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**Mergers and acquisitions: the way out?**

by

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The centre is involved in several major EU projects and collaborates with central research and educational institutions all over Europe. There is particularly close contact with London School of Economics, University of Glasgow, The Graduate Institute of International Studies in Geneva and The Research Institute of Industrial Economics (IUI) in Stockholm. The staff members participate in international research networks, including Centre for Economic Policy Research (CEPR), London and International Association of Maritime Economists (IAME).

## **Mergers and Acquisitions: The way out?**

**By Professor Guttorm Schjelderup**

The past two decades have witnessed a growing trend towards economic integration where national borders have diminished in importance, and capital, firms, and labor have become more mobile internationally. Hand in hand with the economic integration of independent economic systems -- local, national, and otherwise -- has been the immense growth of multinational enterprises. Multinational corporations (MNC) are firms that engage in foreign direct investment (FDI), defined as investments where the firm sets up a subsidiary in a foreign country or acquires a controlling interest in a foreign firm. Most of these investments turn out to be horizontal direct investments, that is, foreign production of products and services similar to those the firm produces for its home market. Vertical investments in contrast geographically fragment the production process by stages of production.

FDIs has grown rapidly throughout the world, with particular strong surges in the late 80s and 90s. For example, at the end of 1997, the gross product (value added) of all multinational corporations including parent firms stood at an estimated \$8 trillion, comprising roughly a quarter of the world's gross domestic product.<sup>1</sup> Furthermore, a significant share of world trade is intra-firm trade (about 30%). Developed countries account for most of outward and inward FDI, and that there is a substantial amount of two-way FDI flows between pairs of developed countries.

Perhaps the most striking feature of this process of FDI is the fact that cross-border mergers and acquisitions (M&As) are the main force behind the rise in FDI. Mergers play an insignificant role in this context. Less than 3% of total cross border M&As were mergers, and that full or outright (100%) acquisitions accounted for 60-70% of all cross border M&As. In reality the main force of firm's international expansion was by means of acquisitions. The alternatives to acquisitions such as Greenfield investments (i.e., organic growth), exports or licensing were not preferred modes of expansion.

In the economic literature there is two theories that try to explain why firms participate in M&As. The first theory is that M&As are done in order to maximize shareholder values either by reducing costs or enhancing revenues. The second theory says that management pursue their own self-interest and that M&As occur even if such activities are not technically efficient or in the interest of shareholders.

The view that M&As are done to maximize shareholder values is perhaps the least controversial view. One main motivation is that time to market is vital and that an acquisition is a much faster way of accomplishing that than any of the other alternatives. Firms that are latecomers to a market or lagging in technology are often in dire need to catch up fast. The shorter lifespan of products and increased competition in global markets are other reasons for why speed is so important. A second motivation for acquiring another firm is the need to appropriate assets such as patents, brand names, R&D know-how, or the possession of local permits and licenses. These strategic assets are seldom sold in the marketplace and they take time to develop if they can be developed at all. A third and very common view of why M&As are important are the anticipated efficiency gains through synergies such as the

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<sup>1</sup> World Investment Report 2000, Ch. 1, United Nations

pooling of resources like management, using each others' marketing and distribution networks, and the matching of complimentary skills within firms. Others factors that are mentioned as motives are the search for new markets (domestic market is saturated), diversification, and the elimination of local competitors, and size. Greater size is important if operations require economies of scale or large expenditures, say, for R&D.<sup>2</sup>

The second theory of M&As says that managers pursue their own self-interest, especially in situations where corporate governance is weak (giving rise to what is often called a principal-agent problem). Managers may be driven by the desire to boost executive power and prestige by 'empire building' even when such behavior is detrimental to the performance and profits of the firm. Another factor may be that managers in some cases have incentives (if under pressure from financial markets) to present the future as bright. Acquiring a firm may then be sufficient to swing the market around. A third explanation is that some managers overestimate their ability to make M&As work.

There is ample empirical evidence on the success of M&As. This literature can be divided in two. The finance literature takes as its starting point that stock markets are efficient so changes in share prices can be used to gauge changes in firm value. These studies typically compare share prices before and after M&As over a significant time period controlling for market movements in general and systematic risk. The findings in this literature can be summarized as follows: (1) Target firm's shareholders benefit while bidding firm's shareholders generally lose or break even: (2) Rates of return earned on common stock tend to

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<sup>2</sup> Some of the reasons for how firms can maximize the value of shares can be encompassed within the OLI paradigm of Dunning (1993). This theory claims that firms investing abroad must poses specific ownership ("O") advantages to overcome the extra costs of investing abroad; that the foreign location must provide location ("L") advantages over the home country; and finally that firms must be better off choosing to internalize ("I") their advantages rather than selling them to other firms (see Dunning, J.H. *Multinational Enterprises and the Global Economy*. Harrow: Addison-Wesley, 1993.)

deteriorate when the period after the merger is extended to more than one year or more leading to the conclusion that M&As do not produce better results in terms of *higher share prices*: (3)

Cross-border M&As do slightly better than domestic ones: (3) There is some evidence of improved performance at the level of the acquiree, indicating that the benefits by the acquiree are more than outweighed by negative effects at the level of the newly firm as a whole.

The second branch of studies has its root in the Industrial Organization literature. These studies are undertaken by measuring corporate performance mainly by comparing various measures of profitability before and after transactions based on accounting data. The success and failure of an M&A is assessed by comparing performance of a relevant control group. The basic message from this literature is that: (1) No significant improvement can be found in long term profits: (2) There is weak support for the hypothesis that conglomerate M&As (i.e. unrelated activities) provide more favorable results than horizontal or vertical M&As: (3) For cross border M&As it seems that large cultural differences between bidder and target companies are positively related to acquisition performance.

An assessment of the empirical literature is therefore that a large number (but not all) of M&As 'fail' in the sense that the share price or profitability of the firm does not rise. Furthermore, a lesson from the theoretical literature seems to be that a successful merger or acquisition must be based on an objective assessment of own capability to make the M&A work, as well as of the advantages it presents to the firm. In making an assessment of where firms invest, empirical findings show little evidence that FDI is positively related to differences in capital endowments across countries. Nor does the return to capital and differences in such play a role. However, skilled-labor endowments are strongly positively related to outward FDI. As one would expect, instability and political risk also affect firm's

choice of investment country, while taxes in the short run seems to be of secondary importance.