UNIVERSITY OF SALFORD

MERGERS AND ACQUISITIONS

CORPORATE FINANCIAL STRATEGIES

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INTRODUCTION

The global market today, dominated by hectic technological development, competitive environment and market power tendency, is facing an upward cycle of Mergers and Acquisitions. Definitely, Mergers and Acquisitions have improved firms' performance by cost-cutting processes, diversification, increased productivity, utilize of "non-mobile" capability (Luong, 2018), as well have disciplined the market and stakeholders implied in a takeover process.

Most of the mergers are "synergy theory" motivated, based in an incremental formula "2+2=5" (Ghosh Ray, K. & Ghosh Ray, S., 2013), providing thus an investment opportunity for creating value for the acquiring firm and its shareholders, even though quantifying synergy gains from mergers hardly is attained. So, a pre-acquisition detailed planned process must be taken in order to evaluate properly the expected gains and risks that might come from an overestimating target, otherwise from the start of the process the value destruction of acquiring firm and shareholders is certified. A significant role plays, as well, the post-acquisition process in creating synergy gains and sealing the success of a takeover. Influenced by the different motives of value creating, decisions of what type of mergers fits best for acquiring firms are indisputable important. Further, mergers' success is related with the acquiring company's strategy compliance.

Apart from the merging motives, and strategy, the payment method of bidder's offer affects the success of a merging or acquisition process, sending confident signals to market which affect the short-returns of shareholders on stocks and later the long-returns on investment, in overall. Basically, mergers and acquisitions represent a great opportunity to grow, but within the market imperfections they expose the stakeholders to the most difficult evaluation decision and process.

MERGERS & ACQUISITIONS THEORIES

In a globalized market and increased opportunities for investing and growing, an increased network and technology development, rapidly increasing competitive environment, the firms cannot resist to the course of buyout potential value creating alternatives. Under such circumstances, Mergers and Acquisitions represent a "modus operandi" in the global market to gratify growth and increase value in a competitive environment. As Motis (2007) notices the differences between mergers and acquisitions, there is a significant difference in controlling interests related to target firm in mergers with a whole buyout and in acquisitions with a limited control buyout, even though both are handled as takeovers.

Having in focus value creating primarily for shareholders and all other stakeholders, the motives that stimulate the mergers and acquisitions are numerous, starting from the growth, synergy (Ghosh Ray K, and Ghosh Ray S, 2013) through efficiency improvement to cost reduction, diversification, and market power. Arnold and Lewis (2019) refer the motives for mergers such as: synergy, market power, economies of scale and economies of scope.

In their empirical investigation, Berkovitch & Narayanan (1993) separate three main motives for takeovers, each of them having different implications in relation between acquirer gains, target gains and total gains. The first motive of takeovers that of synergy presumes that managers of both acquirer and acquired firms are aiming to increase gains for both shareholders' firms, generating a positive correlation between total gains and both shareholders' gains. The second motive of takeovers, the "agency motive" suggests that most of such engagements are motivated by managers' interests and ego of acquirer firm. The reasons behind such decision from the part of managers of acquiring firm include personal gain, increased size firm through free cash-flows, and increasing dependence of firm on management. Such conditions present a disputable negative gain for the acquirer shareholders, and positive results to target and acquirer' managers gains. The third motive, the "hubris hypothesis" claims that managers of acquiring firm make mistakes in evaluating the target firm and realise a takeover that misses synergy. In such circumstances, the managers of acquiring firm will engage in a takeover that has no synergy and gains for the firm, thereby overestimating the target firm and providing negative gains for acquirer shareholders. Such results are indicated as well from Seth and Dastidar (2007) empirical research, in which motives of synergy and hubris are associated with positive gains while managerial motive is related with negative gains.

From the other side, Motis (2007) points the motives of mergers in a different argumentation, grouping them under the following gains and benefits of related parties:

- Shareholder Gains, which are achieved through improved efficiency, economies of scale, economies of scope, synergy, increased know-how and R&D (research and development), cost reduction, purchasing power, financial cost savings, diversification, market power, portfolio spread, disciplinary gains, improved cost of capital, etc.
- Managerial Gains having provenance from X-inefficiency theory (Leibenstein, 1966 citied by Motis, 2007) reinforcing "agency theory", in which conflicts of interests and objectives between owners and managers exist, are motivated mostly by the later interests and profits through "Empire building" actions, "hubris hypothesis" ruled by the overconfident managerial behavior leading to an acquisition or merger that is overestimated and missing gains for the acquirer firm, or portfolio diversification motivated by personal interests of managers.

Following different motives of value creating, firms analyze the options and strategies to achieve such growth resulting in different types of mergers that best achieve their goals. In this way, firms that intend economies of scale and market power follow the horizontal merging (Arnold & Lewis, 2019, p.866), leading the firm to offer a bid to a competitor that is industry and product related. While firms that aspire to ensure the supply of inputs or outputs, and thus cost reductions are directed towards vertical merging, altogether with the market power. Firms that aim diversification and risk reduction, cost reduction and increased efficiency as well market power outright tend to merge with other firms that are industry unrelated creating conglomerates.

Among those mergers that aim to reduce costs and increase market power within their local competitive market, other mergers aim to increase market power through cross-border acquisitions and exploit cheaper inputs, technology and transport costs, as well local market

network of target firm (Luong, 2018, p.654) even though the target firms may have negative productivity. As Luong (2018) emphasizes the incentives behind the cross-border horizontal mergers involve targeting more low-productivity firms since they can be squeezed as "lemons" for the local access they can provide and both their intangible assets, while those of vertical mergers target the "cherries" because of their high productivity in tangible assets exploitation. In addition, mergers may impose market discipline by altering inefficient management in the target firm, thus contributing to an increased value by the merger process.

According to Ghosh Ray, K. & Ghosh Ray, S. (2013 p.115-127) among the important factors underlying cross-border mergers comprehend corporate restructuring, operations rationalization, cost reductions and efficient capital usage, which in overall are contemplated to impose value creation. They distinguish among the merging and acquiring motives:

- The Operating Synergy through optimized utilization of tangible and intangible assets providing, thus, a cost advantage because of economies of scale, and benefits insured by research and development and common distribution channel utilization through economies of scope, as well rich knowledge sharing through economies of learning;
- The Financial Synergy through low costs of internal funding, lower risk, improved capital allocation, low free cash flows, etc. The financial synergy is found in the purpose of cross-border acquisitions between companies with different Weighted Average Cost of Capital (WACC) ensuring a higher return on investment (ROI) for the target and better Net Present Value of the future cash flows and as consequence a higher present wealth for the acquirer (Ghosh Ray, K. & Ghosh Ray, S., 2013. p.130).

The belief that stands behind the merging and acquisition motives is "incrementalism" according to Ghosh Ray, K. & Ghosh Ray, S. (2013), which upholds the theory of synergy with "2+2=5" combination. Such gains and benefits have stimulated the takeovers over the years, even though the statistics data reveal that most of them have resulted mostly on value destruction than value creation in last decades.

VALUE DESTRUCTION

Reading through many literature and case studies, evidences show that shareholder's wealth through Mergers and Acquisitions is destroyed in most of the acquiring firms in last decades' deals resulting in a reduced wealth value of 2 + 2 = 3 instead of 5 according to Fernandes (2020). Researches revealed from the National Bureau of Economic Research on August, 2003 present a tremendous picture of takeovers associated with U.S shareholder losses of more than $200 billion in last 2 decades.

Certainly, an important consideration regarding determination of a good or bad acquiring deal is realized observing whether the attributes of such outcomes are "deal specific" or "firm specific", because of the importance these factors play in the process of realization of the takeover (Fich, Nguyen & Officer, 2018, p.14; Moeller, Schlingemann, Stulz, 2005, p.3), while industry-specific attribute plays also an important role as well in extreme outcomes and deals realized because of the attractiveness and gains they may promise for the investors. The report from Fitch, Nguyen & Officer (2018. p.32) presents that about 40% of large gain/loss deals during the period of 1998- 2001 were made in the Business Equipment industry, and

that more synergy and gains were realized between firms that had business relation/dependence such as input or output supply.

One of the most significant factors that determine the value destruction and shareholder losses from mergers and acquisitions lies in the evaluation process resulting thus in overestimation of the target firm and leading to wrong deals (Lewis & McKone, 2016; Fich, Nguyen & Officer, 2018). Ghosh Ray, K. & Ghosh Ray, S. (2013, p.120) argue that estimating the potential value of synergies is hardly impossible and this makes the possibility of realizing a bad deal a real one. An evaluation process must be considered regarding the investment planning to target the desirable return on capital in order to avoid overvaluation of the target and the shareholders' value destruction because of "winner' curse". One factor that holds a considerable part in acquirer shareholder's value in takeover is related to asymmetric information (Wu, Reuer & Ragozzino, 2013, p.174), which leads mostly the acquirer firm to problem of adverse selection and overpayment risk.

Harding, Jackson, & Shankar (2013) argue that mergers' success is relied on the idea that it certainly has to fit to acquiring company's strategy. The same confirms Mahajan (2019, p.4) when he presents evidences gathered in years from cases of shareholders' value destruction because of strategic risks underestimating.

Results obtained by Berkovitch & Narayanan (1993) put emphasize on the value destruction created by "agency theory" where decisions to takeover are motivated by personal management' welfare at the expense of acquire shareholders. Moreover the same suggests Andricopoulos (2017, p.20) that value destruction of acquiring shareholders comes from highly overconfident CEOs and management. On the other side, Harford, Humphery-Jenner & Powell (2012) argue that a considerable value destruction portion comes from entrenched managers, who with their harden attitude tend to overpay and select low synergy targets.

The "agency theory" problem is evidenced, as well, by Balls (2003) in acquisition deals realized by big firms. On the other hand, big firms acquiring actions give a bad market reaction related to share prices, signalling to the market that the firm may lack further internal growth and efficiency (Balls, 2003), while opposite market reactions and abnormal positive returns are noticed when announcement of acquisitions are made by small firms. As presented in his research, the biggest losses are related to big firms, while acquisitions undertaken by small firms record a higher percentage in announcement return (1.55%) compared to large firms. This finding was confirmed moreover by Fich, Nguyen & Officer (2018) evidencing an increase in the probability of the large outcome related with the increased acquirer's size because of the large wealth implied in the deal.

In fact, one of the most significant factors analyzed in a wealth creation deal relates to target size and as Fich, Nguyen & Officer (2018) find a good deal is realized when the acquirer firm takes over comparatively small targets, known as "bolt-on", instead of equal size targets or larger ones, otherwise large losses are unavoidable. Evidences and arguments reinforce the facts that sustain the relation of firm's size with value creation or destruction size, and major role is attributed to the risk undertaken in such takeovers (Fich, Nguyen & Officer, 2018, p.19).

Besides the pre-acquisition process and variables significant to succeed the takeover, a key role plays the post-acquisition integration process (Ghosh Ray, K. &Ghosh Ray, S., 2013) because synergy gains are earned better when there is a natural and positive integration within two different firms and their assets (being technological or human).

Success of an acquiring deal, not randomly, depends moreover on the payment method or financing of the takeover. Different literature (Fich, Nguyen & Officer, 2018; Morellec & Zhdanov, 2008) suggests that the market reacts favorably towards takeovers that are financed through all-cash payment, signalling confidence in target selection and power of the acquirer, at once avoiding risks that are related with other financing methods (default risk in case of debt financing takeover and bankruptcy costs). Morellec & Zhdanov (2008, p.566) puts emphasize on the importance of capital structure of the winning acquirer. Such evidence is argued as well by Andricopoulos (2017, p.3), where his finding supports the case of shareholder value destruction when a more leveraged structure is used in the deal by acquiring firm.

From the above empirical evidence and researches of different literature, the data indicate that there are a numerous list of variables and factors indicating the failure of a takeover or shareholders' value destruction in this process, and without any objection, from the analysis above the fact that majority of deals end losing value is confirmed.

LONG-TERM FINANCING TAKEOVER

Among the mergers' motives citied above, Morellec & Zhdanov (2008, p.557) argue that different theories support the idea of a capital structure motive behind the merger because of the financial gains it provides such as tax shield and wealth transfer to acquirer firm. Moreover, the completion of the takeover is significantly influenced by the capital structure. A takeover process is financed in three ways: all cash, all equity, and combination of cash and equity (Sherif, 2012), and the decision of financing takes a key role in the takeover success as long as the payment method reveals the true value of the bidding firm (Angelo et.al, 1984 data confirmed in Sherif, 2012, p.3; Vladimirov, 2015, p.1) and the takeover premium.

Based on the "synergy theory", in order to create shareholder' value of the acquiring firm, the premium paid for the target firm must not exceed the due value of synergies to be earned from the merger. Sherif (2012, p.16) states that a takeover, that is financed through all-cash, gives the best returns to both acquirer and acquiring shareholders. Further, according to Vladimirov (2015) there is an advantage related to acquirer bidding in cash, being less aggressive compared to bidding in debt and in equity, thus offering an underbidding for the takeover. In addition, Morellec & Zhdanov (2008, p.571) confirm that a lower levered bidder is likely to win the takeover contest. On the other hand, Andricopoulos (2016) argues "that a higher leveraged firm will destroy more shareholder value in time", because of waste in shareholder's money. As Vladimirov (2015) argues, on the other hand, takeover premiums are 5-8% lower when cash bids are not financed with debt, resulting thus in a cheaper cost of acquisition for the acquirer with the all-cash bids.

Atiyet (2012) empirical results show that a takeover internally financed creates shareholder value for both measures of Economic value added and Market value added, while a debt financed takeover records a negative Market value added. In fact, a takeover financed by other resources than cash signals a bad investment. But, as noticed (Vladimirov, 2015) larger firms and firms with access to competitive capital markets use frequently debt financing. DePamphilis (2011) emphasizes the low after-tax cost long-term debt has in financing, and the potential to improve returns on equity, but it exposes the acquirer firm to default risk and bankruptcy.

If the takeover is financial feasible, it can justify the cost of debt, but as the case studies and evidences from literature show most of the mergers and acquisitions result in acquiring shareholder/firm value destruction because of different variables, then the decision of financing method of takeover plays an important role in the value creation/destruction. Given the low interest rates and other financial gains that debt can provide such as tax shield, an acquiring firm holds more advantages in all-cash financing takeovers. A debt financing takeover has a priority role in eliminating the "agency problem" for the acquirer shareholders, assuring that the managers will not lead the takeover in their personal gains at the expense of shareholder value. The LexisNexis Market Tracker' research on Mergers & Acquisition trends in UK, in 2019, confirms that from the 66 firm offers announced in 2019, 52 (79%) were all-cash offers, making cash "the king" of financing bidders.

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