. For large samples, some M&As succeed, others fail. But well conceived and effectively implemented M&A activity can yield returns to shareholders in excess of broad stock market indexes.

V. Restructuring and Economic Performance

M&As may be good for shareholders. Are they good for the economy? In particular, what happens to jobs? Most acquisition announcements include plans for work force reductions, yet employment has grown. In 1980, 99 million were employed in the U.S. By the end of 1998, employment levels had reached approximately 132 million representing an increase of 33 million over an 18-year period. This represents a gain of just under 2 million jobs per year. In the early 1980s, the unemployment rate was 9.7%. In 1998, the unemployment rate was at the 4.5-4.6% level. By 1998, the annual rate of price change had fallen below 2% per annum.

With only the short downturn associated with the initial uncertainties of the Gulf War in 1989-90, the performance of the economy since 1980 has been outstanding. Jobs lost in restructuring have been offset by new jobs in the growth areas of the economy. A strong case can be made that the threat of takeovers during the 1980s stimulated firms to become lean and efficient. Efficiency included effective utilization of the flow of technological advances and improved management systems.

The theory that the restructuring of U.S. firms had a significant positive influence on U.S. performance is supported by comparisons with the economy of Japan. Real GDP growth during the decade 1988-98 was 26% for the U.S. and 23% for Japan. However, during the 1990s through 1998, real GDP in the U.S. grew 23% and for Japan only 8%. In fact, GDP growth for Japan in 1999 is forecast to be negative. During the decade 1988-98, the Nikkei Index dropped 54% while the U.S. Dow increased 323%.

A number of articles have commented on the failure of Japan's companies to participate in M&As and restructuring activity. A Barron's (1999) article is illustrative. The article states that announcements of restructuring by Japanese companies have been "more smoke than substance." The article avers that Japanese companies are still fiddling while the economic problems of Japan have not been resolved.

The implications of such articles are relevant for the role of M&A activity. Japanese companies had superior performance in the '70s and '80s because of innovations in management systems. However, the threat of takeovers forced U.S. companies to restructure and to become more efficient. American companies embraced the advances in technology with alacrity. Thus, M&As stimulated U.S. companies to embrace change and to increase efficiency. The M&A and restructuring processes moved resources to their highest and best uses and contributed positively to the outstanding economic performance of the U.S. economy since 1982.

Summary

This study seeks to place the merger movement of the 1990s in perspective. M&A and restructuring activities throughout the world have accelerated during the 1990s. Strong change forces have produced new forms and increased intensity of competition. In response to the massive changes in environment forces and new forms of competition, organizations have had to make many forms of adjustments. M&As and restructuring are elements of the multifaceted adjustment processes put in motion.

The responses by business firms to their turbulent environments and the challenging new competitive pressures have produced winners and losers. For firms to stand still would invite sure extinction. Adjustments to the new challenges do not guarantee success. Well conceived

and effectively implemented M&As and restructuring have produced returns to shareholders in excess of broad stock price indexes.

The M&As and restructuring processes have had positive influences on economic performance. Despite job losses associated with individual firm adjustments, the economy has produced almost 2 million new jobs per year since 1980. Economic progress, measured by growth rates in gross domestic product, has been strong and sustained. Price stability and relatively low interest rate levels have been favorable and reinforcing factors. U.S. industry is positioned to adjust effectively to future challenges certain to come.

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