CHAPTER 10

Mergers and Acquisitions

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

1. Describe different types of mergers and acquisitions.
2. Estimate the return to the stockholders of bidding and target firms when there is no strategic relatedness between firms.
3. Describe different sources of relatedness between bidding and target firms.
4. Estimate the return to stockholders of bidding and target firms when there is strategic relatedness between firms.
5. Describe five reasons why bidding firms might still engage in acquisitions, even if, on average, they do not create value for a bidding firm's stockholders.
6. Describe three ways that bidding firms might be able to generate high returns for their equity holders through implementing mergers or acquisitions.
7. Describe the major challenges that firms integrating acquisitions are likely to face.
8. Discuss unique challenges to merger and acquisition strategies in an international context.

The New Acquirers

Mergers and acquisitions have been an important part of the business scene for decades. Historically, acquirers have tended to fall into two categories: strategic acquirers and investment acquirers. **Strategic acquirers** use acquisitions to extend their current business, to leverage their current capabilities, or to diversify into new businesses. These are the acquirers that are the subject of most of the discussion in this chapter.

Investment acquirers have traditionally taken a different approach to acquisitions. These firms typically do not have a central business they are looking to extend or enhance. Instead, they acquire a portfolio of underperforming firms and then implement a variety of incentives and control systems to help turn these underperforming firms into high-performing firms. When the performance of these firms begins to improve, investment acquirers will either "take these firms public" by selling shares to the general public or sell them to strategic acquirers. In general, investment acquirers will hold on to a firm only long enough to turn it around, whereas strategic acquirers will operate the firms they acquire for longer periods of time.

Recently, a new type of acquirer has emerged—the **private equity firm**. Private equity firms are similar to traditional investment acquirers. For example, private equity firms try to buy underperforming firms and install incentives and management controls designed to improve a firm's performance. Once this higher level of performance is achieved, the private equity firms will sell the firms in their portfolio, either by taking them public or by selling them to strategic acquirers. However, private equity firms differ from traditional investment acquirers in one important way: Whereas traditional investment acquirers would often hold on to a firm for 7 to 10 years—to complete its turnaround—and only realize the value they created by selling a firm, private equity firms impose a variety of fees and other charges on the firms they acquire almost immediately. This means that private equity firms are able to appropriate much of the value of their investments much sooner than was the case for traditional investor acquirers.

All of this is perfectly legal, and appropriating more of the value of its investments sooner rather than later is generally consistent with the wealth-maximizing interests of a private equity firm's owners. Recently, however, some of the short-term activities of private equity investors have been questioned. In particular, private equity firms sometimes charge the companies they acquire huge fees for the services they supposedly provide. In one case, these fees totaled over $1 billion. These firms can also charge the firms they have acquired the same fee several times. Private equity firms can also load their acquisitions with debt. This can weaken the balance sheet of these firms and has even sent some firms into bankruptcy.

Consider a few examples. In 2004, Blackstone Group charged a fee of $45 million to Celanse Corporation, a firm it had recently acquired, for the advice it had given Celanse about the acquisition. The owners of Warner Music (including Bain Capital, Thomas H. Lee, and Providence) charged a $75 million fee for giving advice to Warner about being acquired. One group of private equity firms charged Warner Chilcott—a pharmaceutical maker—a fee of $27.4 million when it went public because Warner Chilcott would no longer need its management advice. Another group of private equity firms accumulated $576 million in dividends and fees from Intelsat Global Services—a satellite operator—within one year of buying the firm for $513 million. And while this money was being collected, Intelsat lost $325 million, doubled its debt to $4.75 billion, and laid off 20 percent of its employees. Bare Escentuals Inc., a

San Francisco–based cosmetic maker, borrowed $412 million mostly to pay $309 million in dividends and transactions fees to its private equity owners, even though this firm earned only $24 million in 2005. Despite its low credit rating, in 2006 Bare Escentuals borrowed again to pay its private equity owners $342 million in dividends and fees.

None of this would matter if private equity firms were creating enough long-term value through restructuring the low-performing firms they have acquired. Historically, this has been the case. From 1980 through 2003, the value of companies sold to the public by private equity firms was greater than the value of similar companies sold to the public without the involvement of private equity firms. However, in 2006, this trend turned around. The value of private-equity–backed sales was 10 percentage points lower than the value of similar firms sold without the involvement of private equity firms. This is consistent with private equity firms using fees and dividends to squeeze cash out of the firms in their portfolio, perhaps to the detriment of the long-term performance of those firms.

Sources: E. Thornton (2006)."Gluttons at the gate." *BusinessWeek*, October 30, pp. 58 +; J. Lerner and P. Gompers (2002)."Money chasing deals? The impact of fund inflows on the valuation of private equity investments." *Journal of Financial Economics*, 55, pp. 281–325; G. Ip and H. Sender (2006)." In today's buyouts, payday for firms is never far away." *Wall Street Journal*, July 25, pp. A1 +.

Mergers and acquisitions are one very common way that a firm can accomplish its vertical integration and diversification objectives. However, although a firm may be able to accomplish its vertical integration and diversification objectives through mergers or acquisitions, it is sometimes difficult to generate real economic profit from doing so. Indeed, one of the strongest empirical findings in the fields of strategic management and finance is that, on average, the equity holders of target firms in mergers and acquisitions make money while the equity holders of bidding firms in these same mergers and acquisitions usually only "break even."

What Are Mergers and Acquisitions?

The terms *mergers* and *acquisitions* are often used interchangeably, even though they are not synonyms. A firm engages in an **acquisition** when it purchases a second firm. The form of this purchase can vary. For example, an acquiring firm can use cash it has generated from its ongoing businesses to purchase a target firm; it can go into debt to purchase a target firm; it can use its own equity to purchase a target firm; or it can use a mix of these mechanisms to purchase a target firm. Also, an acquiring firm can purchase all of a target firm's assets; it can purchase a majority of those assets (greater than 51 percent); or it can purchase a **controlling share** of those assets (i.e., enough assets so that the acquiring firm is able to make all the management and strategic decisions in the target firm).

Acquisitions also vary on several other dimensions. For example, **friendly acquisitions** occur when the management of the target firm wants the firm to be acquired. **Unfriendly acquisitions** occur when the management of the target firm does not want the firm to be acquired. Some unfriendly acquisitions are also known as **hostile takeovers**. Some acquisitions are accomplished through direct negotiations between an acquiring firm's managers and the managers of a target firm. This is especially common when a target firm is **privately held** (i.e., when it has not sold shares on the public stock market) or **closely held** (i.e., when it has not sold very many shares on the public stock market). Other acquisitions are

accomplished by the acquiring firm publicly announcing that it is willing to purchase the outstanding shares of a potential target for a particular price. This price is normally greater than the current market price of the target firm's shares. The difference between the current market price of a target firm's shares and the price a potential acquirer offers to pay for those shares is known as an **acquisition premium**. This approach to purchasing a firm is called a **tender offer**. Tender offers can be made either with or without the support of the management of the target firm. Obviously, tender offers with the support of the target firm's management are typically friendly in character; those made without the support of the target firm's management are typically unfriendly.

It is usually the case that larger firms—in terms of sales or assets—acquire smaller firms. For example, this was the case both for DaimlerChrysler's acquisition of Mitsubishi and Renault's acquisition of Nissan. In contrast, when the assets of two similar-sized firms are combined, this transaction is called a **merger**. Mergers can be accomplished in many of the same ways as acquisitions, that is, using cash or stock to purchase a percentage of another firm's assets. Typically, however, mergers will not be unfriendly. In a merger, one firm purchases some percentage of a second firm's assets while the second firm simultaneously purchases some percentage of the first firm's assets. For example, DaimlerChrysler—the firm that purchased Mitsubishi—was created as a merger between Daimler-Benz (the maker of Mercedes-Benz) and Chrysler. Daimler-Benz invested some of its capital in Chrysler, and Chrysler invested some of its capital in Daimler-Benz.

Although mergers typically begin as a transaction between equals—that is, between firms of equal size and profitability—they often evolve after a merger such that one firm becomes more dominant in the management of the merged firm than the other. For example, most observers believe that Daimler (the German part of DaimlerChrysler) has become more dominant in the management of the combined firm than Chrysler (the American part). Indeed, although Daimler management may be willing to "write off" their interests in Mitsubishi as a bad investment, Chrysler management is very reluctant to do so, because they have worked with Mitsubishi to help develop platforms for many of Chrysler's best-selling cars. How long a Daimler-dominated DaimlerChrysler will put up with a "bad" investment that only helps the Chrysler part of the firm is an open question.[1] Put differently, although mergers usually start out as something different from acquisitions, they usually end up looking more like acquisitions than mergers.

The Value of Mergers and Acquisitions

V R I O

That merger and acquisition strategies are an important strategic option open to firms pursuing diversification and vertical integration strategies can hardly be disputed. The number of firms that have used merger and acquisition strategies to become diversified over the last few years is staggering. Worldwide, the total value of announced merger and acquisition activities from 2003 through 2005 was $2.58 trillion. In 2005 alone, 11,013 deals were completed for a market value of $1.2 trillion.[2] These firms ranged in size from Procter & Gamble and Bank of America, two of the largest firms in the world, to Inflazyme Pharmaceuticals, a relatively small biotechnology start-up that acquired Glycodesign, Inc.

The list of firms that engaged in mergers and acquisitions in 2005 was long and varied. For example, SBC purchased its former parent AT&T in a deal valued at $16 billion and then renamed the entire firm AT&T. Procter & Gamble purchased

Gillette for $57 billion. SABMiller bought Columbian brewer Bavaria for $5.6 billion. eBay bought Skype (a firm in the voice over Internet business) for $2 billion. Adidas bought Reebok for $4 billion. Verizon bought MCI for $6.8 billion. Viacom bought DreamWorks for $1.5 billion. The list goes on and on.[3]

That mergers and acquisitions are common is clear. What is less clear is that they actually generate value for firms implementing these strategies. Two cases will be examined here: mergers and acquisitions between strategically unrelated firms and mergers and acquisitions between strategically related firms.

Mergers and Acquisitions: The Unrelated Case

Imagine the following scenario: One firm (the target) is the object of an acquisition effort, and 10 firms (the bidders) are interested in making this acquisition. Suppose the **current market value** of the target firm is $10,000—that is, the price of each of this firm's shares times the number of shares outstanding equals $10,000. Also, suppose the current market value of each of the bidding firms is $15,000.[4] Finally, suppose there is no strategic relatedness between these bidding firms and the target. This means that the value of any one of these bidding firms when combined with the target firm exactly equals the sum of the value of these firms as separate entities. In this example, because the current market value of the target is $10,000 and the current market value of the bidding firms is $15,000, the value of this target when combined with any of these bidders would be $25,000 ($10,000 + $15,000). Given this information, at what price will this target be acquired, and what are the economic performance implications for bidding and target firms at this price?

In this, and all acquisition situations, bidding firms will be willing to pay a price for a target up to the value that the target firm adds to the bidder once it is acquired. This price is simply the difference between the value of the two firms combined (in this case $25,000) and the value of the bidding firm by itself (in this case $15,000). Notice that this price does not depend on the value of the target firm acting as an independent business; rather, it depends on the value that the target firm creates when it is combined with the bidding firm. Any price for a target less than this value (i.e., less than $10,000) will be a source of economic profit for a bidding firm; any price equal to this value (i.e., equal to $10,000) will be a source of zero economic profits; and any price greater than this value (i.e. greater than $10,000) will be a source of economic losses for the bidding firm that acquires the target.

It is not hard to see that the price of this acquisition will quickly rise to $10,000, and that at this price the bidding firm that acquires the target will earn zero economic profits. The price of this acquisition will quickly rise to $10,000 because any bid less than $10,000 will generate economic profits for a successful bidder. These potential profits, in turn, will generate entry into the bidding war for a target. Because entry into the acquisition contest is very likely, the price of the acquisition will quickly rise to its value, and economic profits will not be created.

Moreover, at this $10,000 price the target firm's equity holders will also gain zero economic profits. Indeed, for them, all that has occurred is that the market value of the target firm has been capitalized in the form of a cash payment from the bidder to the target. The target was worth $10,000, and that is exactly what these equity holders will receive.

Mergers and Acquisitions: The Related Case

The conclusion that the acquisition of strategically unrelated targets will generate only zero economic profits for both the bidding and the target firms is not surprising. It is very consistent with the discussion of the economic consequences of unrelated diversification in Chapter 7. There it was argued that there is no economic justification for a corporate diversification strategy that does not build on some type of economy of scope across the businesses within which a firm operates, and therefore unrelated diversification is not an economically viable corporate strategy. So, if there is any hope that mergers and acquisitions will be a source of superior performance for bidding firms, it must be because of some sort of strategic relatedness or economy of scope between bidding and target firms.

Types of Strategic Relatedness

Of course, bidding and target firms can be strategically related in a wide variety of ways. Three particularly important lists of these potential linkages are discussed here.[5]

The FTC Categories. Because mergers and acquisitions can have the effect of increasing (or decreasing) the level of concentration in an industry, the Federal Trade Commission (FTC) is charged with the responsibility of evaluating the competitive implications of proposed mergers or acquisitions. In principle, the FTC will disallow any acquisition involving firms with headquarters in the United States that could have the potential for generating monopoly (or oligopoly) profits in an industry. To help in this regulatory effort, the FTC has developed a typology of mergers and acquisitions (see Table 10.1). Each category in this typology can be thought of as a different way in which a bidding firm and a target firm can be related in a merger or acquisition.

According to the FTC, a firm engages in a **vertical merger** when it vertically integrates, either forward or backward, through its acquisition efforts. Vertical mergers could include a firm purchasing critical suppliers of raw materials (backward vertical integration) or acquiring customers and distribution networks (forward vertical integration). eBay's acquisition of Skype is an example of a backward vertical integration as eBay tries to assemble all the resources to compete in the Internet telephone industry. Disney's acquisition of Capital Cities/ABC can be understood as an attempt by Disney to forward vertically integrate into the entertainment distribution industry, and its acquisition of ESPN can be seen as backward vertical integration into the entertainment production business.[6]

Table 10.1 **FTC Categories of Mergers and Acquisitions**

Category	Description
■ Vertical merger	A firm acquires former suppliers or customers.
■ Horizontal merger	A firm acquires a former competitor.
■ Product extension merger	A firm gains access to complementary products through an acquisition.
■ Market extension merger	A firm gains access to complementary markets through an acquisition.
■ Conglomerate merger	There is no strategic relatedness between a bidding and a target firm.

A firm engages in a **horizontal merger** when it acquires a former competitor; Adidas' acquisition of Reebok is an example of a horizontal merger, as the number 2 and number 3 sneaker manufacturers in the world combined their efforts. Obviously, the FTC is particularly concerned with the competitive implications of horizontal mergers because these strategies can have the most direct and obvious anticompetitive implications in an industry. For example, the FTC raised antitrust concerns in the $10 billion merger between Oracle and PeopleSoft, because these firms, collectively, dominated the enterprise software market. Similar concerns were raised in the $16.4 billion merger between ChevronTexaco and Unocal and the merger between Mobil and Exxon.

The third type of merger identified by the FTC is a **product extension merger**. In a product extension merger, firms acquire complementary products through their merger and acquisition activities. Examples include SBC's acquisition of AT&T and Verizon's acquisition of MCI.

The fourth type of merger identified by the FTC is a **market extension merger**. Here, the primary objective is to gain access to new geographic markets. Examples include SABMiller's acquisition of Bavaria Brewery Company in Columbia, South America.

The final type of merger or acquisition identified by the FTC is a **conglomerate merger**. For the FTC, conglomerate mergers are a residual category. If there are no vertical, horizontal, product extension, or market extension links between firms, the FTC defines the merger or acquisition activity between firms as a conglomerate merger. Given our earlier conclusion that mergers or acquisitions between strategically *unrelated* firms will not generate economic profits for either bidders or targets, it should not be surprising that there are currently relatively few examples of conglomerate mergers or acquisitions; however, at various times in history, they have been relatively common. In the 1960s, for example, many acquisitions took the form of conglomerate mergers. Research has shown that the fraction of single-business firms in the *Fortune* 500 dropped from 22.8 percent in 1959 to 14.8 percent in 1969, while the fraction of firms in the *Fortune* 500 pursuing unrelated diversification strategies rose from 7.3 to 18.7 percent during the same time period. These findings are consistent with an increase in the number of conglomerate mergers and acquisitions during the 1960s.[7]

Despite the popularity of conglomerate mergers in the 1960s, many mergers or acquisitions among strategically unrelated firms are divested shortly after they are completed. One study estimated that over one-third of the conglomerate mergers of the 1960s were divested by the early 1980s. Another study showed that over 50 percent of these acquisitions were subsequently divested. These results are all consistent with our earlier conclusion that mergers or acquisitions involving strategically unrelated firms are not a source of economic profits.[8]

Other Types of Strategic Relatedness. Although the FTC categories of mergers and acquisitions provide some information about possible motives underlying these corporate strategies, they do not capture the full complexity of the links that might exist between bidding and target firms. Several authors have attempted to develop more complete lists of possible sources of relatedness between bidding and target firms. One of these lists, developed by Professor Michael Lubatkin, is summarized in Table 10.2. This list includes **technical economies** (in marketing, production, and similar forms of relatedness), **pecuniary economies** (market power), and **diversification economies** (in portfolio management and risk reduction) as possible bases of strategic relatedness between bidding and target firms.

Table 10.2 **Lubatkin's List of Potential Sources of Strategic Relatedness Between Bidding and Target Firms**

Technical economies	Scale economies that occur when the physical processes inside a firm are altered so that the same amounts of input produce a higher quantity of outputs. Sources of technical economies include marketing, production, experience, scheduling, banking, and compensation.
Pecuniary economies	Economies achieved by the ability of firms to dictate prices by exerting market power.
Diversification economies	Economies achieved by improving a firm's performance relative to its risk attributes or lowering its risk attributes relative to its performance. Sources of diversification economies include portfolio management and risk reduction.

Source: M. Lubatkin (1983). "Mergers and the performance of the Acquiring Firm." *Academy of Management Review*, 8, pp. 218–225. © 1983 by the Academy of Management. Reproduced with permission.

A second important list of possible sources of strategic relatedness between bidding and target firms was developed by Michael Jensen and Richard Ruback after a comprehensive review of empirical research on the economic returns to mergers and acquisitions. This list is summarized in Table 10.3 and includes the following factors as possible sources of economic gains in mergers and acquisitions: potential reductions in production or distribution costs (from economies of

Table 10.3 **Jensen and Ruback's List of Reasons Why Bidding Firms Might Want to Engage in Merger and Acquisition Strategies**

To reduce production or distribution costs:

1. Through economies of scale.
2. Through vertical integration.
3. Through the adoption of more efficient production or organizational technology.
4. Through the increased utilization of the bidder's management team.
5. Through a reduction of agency costs by bringing organization-specific assets under common ownership.

Financial motivations:

1. To gain access to underutilized tax shields.
2. To avoid bankruptcy costs.
3. To increase leverage opportunities.
4. To gain other tax advantages.
5. To gain market power in product markets.
6. To eliminate inefficient target management.

Source: Reprinted from "The Market for Corporate Control: The Scientific Evidence." *Journal of Financial Economics*, 11, pp. 5–50. Vol. II, Jensen M. C. and R. S. Ruback. Copyright © 1983, with permission from Elsevier.

scale, vertical integration, reduction in agency costs, and so forth); the realization of financial opportunities (such as gaining access to underutilized tax shields, avoiding bankruptcy costs); the creation of market power; and the ability to eliminate inefficient management in the target firm.

To be economically valuable, links between bidding and target firms must meet the same criteria as diversification strategies (see Chapter 7). First, these links must build on real economies of scope between bidding and target firms. These economies of scope can reflect either cost savings or revenue enhancements that are created by combining firms. Second, not only must this economy of scope exist, but it must be less costly for the merged firm to realize than for outside equity holders to realize on their own. As is the case with corporate diversification strategies, by investing in a diversified portfolio of stocks, outside equity investors can gain many of the economies associated with a merger or acquisition on their own. Moreover, investors can realize some of these economies of scope at almost zero cost. In this situation, it makes little sense for investors to "hire" managers in firms to realize these economies of scope for them through a merger or acquisition. Rather, firms should pursue merger and acquisition strategies only to obtain valuable economies of scope that outside investors find too costly to create on their own.

Economic Profits in Related Acquisitions

If bidding and target firms are strategically related, then the economic value of these two firms combined is greater than their economic value as separate entities. To see how this changes returns to merger and acquisition strategies, consider the following scenario: As before, there is one target firm and 10 bidding firms. The market value of the target firm as a stand-alone entity is $10,000, and the market value of the bidding firms as stand-alone entities is $15,000. However, unlike the earlier scenario in this chapter, the bidding and target firms are strategically related. Any of the types of relatedness identified in Table 10.1, Table 10.2, or Table 10.3 could be the source of these economies of scope. They imply that when any of the bidding firms and the target are combined, the market value of this combined entity will be $32,000—note that $32,000 is greater than the sum of $15,000 and $10,000. At what price will this target firm be acquired, and what are the economic profit implications for bidding and target firms at this price?

As before, bidding firms will be willing to pay a price for a target up to the value that a target firm adds once it is acquired. Thus, the maximum price bidding firms are willing to pay is still the difference between the value of the combined entity (here, $32,000) and the value of a bidding firm on its own (here, $15,000), or $17,000.

As was the case for the strategically unrelated acquisition, it is not hard to see that the price for actually acquiring the target firm in this scenario will rapidly rise to $17,000, because any bid less than $17,000 has the potential for generating profits for a bidding firm. Suppose that one bidding firm offers $13,000 for the target. For this $13,000, the bidding firm gains access to a target that will generate $17,000 of value once it is acquired. Thus, to this bidding firm, the target is worth $17,000, and a bid of $13,000 will generate $4,000 economic profit. Of course, these potential profits will motivate entry into the competitive bidding process. Entry will continue until the price of this target equals $17,000. Any price greater than $17,000 would mean that a bidding firm is actually losing money on its acquisition.[9]

At this $17,000 price, the successful bidding firm earns zero economic profits. After all, this firm has acquired an asset that will generate $17,000 of value and

has paid $17,000 to do so. However, the owners of the target firm will earn an economic profit worth $7,000. As a stand-alone firm, the target is worth $10,000; when combined with a bidding firm, it is worth $17,000. The difference between the value of the target as a stand-alone entity and its value in combination with a bidding firm is the value of the economic profit that can be appropriated by the owners of the target firm.

Thus, the existence of strategic relatedness between bidding and target firms is not a sufficient condition for the equity holders of bidding firms to earn economic profits from their acquisition strategies. If the economic potential of acquiring a particular target firm is widely known and if several potential bidding firms can all obtain this value by acquiring a target, the equity holders of bidding firms will, at best, earn only zero economic profits from implementing an acquisition strategy. In this setting, a "strategically related" merger or acquisition will create economic value, but this value will be distributed in the form of economic profits to the equity holders of acquired target firms.

Because so much of the value created in a merger or acquisition is appropriated by the stockholders of the target firm, it is not surprising that many small and entrepreneurial firms look to be acquired as one way to compensate their owners for taking the risks associated with founding these firms. This phenomenon is discussed in more detail in the Strategy in the Emerging Enterprise feature.

What Does Research Say About Returns to Mergers and Acquisitions?

The empirical implications of this discussion of returns to bidding and target firms in strategically related and strategically unrelated mergers and acquisitions have been examined in a variety of academic literatures. One study reviewed over 40 empirical merger and acquisition studies in the finance literature. This study concluded that acquisitions, on average, increased the market value of target firms by about 25 percent and left the market value of bidding firms unchanged. The authors of this report concluded that "corporate takeovers generate positive gains, . . . target firm equity holders benefit, and . . . bidding firm equity holders do not lose."[10] The way these studies evaluate the return to acquisition strategies is discussed in the Strategy in Depth feature.

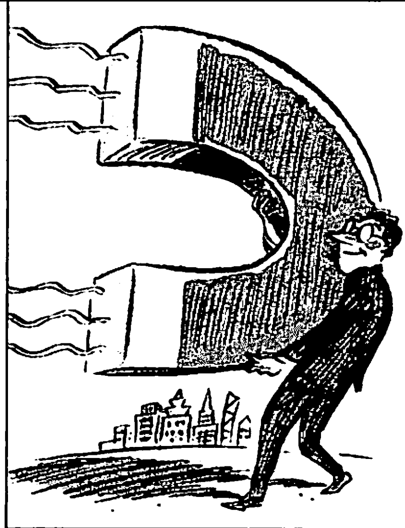
Strategy researchers have also attempted to examine in more detail the sources of value creation in mergers and acquisitions and the question of whether these sources of value creation affect whether bidders or targets appropriate this value. For example, two well-known studies examined the impact of the type and degree of strategic relatedness (defined using the FTC typology summarized in Table 10.1) between bidding and target firms on the economic consequences of mergers and acquisitions.[11] These studies found that the more strategically related bidding and target firms are, the more economic value mergers and acquisitions create. However, like the finance studies, this work found that this economic value was appropriated by the owners of the target firm, regardless of the type or degree of relatedness between the bidding and target firms. Bidding firms—even when they attempt to acquire strategically related targets—earn, on average, zero economic profits from their merger and acquisition strategies.

Strategy in the Emerging Enterprise

Imagine you are an entrepreneur. You have mortgaged your home, taken out loans, run up your credit cards, and put all you own on the line in order to help grow a small company. And finally, after years of effort, things start going well. Your product or service starts to sell, customers start to appreciate your unique value proposition, and you actually begin to pay yourself a reasonable salary. What do you do next to help grow your company?

Some entrepreneurs in this situation decide that maintaining control of the firm is very important. These entrepreneurs may compensate certain critical employees with equity in the firm, but typically limit the number of outsiders who make equity investments in their firm. To grow these closely held firms, these entrepreneurs must rely on capital generated from their ongoing operations (called **retained earnings**) and debt capital provided by banks, customers, and suppliers. Entrepreneurs who decide to maintain control of their companies are compensated for taking the risks associated with starting a firm through the salary they pay themselves.

Other entrepreneurs get more outside equity investors involved in providing the capital a firm needs to grow. These outside investors might include wealthy individuals—called **business angels**—looking to invest in entrepreneurial ventures or **venture capital firms.** Venture capital firms typically raise money from numerous smaller investors that they then invest in a portfolio of entrepreneurial firms. Over time, many of these firms decide to "go public" by engaging in what is called an **initial public offering**, or **IPO**. In an IPO, a firm, typically working with an investment banker, sells its equity to the public at large. Entrepreneurs who decide to sell equity in their firm are compensated for taking the risks associated with starting a firm through the sale of their equity on the public markets through an IPO. An entrepreneur who receives compensation for risk-taking in this manner is said to be **cashing out**.



Cashing Out

Finally, still other entrepreneurs may decide to not use an IPO to cash out, but rather to have their firm acquired by another, typically larger, firm. In this scenario, entrepreneurs are compensated by the acquiring firm for taking the risks associated with starting a firm. Indeed, because the demand for IPOs has been volatile since the technology-bubble burst of 2000, more and more small and entrepreneurial firms are looking to be acquired as a way for their founders to cash out. Moreover, because the stockholders of target firms typically appropriate a large percentage of the total value created by an acquisition, and because the founders of these entrepreneurial firms are also often large stockholders, being acquired is often a source of great wealth for an entrepreneurial firm's founders.

The choice between keeping a firm private, going public, or being acquired is a difficult and multidimensional one. Issues such as the personal preferences of a firm's founders, demand for IPOs, how much capital a firm will need in order to continue to grow its business, and what other resources—besides capital—the firm will need to create additional value all play a role. In general, firms that do not need a great deal of money or other resources to grow will choose to remain private. Those that need only money to grow will choose IPOs, whereas those that need managerial or technical resources controlled by another firm to grow will typically be acquired. Of course, this changes if the entrepreneurs decide to maintain control of their firms because they want to.

Sources: R. Hennessey (2004). "Underwriters cut prices on IPOs as market softens." *Wall Street Journal*, May 27, p. C4; F. Vogelstein (2003). "Can Google grow up?" *Fortune*, December 8, pp. 102 +.

Why Are There So Many Mergers and Acquisitions?

Given the overwhelming empirical evidence that most of the economic value created in mergers and acquisitions is appropriated by the owners of the target firm most of the time, an important question becomes: "Why do managers of bidding

Table 10.4 **Possible Motivations to Engage in Mergers and Acquisitions Even Though They Usually Do Not Generate Profits for Bidding Firms**

1. To ensure survival
2. Free cash flow
3. Agency problems
4. Managerial hubris
5. The potential for above-normal profits

firms continue to engage in merger and acquisition strategies?" Some possible explanations are summarized in Table 10.4 and discussed in this section.

To Ensure Survival

Even if mergers and acquisitions, on average, generate only zero economic profits for bidding firms, it may be necessary for bidding firms to engage in these activities to ensure their survival. In particular, if all of a bidding firm's competitors have been able to improve their efficiency and effectiveness through a particular type of acquisition, then failing to make such an acquisition may put a firm at a competitive disadvantage. Here, the purpose of a merger or acquisition is not to gain competitive advantages, but rather to gain competitive parity.

Many recent mergers among banks in the United States seem to have competitive parity and normal economic profits as an objective. Most bank managers recognize that changing bank regulations, increased competition from nonbanking financial institutions, and soft demand are likely to lead to a consolidation of the U.S. banking industry. To survive in this consolidated industry, many U.S. banks will have to merge. As the number of banks engaging in mergers and acquisitions goes up, the ability to earn superior profits from those strategies goes down. These lower returns from acquisitions have already reduced the economic value of some of the most aggressive acquiring banks. Despite these lower returns, acquisitions are likely to continue for the foreseeable future, as banks seek survival opportunities in a consolidated industry.[12]

Free Cash Flow

Another reason why firms may continue to invest in merger and acquisition strategies is that these strategies, on average, can be expected to generate at least competitive parity for bidding firms. This zero economic profit may be a more attractive investment for some firms than alternative strategic investments. This is particularly the case for firms that generate free cash flow.[13]

Free cash flow is simply the amount of cash a firm has to invest after all positive net present-value investments in its ongoing businesses have been funded. Free cash flow is created when a firm's ongoing business operations are very profitable but offer few opportunities for additional investment. One firm that seems to have generated a great deal of free cash flow over the last several years is Philip Morris. Philip Morris's retail tobacco operations are extremely profitable. However, regulatory constraints, health concerns, and slowing growth in demand limit investment opportunities in the tobacco industry. Thus, the amount of cash generated by Philip Morris's ongoing tobacco business has probably been larger than the sum of its positive net present-value investments in that business. This difference is free cash flow for Philip Morris.[14]

Strategy in Depth

Evaluating the Performance Effects of Acquisitions

By far, the most popular way to evaluate the performance effects of acquisitions for bidding firms is called **event study analysis.** Rooted in the field of financial economics, event study analysis compares the actual performance of a stock after an acquisition has been announced to the expected performance of that stock, if no acquisition had been announced. Any performance greater (or less) than what was expected in a short period of time around when an acquisition is announced is attributed to that acquisition. This **cumulative abnormal return,** or **CAR** can be positive or negative, depending on whether the stock in question performs better or worse than what was expected without an acquisition.

The CAR created by an acquisition is calculated in several stages. First, the expected performance of a stock, without an acquisition, is estimated with the following regression equation:

$$E(R_{j,t}) = a_j + b_j R_{m,t} + e_{j,t}$$

where $E(R_{j,t})$ is the expected return of stock j during time t; a_j is a constant (approximately equal to the rate of return on risk-free equities); b_j is an empirical estimate of the financial parameter β (equal to the covariance between the returns of a particular firm's stock and the average return of all stocks in the market, over time); $R_{m,t}$ is the actual average rate of return of all stocks in the market over time; and $e_{j,t}$ is an error term. The form of this equation is derived from the capital asset pricing model in finance. In this model, $E(R_{j,t})$ is simply the expected performance of a stock, given the historical relationship between that stock and the overall performance of the stock market.

To calculate the unexpected performance of a stock, this expected level of performance is simply subtracted from the actual level of performance for a stock. This is done in the following equation:

$$XR_{j,t} = R_{j,t} - (a_j + b_j R_{m,t})$$

where $R_{j,t}$ is the actual performance of stock j during time t, and $XR_{j,t}$ is the unexpected performance of stock j during time t.

In calculating the CAR for a particular acquisition, it is necessary to sum the unexpected returns ($XR_{j,t}$) for a stock across the t periods when the stock market is responding to news about this acquisition. Most analyses of acquisitions examine the market's reaction one day before an acquisition is formally announced to three days after it is announced. The sum of these unexpected returns over this time period is the CAR attributable to this acquisition.

This methodology has been applied to literally thousands of acquisition episodes. For example, when Manulife Financial purchased John Hancock Financial, Manulife's CAR was –10 percent, whereas John Hancock's CAR was 6 percent; when Anthem acquired Wellpoint, Anthem's CAR was –10 percent, and Wellpoint's was 7 percent; when Bank of America acquired FleetBoston Financial, Bank of America's CAR was –9 percent, and FleetBoston's was 24 percent; and when UnitedHealth acquired Mid Atlantic Medical, UnitedHealth's CAR was –4 percent, and Mid Atlantic Medical's was 11 percent.

Although the event study method has been used widely, it does have some important limitations. First, it is based entirely on the capital asset pricing model, and there is some reason to believe that this model is not a particularly good predictor of a firm's expected stock price. Second, it assumes that a firm's equity holders can anticipate all the benefits associated with making an acquisition at the time that acquisition is made. Some scholars have argued that value creation continues long after an acquisition is announced as parties in this exchange discover value-creating opportunities that could not have been anticipated.

Sources: A. Arikan (2004). "Long-term returns to acquisitions: The case of purchasing tangible and intangible assets." Unpublished, Fisher College of Business, Ohio State University; S. J. Brown and J. B. Warner (1985). "Using daily stock returns: The case of event studies." *Journal of Financial Economics,* 14, pp. 3–31; D. Henry, M. Der Hovanseian, and D. Foust (2003). "M&A deals: Show me." *BusinessWeek,* November 10, pp. 38 +.

A firm that generates a great deal of free cash flow must decide what to do with this money. One obvious alternative would be to give it to stockholders in the form of dividends or stock buybacks. However, in some situations (e.g., when stockholders face high marginal tax rates), stockholders may prefer a firm to retain this cash flow and invest it for them. When this is the case, how should a firm invest its free cash flow?

Because (by definition) no positive net present-value investment opportunities in a firm's ongoing business operations are available, firms have only two investment options: to invest their free cash flow in strategies that generate competitive parity or in strategies that generate competitive disadvantages. In this context, merger and acquisition strategies are a viable option, because bidding firms, on average, can expect to generate at least competitive parity. Put differently, although mergers and acquisitions may not be a source of superior profits, there are worse things you could do with your free cash flow.

Agency Problems

Another reason why firms might continue to engage in mergers and acquisitions, despite earning only competitive parity from doing so, is that mergers and acquisitions benefit managers directly, independent of any value they may or may not create for a bidding firm's stockholders. As suggested in Chapter 8, these conflicts of interest are a manifestation of agency problems between a firm's managers and its stockholders.

Merger and acquisition strategies can benefit managers—even if they do not directly benefit a bidding firm's equity holders—in at least two ways. First, managers can use mergers and acquisitions to help diversify their human capital investments in their firm. As discussed in Chapter 7, managers have difficulty diversifying their firm-specific human capital investments when a firm operates in a narrow range of businesses. By acquiring firms with cash flows that are not perfectly correlated with the cash flows of a firm's current businesses, managers can reduce the probability of bankruptcy for their firm and thus partially diversify their human capital investments in their firm.

Second, managers can use mergers and acquisitions to quickly increase firm size, measured in either sales or assets. If management compensation is closely linked to firm size, managers who increase firm size are able to increase their compensation. Of all the ways to increase the size of a firm quickly, growth through mergers and acquisitions is perhaps the easiest. Even if there are no economies of scope between a bidding and a target firm, an acquisition ensures that the bidding firm will grow by the size of the target (measured in either sales or assets). If there are economies of scope between a bidding and a target firm, the size of the bidding firm can grow at an even faster rate, as can the value of management's compensation, even though, on average, acquisitions do not generate wealth for the owners of the bidding firm.

Managerial Hubris

Another reason why managers may choose to continue to invest in mergers and acquisitions, despite the fact that, on average, they gain no profits from doing so, is the existence of what has been called **managerial hubris.**[15] This is the unrealistic belief held by managers in bidding firms that they can manage the assets of a target firm more efficiently than the target firm's current management. This notion can lead bidding firms to engage in acquisition strategies even though there may not be positive economic profits from doing so.

The existence of managerial hubris suggests that the economic value of bidding firms will fall once they announce a merger or acquisition strategy. Although managers in bidding firms might truly believe that they can manage a target firm's assets more efficiently than the target firm's managers, investors in the capital markets are much less likely to be caught up in this hubris. In this context, a commitment to a merger or acquisition strategy is a strong signal that a bidding firm's management has deluded itself about its abilities to manage a target firm's assets. Such delusions will certainly adversely affect the economic value of the bidding firm.

Of course, empirical work on mergers and acquisitions discussed earlier in this chapter has concluded that although bidding firms do not obtain profits from their merger and acquisition strategies, they also do not, on average, reduce their economic value from implementing these strategies. This is inconsistent with the "hubris hypothesis." However, the fact that, on average, bidding firms do not lose economic value does not mean that some bidding firms do not lose economic value. Thus, although it is unlikely that all merger and acquisition strategies are motivated by managerial hubris, it is likely that at least some of them are.[16]

The Potential for Economic Profits

A final reason why managers might continue to pursue merger and acquisition strategies is the potential that these strategies offer for generating profits for at least some bidding firms. The empirical research on returns to bidding firms in mergers and acquisitions is very strong. On average, bidding firms do not gain profits from their merger and acquisition strategies. However, the fact that bidding firms, *on average*, do not earn profits on these strategies does not mean that *all* bidding firms will *always* fail to earn profits. In some situations bidding firms may be able to gain competitive advantages from merger and acquisition activities. These situations are discussed in the following section.

Mergers and Acquisitions and Sustained Competitive Advantage

We have already seen that the economies of scope that motivate mergers and acquisitions between strategically related bidding and target firms can be valuable. However, the ability of these economies to generate profits and competitive advantages for bidding firms depends not only on their economic value, but also on the competitiveness of the market for corporate control through which these valuable economies are realized. The **market for corporate control** is the market that is created when multiple firms actively seek to acquire one or several firms. Only when the market for corporate control is imperfectly competitive might it be possible for bidding firms to earn profits from implementing a merger or acquisition strategy. To see how the competitiveness of the market for corporate control can affect returns to merger and acquisition strategies, we will consider three scenarios involving bidding and target firms and examine their implications for the managers of these firms.[17]

V R I O

Valuable, Rare, and Private Economies of Scope

An imperfectly competitive market for corporate control can exist when a target is worth more to one bidder than it is to any other bidders and when no other firms—including bidders and targets—are aware of this additional value. In this setting, the

price of a target will rise to reflect public expectations about the value of the target. Once the target is acquired, however, the performance of the special bidder that acquires the target will be greater than generally expected, and this level of performance will generate profits for the equity holders of the bidding firm.

Consider a simple case. Suppose the market value of bidder Firm A combined with target firms is $12,000, whereas the market value of all other bidders combined with targets is $10,000. No other firms (bidders or targets) are aware of Firm A's unique relationship with these targets, but they are aware of the value of all other bidders combined with targets (i.e., $10,000). Suppose also that the market value of all bidding firms, as stand-alone entities, is $7,000. In this setting, Firm A will be willing to pay up to $5,000 to acquire a target ($12,000 – $7,000), and all other bidders will only be willing to pay up to $3,000 to acquire a target ($10,000 – $7,000).

Because publicly available information suggests that acquiring a target is worth $3,000 more than the target's stand-alone price, the price of targets will rapidly rise to this level, ensuring that if bidding firms, apart from Firm A, acquire a target, they will obtain no profits. If there is only one target in this market for corporate control, then Firm A will be able to bid slightly more than $3,000 (perhaps $3,001) for this target. No other firms will bid higher than Firm A, because, from their point of view, the acquisition is simply not worth more than $3,000. At this $3,001 price, Firm A will earn a profit of $1,999—Firm A had to spend only $3,001 for a firm that brings $5,000 in value above its stand-alone market price. Alternatively, if there are multiple targets, then several bidding firms, including Firm A, will pay $3,000 for their targets. At this price, these bidding firms will all earn zero economic profits, except for Firm A, which will earn an economic profit equal to $2,000. That is, only Firm A will gain a competitive advantage from acquiring a target in this market.

In order for Firm A to obtain this profit, the value of Firm A's economy of scope with target firms must be greater than the value of any other bidding firms with that target. This special value will generally reflect unusual resources and capabilities possessed by Firm A—resources and capabilities that are more valuable in combination with target firms than are the resources and capabilities that other bidding firms possess. Put differently, to be a source of economic profits and competitive advantage, Firm A's link with targets must be based on resources and capabilities that are rare among those firms competing in this market for corporate control.

However, not only does Firm A have to possess valuable and rare links with bidding firms to gain economic profits and competitive advantages from its acquisition strategies, but information about these special economies of scope must not be known by other firms. If other bidding firms know about the additional value associated with acquiring a target, they are likely to try to duplicate this value for themselves. Typically, they would accomplish this by imitating the type of relatedness that exists between Firm A and its targets by developing the resources and capabilities that enabled Firm A to have its valuable economies of scope with targets. Once other bidders developed the resources and capabilities necessary to obtain this more valuable economy of scope, they would be able to enter into bidding, thereby increasing the likelihood that the equity holders of successful bidding firms would earn no economic profits.

Target firms must also be unaware of Firm A's special resources and capabilities if Firm A is to obtain competitive advantages from an acquisition. If target

firms were aware of this extra value available to Firm A, along with the sources of this value, they could inform other bidding firms. These bidding firms could then adjust their bids to reflect this higher value, and competitive bidding would reduce profits to bidders. Target firms are likely to inform bidding firms in this way because increasing the number of bidders with more valuable economies of scope increases the likelihood that target firms will extract all the economic value created in a merger or acquisition.[18]

VRIO

Valuable, Rare, and Costly-to-Imitate Economies of Scope

The existence of firms that have valuable, rare, and private economies of scope with targets is not the only way that the market for corporate control can be imperfectly competitive. If other bidders cannot imitate one bidder's valuable and rare economies with targets, then competition in this market for corporate control will be imperfect, and the equity holders of this special bidding firm will earn economic profits. In this case, the existence of valuable and rare economies does not need to be private, because other bidding firms cannot imitate these economies, and therefore bids that substantially reduce the profits for the equity holders of the special bidding firm are not forthcoming.

Typically, bidding firms will be unable to imitate one bidder's valuable and rare economies of scope with targets when the strategic relatedness between the special bidder and the targets stems from some rare and costly-to-imitate resources or capabilities controlled by the special bidding firm. Any of the costly-to-imitate resources and capabilities discussed in Chapter 3 could create costly-to-imitate economies of scope between a firm and a target. If, in addition, these economies are valuable and rare, they can be a source of profits to the equity holders of the special bidding firm. This can happen even if all firms in this market for corporate control are aware of the more valuable economies of scope available to this firm and its sources. Although information about this special economy of scope is publicly available, equity holders of special bidding firms will earn a profit when acquisition occurs. The equity holders of target firms will not obtain all of this profit, because competitive bidding dynamics cannot unfold when the sources of a more valuable economy of scope are costly to imitate.

Of course, it may be possible for a valuable, rare, and costly-to-imitate economy of scope between a bidding and a target firm to also be private. Indeed, it is often the case that those attributes of a firm that are costly to imitate are also difficult to describe and thus can be held as proprietary information. In that case, the analysis of profits associated with valuable, rare, and private economies of scope presented earlier applies.

Unexpected Valuable Economies of Scope Between Bidding and Target Firms

Thus far, this discussion has adopted, for convenience, the strong assumption that the present value of the strategic relatedness between bidders and targets is known with certainty by individual bidders. This is, in principle, possible, but certainly not likely. Most modern acquisitions and mergers are massively complex, involving numerous unknown and complicated relationships between firms. In these settings, unexpected events after an acquisition has been completed may make an acquisition or merger more valuable than bidders and targets anticipated it would be. The price that bidding firms will pay to acquire a target will equal the expected value of the target only when the target is combined with the bidder. The

difference between the unexpected value of an acquisition actually obtained by a bidder and the price the bidder paid for the acquisition is a profit for the equity holders of the bidding firm.

Of course, by definition, bidding firms cannot expect to obtain unexpected value from an acquisition. Unexpected value, in this context, is a surprise, a manifestation of a bidding firm's good luck, not its skill in acquiring targets. For example, when the British advertising firm WPP acquired J. Walter Thompson for $550 million, it discovered some property owned by J. Walter Thomson in Tokyo. No one knew of this property when the firm was acquired. It turned out to be worth over $100 million after taxes, a financial windfall that helped offset the high cost of this acquisition. When asked, Martin Sorrel, president of WPP and the architect of this acquisition, admitted that this $100 million windfall was simply good luck.[19]

Implications for Bidding Firm Managers

The existence of valuable, rare, and private economies of scope between bidding and target firms and of valuable, rare, and costly-to-imitate economies of scope between bidding and target firms suggests that although, on average, most bidding firms do not generate competitive advantages from their acquisition strategies, in some special circumstances it may be possible for them to do so. Thus, the task facing managers in firms contemplating merger and acquisition strategies is to choose strategies that have the greatest likelihood of being able to generate profits for their equity holders. Several important managerial prescriptions can be derived from this discussion. These "rules" for bidding firm managers are summarized in Table 10.5.

Search for Rare Economies of Scope

One of the main reasons why bidding firms do not obtain competitive advantages from acquiring strategically related target firms is that several other bidding firms value the target firm in the same way. When multiple bidders all value a target in the same way, competitive bidding is likely. Competitive bidding, in turn, drives out the potential for superior performance. To avoid this problem, bidding firms should seek to acquire targets with which they enjoy valuable and rare linkages.

Operationally, the search for rare economies of scope suggests that managers in bidding firms need to consider not only the value of a target firm when combined with their own company, but also the value of a target firm when combined with other potential bidders. This is important, because it is the difference between the value of a particular bidding firm's relationship with a target and the value of other bidding firms' relationships with that target that defines the size of the potential economic profits from an acquisition.

Table 10.5 **Rules for Bidding Firm Managers**

1. Search for valuable and rare economies of scope.
2. Keep information away from other bidders.
3. Keep information away from targets.
4. Avoid winning bidding wars.
5. Close the deal quickly.
6. Operate in "thinly traded" acquisition markets.

In practice, the search for valuable and rare economies of scope is likely to become a search for valuable and rare resources already controlled by a firm that are synergistically related to a target. For example, if a bidding firm has a unique reputation in its product market, and if the target firm's products could benefit by association with that reputation, then the target firm may be more valuable to this particular bidder than to other bidders (firms that do not possess this special reputation). Also, if a particular bidder possesses the largest market share in its industry, the best distribution system, or restricted access to certain key raw materials, and if the target firm would benefit from being associated with these valuable and rare resources, then the acquisition of this target may be a source of economic profits.

The search for valuable and rare economies of scope as a basis of mergers and acquisitions tends to rule out certain interfirm linkages as sources of economic profits. For example, most acquisitions can lead to a reduction in overhead costs, because much of the corporate overhead associated with the target firm can be eliminated subsequent to acquisition. However, the ability to eliminate these overhead costs is not unique to any one bidder, and thus the value created by these reduced costs will usually be captured by the equity holders of the target firm.

Keep Information Away from Other Bidders

One of the keys to earning superior performance in an acquisition strategy is to avoid multiple bidders for a single target. One way to accomplish this is to keep information about the bidding process, and about the sources of economies of scope between a bidder and target that underlie this bidding process, as private as possible. In order for other firms to become involved in bidding for a target, they must be aware of the value of the economies of scope between themselves and that target. If only one bidding firm knows this information, and if this bidding firm can close the deal before the full value of the target is known, then it may gain a competitive advantage from completing this acquisition.

Of course, in many circumstances, keeping all this information private is difficult. Often, it is illegal. For example, when seeking to acquire a publicly traded firm, potential bidders must meet disclosure requirements that effectively reduce the amount of private information a bidder can retain. In these circumstances, unless a bidding firm has some valuable, rare, and costly-to-imitate economy of scope with a target firm, the possibility of economic profits coming from an acquisition is very low. It is not surprising that the research conducted on mergers and acquisitions of firms traded on public stock exchanges governed by the U.S. Securities and Exchange Commission (SEC) disclosure rules suggests that, most of the time, bidding firms do not earn economic profits from implementing their acquisition strategies.

However, not all potential targets are publicly traded. Privately held firms may be acquired in an information environment that can create opportunities for above-normal performance for bidding firms. Moreover, even when acquiring a publicly traded firm, a bidder does not have to release all the information it has about the potential value of that target in combination with itself. Indeed, if some of this value reflects a bidding firm's taken-for-granted "invisible" assets, it may not be possible to communicate this information. In this case, as well, there may be opportunities for competitive advantages for bidding firms.

Keep Information Away from Targets

Not only should bidding firms keep information about the value of their economy of scope with a target away from other bidders; they should also keep this information away from target firms. Suppose that the value of a target firm to a bidding firm is $8,000, but the bidding firm, in an attempt to earn economic profits, has bid only $5,000 for the target. If the target knows that it is actually worth $8,000, it is very likely to hold out for a higher bid. In fact, the target may contact other potential bidding firms and tell them of the opportunity created by the $5,000 bid. As the number of bidders goes up, the possibility of superior economic performance for bidders goes down. Therefore, to keep the possibility of these profits alive, bidding firms must not fully reveal the value of their economies of scope with a target firm. Again, in some circumstances, it is very difficult, or even illegal, to attempt to limit the flow of information to target firms. In these settings, superior economic performance for bidding firms is very unlikely.

Limiting the amount of information that flows to the target firm may have some other consequences as well. For example, it has been shown that a complete sharing of information, insights, and perspectives before an acquisition is completed increases the probability that economies of scope will actually be realized once it is completed.[20] By limiting the flow of information between itself and a target, a bidding firm may actually be increasing the cost of integrating the target into its ongoing business, thereby jeopardizing at least some of the superior economic performance that limiting information flow is designed to create. Bidding firms will need to carefully balance the economic benefits of limiting the information they share with the target firm against the costs that limiting information flow may create.

Avoid Winning Bidding Wars

It should be reasonably clear that if a number of firms bid for the same target, the probability that the firm that successfully acquires the target will gain competitive advantages is very low. Indeed, to ensure that competitive bidding occurs, target firms can actively encourage other bidding firms to enter into the bidding process. The implications of these arguments are clear: Bidding firms should generally avoid winning a bidding war. To "win" a bidding war, a bidding firm will often have to pay a price at least equal to the full value of the target. Many times, given the emotions of an intense bidding contest, the winning bid may actually be larger than the true value of the target. Completing this type of acquisition will certainly reduce the economic performance of the bidding firm.

The only time it might make sense to "win" a bidding war is when the winning firm possesses a rare and private or a rare and costly-to-imitate economy of scope with a target that is more valuable than the strategic relatedness that exists between any other bidders and that target. In this setting, the winning firm may be able to earn a profit if it is able to fully realize the value of its relationship with the target.

Close the Deal Quickly

Another rule of thumb for obtaining superior performance from implementing merger and acquisition strategies is to close the deal quickly. All the economic processes that make it difficult for bidding firms to earn economic profits from acquiring a strategically related target take time to unfold. It takes time for other bidders to become aware of the economic value associated with acquiring a target; it takes time for the target to recruit other bidders; information leakage becomes

more of a problem over time; and so forth. A bidding firm that begins and ends the bidding process quickly may forestall some of these processes and thereby retain some superior performance for itself.

The admonition to close the deal quickly should not be taken to mean that bidding firms need to make their acquisition decisions quickly. Indeed, the search for valuable and rare economies of scope should be undertaken with great care. There should be little rush in isolating and evaluating acquisition candidates. However, once a target firm has been located and valued, bidding firms have a strong incentive to reduce the period of time between the first bid and the completion of the deal. The longer this period of negotiation, the less likely it is that the bidding firm will earn economic profits from the acquisition.

Complete Acquisitions in "Thinly Traded" Markets

Finally, an acquisition strategy can be a source of economic profits to bidding firms if these firms implement this corporate strategy in what could be described as "thinly traded markets." In general, a **thinly traded market** is a market where there are only a small number of buyers and sellers, where information about opportunities in this market is not widely known, and where interests besides purely maximizing the value of a firm can be important. In the context of mergers and acquisitions, thinly traded markets are markets where only a few (often only one) firms are implementing acquisition strategies. These unique firms may be the only firms that understand the full value of the acquisition opportunities in this market. Even target firm managers may not fully understand the value of the economic opportunities in these markets, and, if they do, they may have other interests besides maximizing the value of their firm if it becomes the object of a takeover.

In general, thinly traded merger and acquisition markets are highly fragmented. Competition in these markets occurs at the local level, as one small local firm competes with other small local firms for a common group of geographically defined customers. Most of these small firms are privately held. Many are sole proprietorships. Examples of these thinly traded markets have included, at various points in history, the printing industry, the fast-food industry, the used car industry, the dry cleaning industry, and the barber shop/hair salon industry.

As was suggested in Chapter 2, the major opportunity in all highly fragmented industries is consolidation. In the context of mergers and acquisitions, consolidation can occur by one firm (or a small number of firms) buying numerous independent firms to realize economies of scope in these industries. Often, these economies of scope reflect economies of scale in these industries—economies of scale that were not realized in a highly fragmented setting. As long as the number of firms implementing this consolidation strategy is small, then the market for corporate control in these markets will probably be less than perfectly competitive, and opportunities for profits from implementing an acquisition strategy may be possible.

More generally, if a merger or acquisition contest is played out through full-page ads in the *Wall Street Journal*, the ability of bidding firms to gain competitive advantages from their acquisitions is limited. Such highly public acquisitions are likely to lead to very competitive markets for corporate control. Competitive markets for corporate control, in turn, assure that the equity holders of the target firm will appropriate any value that could be created by an acquisition. However, if these contests occur in obscure, out-of-the-way industries, it is more likely that bidding firms will be able to earn profits from their acquisitions.

Service Corporation International: An Example

Empirical research on mergers and acquisitions suggests that it is not easy for bidding firms to earn economic profits from these strategies. However, it may be possible for some bidding firms, some of the time, to do so. One firm that has been successful in gaining competitive advantages from its merger and acquisition strategies is Service Corporation International (SCI). SCI is in the funeral home and cemetery business. It grew from a collection of five funeral homes in 1967 to being the largest owner of cemeteries and funeral homes in the United States today. It has done this through an aggressive and what was until recently a highly profitable acquisitions program in this historically fragmented industry.

The valuable and rare economy of scope that SCI brought to the funeral home industry is the application of traditional business practices in a highly fragmented and not often professionally managed industry. SCI-owned funeral homes operate with gross margins approaching 30 percent, nearly three times the gross margins of independently owned funeral homes. Among other things, higher margins reflected savings from centralized purchasing services, centralized embalming and professional services, and the sharing of underutilized resources (including hearses) among funeral homes within geographic regions. SCI's scale advantages made a particular funeral home more valuable to SCI than to one of SCI's smaller competitors, and more valuable than if a particular funeral home was left as a stand-alone business.

Moreover, the funeral homes that SCI targeted for acquisition were, typically, family owned and lacked heirs to continue the business. Many of the owners or operators of these funeral homes were not fully aware of the value of their operations to SCI (they are morticians more than business managers), nor were they just interested in maximizing the sale price of their funeral homes. Rather, they were often looking to maintain continuity of service in a community, secure employment for their loyal employees, and ensure a comfortable (if not lavish) retirement for themselves. Being acquired by SCI was likely to be the only alternative to closing the funeral home once an owner or operator retired. Extracting less than the full value of the funeral home when selling to SCI often seemed preferable to other alternatives.

Because SCI's acquisition of funeral homes exploited real and valuable economies of scope, this strategy had the potential for generating superior economic performance. Because SCI was, for many years, the only firm implementing this strategy in the funeral home industry, because the funeral homes that SCI acquired were generally not publicly traded, and because the owner or operators of these funeral homes often had interests besides simply maximizing the price of their operation when they sold it, it seems likely that SCI's acquisition strategy generated superior economic performance for many years. However, in the last several years, information about SCI's acquisition strategy has become widely known. This has led other funeral homes to begin bidding to acquire formerly independent funeral homes. Moreover, independent funeral home owners have become more aware of their full value to SCI. Although SCI's economy of scope with independent funeral homes is still valuable, it is no longer rare, and thus it is no longer a source of economic profits to SCI. Put differently, the imperfectly competitive market for corporate control that SCI was able to exploit for almost 10

Global Perspectives

In the late 1980s, managers at Ford Motor Company faced a problem. While Ford had been able to get its quality on par with the best manufacturers—through its "Quality Is Job One" program—worldwide competition in small and medium-sized cars had reduced the profit margin on Ford's small-car lines to almost nothing. The only cars that continued to deliver high profit margins to Ford were its luxury cars—the Lincoln and related cars. Unfortunately, Lincoln was an aging brand. It was being rapidly displaced in the highly profitable luxury car market by Mercedes Benz and BMW—German automobiles that had more attraction among younger car buyers than Lincoln. Moreover, Nissan (through its Infiniti division), Honda (through its Acura division), and Toyota (through its Lexus division) were beginning to invest in the luxury car market.

At the same time, managers at Jaguar also faced a problem. They were about to go out of business. Despite having a well-known brand and beautifully designed cars, Jaguar's quality problems had just about driven this firm out of business; its poor quality was legendary. The joke was that you had to buy two brand-new Jaguars—one to drive and one for parts. To give its customers some sense of security, Jaguar introduced a free towing service for new-car buyers. The service would tow your broken-down Jaguar to a Jaguar dealer free. The usage rate of this free towing service among Jaguar owners was 118 percent—essentially every Jaguar owner had to have his or her new car towed in for repairs, and some more than once. In the J. D. Power ratings of initial quality, Jaguar in the early 1990s was ranked ahead of only one other firm: Yugo. Yugo manufactured very low-quality cheap cars for sale in Europe and import into the United States. Jaguar was manufacturing very low-quality cars for sale around the world, but they were not cheap! What a deal—a luxury car price with Yugo quality!

Ford's Acquisition of Jaguar

The match between Ford and Jaguar seemed perfect. Ford needed a new luxury brand to compete with Mercedes, BMW, Lexus, and so forth; Jaguar had such a brand. Jaguar desperately needed to learn how to manufacture quality automobiles; Ford now knew how to do that. Assuming Ford could use its manufacturing skills with Jaguar without destroying the value of Jaguar's brand name, it seemed likely that a Ford acquisition of Jaguar would create real economic value.

But who would appropriate that value—Ford's stockholders or Jaguar's stockholders? To answer this question, it is necessary to understand if any other firms would profit from acquiring Jaguar in about the same way as Ford. What about General Motors? GM faced the same profit squeeze in small cars as Ford. It also had its own aging luxury line of cars, the Cadillac.

years has become more perfectly competitive. Future acquisitions by SCI are not likely to be a source of sustained competitive advantage and economic profit. For these reasons, SCI is currently reevaluating its corporate strategy, attempting to discover a new way that it might be able to generate superior profits.[21]

This same form of analysis can be applied to virtually any merger and acquisition strategy. Consider, for example, the acquisition discussed in the Global Perspectives feature.

Implications for Target Firm Managers

Although bidding firm managers can do several things to attempt to maximize the probability of earning economic profits from their merger and acquisition strategies, target firm managers can attempt to counter these efforts, to ensure

And GM had also recently begun improving its manufacturing quality dramatically. Would GM be interested in purchasing Jaguar?

It turns out that although GM never made a formal offer for Jaguar, it did hold discussions about a possible acquisition. The bid that Ford made to take over Jaguar had to anticipate the possibility that GM was also interested. Initially, Ford paid $2.5 billion for Jaguar; since the acquisition, Ford has invested another $3.5 billion. Together, the almost $6 billion invested in Jaguar is almost $2.5 billion more than Jaguar's market price when it was a stand-alone company. This means that in order for this acquisition to pay off for Ford's stockholders, Ford must create more than $2.5 billion of extra value from its acquisition of Jaguar.

What has Ford done with Jaguar? First and foremost, it helped Jaguar improve its quality problems. Indeed, Jaguar went from having the second-worst initial quality of any car manufacturer ranked by J. D. Powers in 1992 to having the best initial quality in 1999. Since 1999, Jaguar's rankings have dropped some, but it is still among the world's elite in initial quality rankings. However, it is reasonable to expect that much of the value created through this quality effort was anticipated in the price for Jaguar. That is, the value created here is part of the $2.5 billion premium paid for Jaguar. For it to be a source of profits for Ford's stockholders, Ford must create value in excess of this $2.5 billion.

Ford also helped Jaguar develop new models, including the mid-size "S-Type" and the smaller "X-Type" Jaguars. Although these vehicles have dramatically increased Jaguar's volume of production, some observers worry that these automobile lines blur the distinction between the Ford and Jaguar brands. This is especially a problem for the "X-Type," or "baby Jag"—a car that looks disturbingly like a Hyundai Sonata. Although it seems reasonable to assume that the premium paid for Jaguar anticipated Ford's ability to help Jaguar introduce some new models, the specific details of these models and their ultimate success would have been difficult to anticipate at the time Jaguar was acquired. If these models turn out to be successful, they may be a source of superior profits for Ford's shareholders.

More recently, Ford has used additional acquisitions to round out its line of luxury cars—including its recent acquisition of Volvo and Range Rover. Ford is currently experimenting with the creation of single dealerships that sell Jaguars, Volvos, and Range Rovers. In this way, Ford's customers can gain access to a full line of luxury cars in a single location. It is also likely that these additional acquisitions were not anticipated at the time Ford acquired Jaguar. If this "one-stop-shop" approach to luxury car shopping ends up creating value, this value is also likely to be a source of superior performance to Ford's shareholders.

Of course, all this discussion begs a more fundamental question: Did Ford have to acquire Jaguar to obtain all the value described here? Couldn't Ford have created its own new luxury brand, the same way that Nissan, Honda, and Toyota did? And, which would have been cheaper, Ford paying a $2.5 billion premium for Jaguar or developing its own new luxury brand?

Sources: T. Luehrman (1991). "Jaguar plc, 1989." Harvard Business School Case No. 9-291-034; J. D. Powers (1999). "Jaguar is top make in initial quality." *Special Power Report*; J. Flint (2004). "Tarnished jewels." www.forbes.com, January 27, 2004; D. Kiley (2001). "$29,950 soon can buy you a 'baby' Jag," *USA Today*, February 14, p. 1.

that the owners of target firms appropriate whatever value is created by a merger or acquisition. These "rules" for target firm managers are summarized in Table 10.6.

Seek Information from Bidders

One way a bidder can attempt to obtain superior performance from implementing an acquisition strategy is to keep information about the source and value of the strategic relatedness that exists between the bidder and target private. If that relationship is actually worth $12,000, but targets believe it is only worth $8,000, then a target might be willing to settle for a bid of $8,000 and thereby forgo the extra $4,000 it could have extracted from the bidder. Once the target knows that its true value to the bidder is $12,000, it is in a much better position to obtain this full

Table 10.6 **Rules for Target Firm Managers**

1. Seek information from bidders.
2. Invite other bidders to join the bidding competition.
3. Delay but do not stop the acquisition.

value when the acquisition is completed. Therefore, not only should a bidding firm inform itself about the value of a target, target firms must inform themselves about their value to potential bidders. In this way, they can help obtain the full value of their assets.

Invite Other Bidders to Join the Bidding Competition

Once a target firm is fully aware of the nature and value of the economies of scope that exist between it and current bidding firms, it can exploit this information by seeking other firms that may have the same relationship with it and then informing these firms of a potential acquisition opportunity. By inviting other firms into the bidding process, the target firm increases the competitiveness of the market for corporate control, thereby increasing the probability that the value created by an acquisition will be fully captured by the target firm.

Delay, but Do Not Stop, the Acquisition

As suggested earlier, bidding firms have a strong incentive to expedite the acquisition process in order to prevent other bidders from becoming involved in an acquisition. Of course, the target firm wants other bidding firms to enter the process. To increase the probability of receiving more than one bid, target firms have a strong incentive to delay an acquisition.

The objective, however, should be to delay an acquisition to create a more competitive market for corporate control, not to stop an acquisition. If a valuable economy of scope exists between a bidding firm and a target firm, the merger of these two firms will create economic value. If the market for corporate control within which this merger occurs is competitive, then the equity holders of the target firm will appropriate the full value of this economy of scope. Preventing an acquisition in this setting can be very costly to the equity holders of the target firm.

Target firm managers can engage in a wide variety of activities to delay the completion of an acquisition. Some common responses of target firm management to takeover efforts, along with their economic implications for the equity holders of target firms, are discussed in the Research Made Relevant feature.

V R I O

Organizing to Implement a Merger or Acquisition

To realize the full value of any strategic relatedness that exists between a bidding firm and a target firm, the merged organizations must be organized appropriately. The realization of each of the types of strategic relatedness discussed earlier in this chapter requires at least some coordination and integration between the bidding and target firms after an acquisition has occurred. For example, to realize economies of scale from an acquisition, bidding and target firms must coordinate

Research Made Relevant

Managers in potential target firms can respond to takeover attempts in a variety of ways. As suggested in Table 10.7, some of these responses increase the wealth of target firm shareholders, some have no impact on target firm shareholders, and others decrease the wealth of target firm shareholders.

Management responses that have the effect of reducing the value of target firms include greenmail, standstill agreements, and "poison pills." Each of these is an anti-takeover action that target firm managers can take reduces the wealth of target firm equity holders. **Greenmail** is a maneuver in which a target firm's management purchases any of the target firm's stock owned by a bidder and does so for a price that is greater than the current market value of that stock. Greenmail effectively ends a bidding firm's effort to acquire a particular target and does so in a way that can greatly reduce the wealth of a target firm's equity holders. Not only do these equity holders not appropriate any economic value that could have been created if an acquisition had been completed, but they have to bear the cost of the premium price that management pays to buy its stock back from the bidding firm.

The Wealth Effects of Management Responses to Takeover Attempts

Not surprisingly, target firms that resort to greenmail substantially reduce the economic wealth of their equity holders. One study found that the value of target firms that pay greenmail drops, on average, 1.76 percent. Another study reported a 2.85 percent drop in the value of such firms. These reductions in value are greater if greenmail leads to the cancellation of a takeover effort. Indeed, this second study found that such episodes led to a 5.50 percent reduction in the value of target firms. These reductions in value as a response to greenmail activities stand in marked contrast to the generally positive market response to efforts by a firm to repurchase its own shares in non-greenmail situations.

Standstill agreements are often negotiated in conjunction with greenmail. A standstill agreement is a contract between a target and a bidding firm wherein the bidding firm agrees not to attempt to take over the target for some period of time. When a target firm negotiates a standstill agreement, it prevents the current acquisition effort from being completed, and it reduces the number of bidders that might become involved in future acquisition efforts. Thus, the equity holders of this target firm forgo any value that could have been created if the current acquisition had occurred, and they also lose some of the value that they could have appropriated in future acquisition episodes by the target's inviting multiple bidders into a market for corporate control.

Table 10.7 **The Wealth Effects of Target Firm Management Responses to Acquisition Efforts**

1. Responses that reduce the wealth of target firm equity holders:
   - Greenmail
   - Standstill agreements
   - Poison pills
2. Responses that do not affect the wealth of target firm equity holders:
   - Shark repellents
   - Pac Man defense
   - Crown jewel sale
   - Lawsuits
3. Responses that increase the wealth of target firm equity holders:
   - Search for white knights
   - Creation of bidding auctions
   - Golden parachutes

(continued)

Standstill agreements, either alone or in conjunction with greenmail, reduce the economic value of a target firm. One study found that standstill agreements that were unaccompanied by stock repurchase agreements reduced the value of a target firm by 4.05 percent. Such agreements, in combination with stock repurchases, reduced the value of a target firm by 4.52 percent.

So-called **poison pills** include any of a variety of actions that target firm managers can take to make the acquisition of the target prohibitively expensive. In one common poison-pill maneuver, a target firm issues rights to its current stockholders indicating that if the firm is acquired in an unfriendly takeover, it will distribute a special cash dividend to stockholders. This cash dividend effectively increases the cost of acquiring the target and can discourage otherwise interested bidding firms from attempting to acquire this target. Another poison-pill tactic substitutes the distribution of additional shares of a target firm's stock, at very low prices, for the special cash dividend. Issuing this low-price stock to current stockholders effectively undermines the value of a bidding firm's equity investment in a target and thus increases the cost of the acquisition. Other poison pills involve granting current stockholders other rights—rights that effectively increase the cost of an unfriendly takeover.

Although poison pills are creative devices that target firms can use to prevent an acquisition, they generally have not been very effective. If a bidding firm and a target firm are strategically related, the value that can be created in an acquisition can be substantial, and most of this value will be appropriated by the stockholders of the target firm. Thus, target firm stockholders have a strong incentive to see that the target firm is acquired, and they are amenable to direct offers made by a bidding firm to them as individual investors; these are called **tender offers.** However, to the extent that poison pills actually do prevent mergers and acquisitions, they are usually bad for the equity holders of target firms.

Target firm management can also engage in a wide variety of actions that have little or no impact on the wealth of a target firm's equity holders. One class of these responses is known as shark repellents. **Shark repellents** include a variety of relatively minor corporate governance changes that, in principle, are supposed to make it somewhat more difficult to acquire a target firm. Common examples of shark repellents include **supermajority voting rules** (which specify that more than 50 percent of the target firm's board of directors must approve a takeover) and state incorporation laws (in some states, incorporation laws make it difficult to acquire a firm incorporated in that state). However, if the value created by an acquisition is sufficiently large, these shark repellents will neither slow an acquisition attempt significantly nor prevent it from being completed.

Another response that does not affect the wealth of target firm equity holders is known as the **Pac Man defense**. Targets using this tactic fend off an acquisition by taking over the firm or firms bidding for them. Just as in the old video game, the hunted becomes the hunter; the target turns the tables on current and potential bidders. It should not be too surprising that the Pac Man defense does not, on average, either hurt or help the stockholders of target firms. In this defense, targets become bidders, and we know from empirical literature that, on average, bidding firms earn only zero economic profits from their acquisition efforts. Thus, one would expect that, on average, the Pac Man defense would generate only zero economic profits for the stockholders of target firms implementing it.

Another ineffective and inconsequential response is called a **crown jewel sale**. The idea behind a crown jewel sale is that sometimes a bidding firm is interested in just a few of the businesses currently being operated by the target firm. These businesses are the target firm's "crown jewels." To prevent an acquisition, the target firm can sell off these crown jewels, either directly to the bidding firm or by setting up a separate company to own and operate these businesses. In this way, the bidding firm is likely to be less interested in acquiring the target.

A final, relatively ineffective defense that most target firm managers pursue is filing lawsuits against bidding firms. Indeed, at least in the United States, the filing of a lawsuit has been almost automatic as soon as an acquisition effort is announced. These suits, however, usually do not delay or stop an acquisition or merger.

Finally, as suggested in Table 10.7, some of the actions that the man-

agement of target firms can take to delay (but not stop) an acquisition actually benefit target firm equity holders. The first of these is the search for a **white knight**—another bidding firm that agrees to acquire a particular target in the place of the original bidding firm. Target firm management may prefer to be acquired by some bidding firms more than by others. For example, it may be that some bidding firms possess much more valuable economies of scope with a target firm than other bidding firms. It may also be that some bidding firms will take a longer-term view in managing a target firm's assets than other bidding firms. In both cases, target firm managers are likely to prefer some bidding firms over others.

Whatever motivation a target firm's management has, inviting a white knight to bid on a target firm has the effect of increasing the number of firms bidding for a target by at least one. If there is currently only one bidder, inviting a white knight into the bidding competition doubles the number of firms bidding for a target. As the number of bidders increases, the competitiveness of the market for corporate control and the likelihood that the equity holders of the target firm will appropriate all the value created by an acquisition also increase. On average, the entrance of a white knight into a competitive bidding contest for a target firm increases the wealth of target firm equity holders by 17 percent.

If adding one firm into the competitive bidding process increases the wealth of target firm equity holders some, then adding more firms to the process is likely to increase this wealth even more. Target firms can accomplish this outcome by creating an **auction** among bidding firms. On average, the creation of an auction among multiple bidders increases the wealth of target firm equity holders by 20 percent.

A third action that the managers of a target firm can take to increase the wealth of their equity holders from an acquisition effort is the institution of **golden parachutes**. A golden parachute is a compensation arrangement between a firm and its senior management team that promises these individuals a substantial cash payment if their firm is acquired and they lose their jobs in the process. These cash payments can appear to be very large, but they are actually quite small in comparison to the total value that can be created if a merger or acquisition is completed. In this sense, golden parachutes are a small price to pay to give a potential target firm's top managers incentives not to stand in the way of completing a takeover of their firm. Put differently, golden parachutes reduce agency problems for the equity holders of a potential target firm by aligning the interests of top managers with the interests of that firm's stockholders. On average, when a firm announces golden parachute compensation packages for its top management team, the value of this potential target firm's equity increases by 7 percent.

Overall, substantial evidence suggests that delaying an acquisition long enough to ensure that a competitive market for corporate control emerges can significantly benefit the equity holders of target firms. One study found that when target firms did not delay the completion of an acquisition, their equity holders experienced, on average, a 36 percent increase in the value of their stock once the acquisition was complete. If, however, target firms did delay the completion of the acquisition, this average increase in value jumped to 65 percent.

Of course, target firm managers can delay too long. Delaying too long can create opportunity costs for their firm's equity holders, because these individuals do not actually realize the gain from an acquisition until it has been completed. Also, long delays can jeopardize the completion of an acquisition, in which case the equity holders of the target firm do not realize any gains from the acquisition.

Sources: R. Walkling and M. Long (1984). "Agency theory, managerial welfare, and takeover bid resistance." *Rand Journal of Economics*, 15(1), pp. 54–68; R. D. Kosnik (1987). "Greenmail: A study of board performance in corporate governance." *Administrative Science Quarterly*, 32, pp. 163–185; J. Walsh (1989). "Doing a deal: Merger and acquisition negotiations and their impact upon target company top management turnover." *Strategic Management Journal*, 10, pp. 307–322; L. Y. Dann and H. DeAngelo (1983). Standstill agreements, privately negotiated stock repurchases, and the market for corporate control." *Journal of Financial Economics*, 11, pp. 275–300; M. Bradey and L. Wakeman (1983). "The wealth effects of targeted share repurchases." *Journal of Financial Economics*, 11, pp. 301–328; H. Singh and F. Haricento (1989). "Top management tenure, corporate ownership and the magnitude of golden parachutes." *Strategic Management Journal*, 10, pp. 143–156; T. A. Turk (1987). "The determinants of management responses to interfirm tender offers and their effect on shareholder wealth." Unpublished doctoral dissertation, Graduate School of Management, University of California at Irvine.

in the combined firm the functions that are sensitive to economies of scale. To realize the value of any technology that a bidding firm acquires from a target firm, the combined firm must use this technology in developing, manufacturing, or selling its products. To exploit underutilized leverage capacity in the target firm, the balance sheets of the bidding and target firms must be merged, and the resulting firm must then seek additional debt funding. To realize the opportunity of replacing the target firm's inefficient management with more efficient management from the bidding firm, these management changes must actually take place.

Post-acquisition coordination and integration is essential if bidding and target firms are to realize the full potential of the strategic relatedness that drove the acquisition in the first place. If a bidding firm decides not to coordinate or integrate any of its business activities with the activities of a target firm, then why was this target firm acquired? Just as corporate diversification requires the active management of linkages among different parts of a firm, mergers and acquisitions (as one way in which corporate diversification strategies can be created) require the active management of linkages between a bidding and a target firm.

Post-Merger Integration and Implementing a Diversification Strategy

Given that most merger and acquisition strategies are used to create corporate diversification strategies, the organizational approaches previously described for implementing diversification are relevant for implementing merger and acquisition strategies as well. Thus, mergers and acquisitions designed to create diversification strategies should be managed through the M-form structure. The management control systems and compensation policies associated with implementing diversification strategies should also be applied in organizing to implement merger and acquisition strategies. In contrast, mergers and acquisitions designed to create vertical integration strategies should be managed through the U-form structure and have management controls and compensation policies consistent with this strategy.

Special Challenges in Post-Merger Integration

Although, in general, organizing to implement merger and acquisition strategies can be seen as a special case of organizing to implement corporate diversification strategies or vertical integration strategies, implementing merger and acquisition strategies can create special problems. Most of these problems reflect the fact that operational, functional, strategic, and cultural differences between bidding and target firms involved in a merger or acquisition are likely to be much greater than these same differences between the different parts of a diversified or vertically integrated business that was not created through acquisition. The reason for this difference is that the firms involved in a merger or acquisition have had a separate existence, separate histories, separate management philosophies, and separate strategies.

Differences between bidding and target firms can manifest themselves in a wide variety of ways. For example, they may own and operate different computer systems, different telephone systems, and other conflicting technologies. These firms might have very different human resource policies and practices. One firm might have a very generous retirement and health care program; the other, a less

generous program. One firm's compensation system might focus on high salaries; the other firm's compensation system might focus on large cash bonuses and stock options. Also, these firms might have very different relationships with customers. At one firm, customers might be thought of as business partners; in another, the relationship with customers might be more arm's-length in character. Integrating bidding and target firms may require the resolution of numerous differences.

Perhaps the most significant challenge in integrating bidding and target firms has to do with cultural differences.[22] In Chapter 3, it was suggested that it can often be difficult to change a firm's organizational culture. The fact that a firm has been acquired does not mean that the culture in that firm will rapidly change to become more like the culture of the bidding firm; cultural conflicts can last for very long periods of time. Indeed, the difference between the relative success of Renault's acquisition of Nissan and DaimlerChrysler's acquisition of Mitsubishi has largely been attributed to the inability of Mitsubishi to modify its traditional management culture.

Cultural differences were apparently an important part of the post-merger integration challenges in the merger between Bank One and First Chicago Bank. Bank One had many operations and offices in small and medium-sized cities in the Midwest. First Chicago was a more urban bank. Different kinds of employees may have been attracted to these different firms, leading to significant cultural clashes as these two firms sought to rationalize their combined operations.[23] Most reports suggest that First Chicago employees have come to dominate this "merger." Unlike the merger between Bank One and First Chicago, JP Morgan Chase clearly acquired Bank One in 2004.

Operational, functional, strategic, and cultural differences between bidding and target firms can all be compounded by the merger and acquisition process—especially if that process was unfriendly. Unfriendly takeovers can generate anger and animosity among the target firm management that is directed toward the management of the bidding firm. Research has shown that top management turnover is much higher in firms that have been taken over compared to firms not subject to takeovers, reflecting one approach to resolving these management conflicts.[24]

The difficulties often associated with organizing to implement a merger and acquisition strategy can be thought of as an additional cost of the acquisition process. Bidding firms, in addition to estimating the value of the strategic relatedness between themselves and a target firm, also need to estimate the cost of organizing to implement an acquisition. The value that a target firm brings to a bidding firm through an acquisition should be discounted by the cost of organizing to implement this strategy. In some circumstances, it may be the case that the cost of organizing to realize the value of strategic relatedness between a bidding firm and a target may be greater than the value of that strategic relatedness, in which case the acquisition should not occur. For this reason, many observers argue that potential economies of scope between bidding and target firms are often not fully realized. For example, despite the numerous multimedia mergers in the 1990s (Time Warner, Turner Broadcasting, and AOL; The Walt Disney Company, Capital Cities/ABC, and ESPN; GE and NBC; Westinghouse and CBS), few seem to have been able to realize any important economies of scope.[25]

Although organizing to implement mergers and acquisitions can be a source of significant cost, it can also be a source of value and opportunity. Some scholars

have suggested that value creation can continue to occur in a merger or acquisition long after the formal acquisition is complete.[26] As bidding and target firms continue to coordinate and integrate their operations, unanticipated opportunities for value creation can be discovered. These sources of value could not have been anticipated at the time a firm was originally acquired (and thus are, at least partially, a manifestation of a bidding firm's good luck), but bidding firms can influence the probability of discovering these unanticipated sources of value by learning to cooperate effectively with target firms while organizing to implement a merger or acquisition strategy.

Mergers and Acquisitions in an International Context

All the issues associated with mergers and acquisitions described thus far also apply to those that occur in an international setting. For example, firms exploring international merger and acquisition opportunities will need to follow the guidelines in Table 10.5 if they hope to gain competitive advantages from these strategies; international targets need to follow the guidelines in Table 10.6 if they are to extract as much of the value created by an acquisition as possible. However, one additional aspect of international mergers and acquisitions requires additional discussion: Challenges created for post-merger integration caused by cultural differences between countries.

We have already seen that post-merger integration usually involves resolving conflicts between the cultures of merged or acquired firms. However, when these organizational cultures reflect deep-seated country cultures, post-merger integration can be even more difficult. Thus, the integration of merged firms in an international context is often confounded by the need to discover how different country cultures can work together.

The most influential study of cultures around the world, by Geert Hofstede, suggests that cultures can be described as varying along the five dimensions presented in Figure 10.1.[27] Differences along each of these dimensions create potential challenges when integrating acquisitions conducted across country and cultural borders. These differences are rarely easy to resolve.

For example, a firm that operates in an individualistic culture may have a compensation scheme that celebrates individual achievement. If this firm acquires a company that operates in a collectivist culture, imposing an individualistic compensation policy can lead to misunderstanding and disagreement. Senior managers in a firm that operates in a culture that respects power may assume that their orders to employees in a firm that operates in a culture that only tolerates power will be carried out, but these employees will not do anything until they hear the boss's justification of those orders. A firm used to innovation and risk-seeking may be very frustrated if it acquires a company that operates in a culture that avoids rather than celebrates uncertainty. Employees that work in a firm that operates in a culture that values material possessions and hard work to obtain those possessions may be shocked to see employees in an acquired firm that operates in a culture that values the quality of life over material possessions go home at 5:00 P.M.—even if the work for the day is not done. Finally, employees that work in a firm that operates in a culture that values looking to the future may find it very difficult to work with employees in a firm that operates in a culture that values looking to the past.

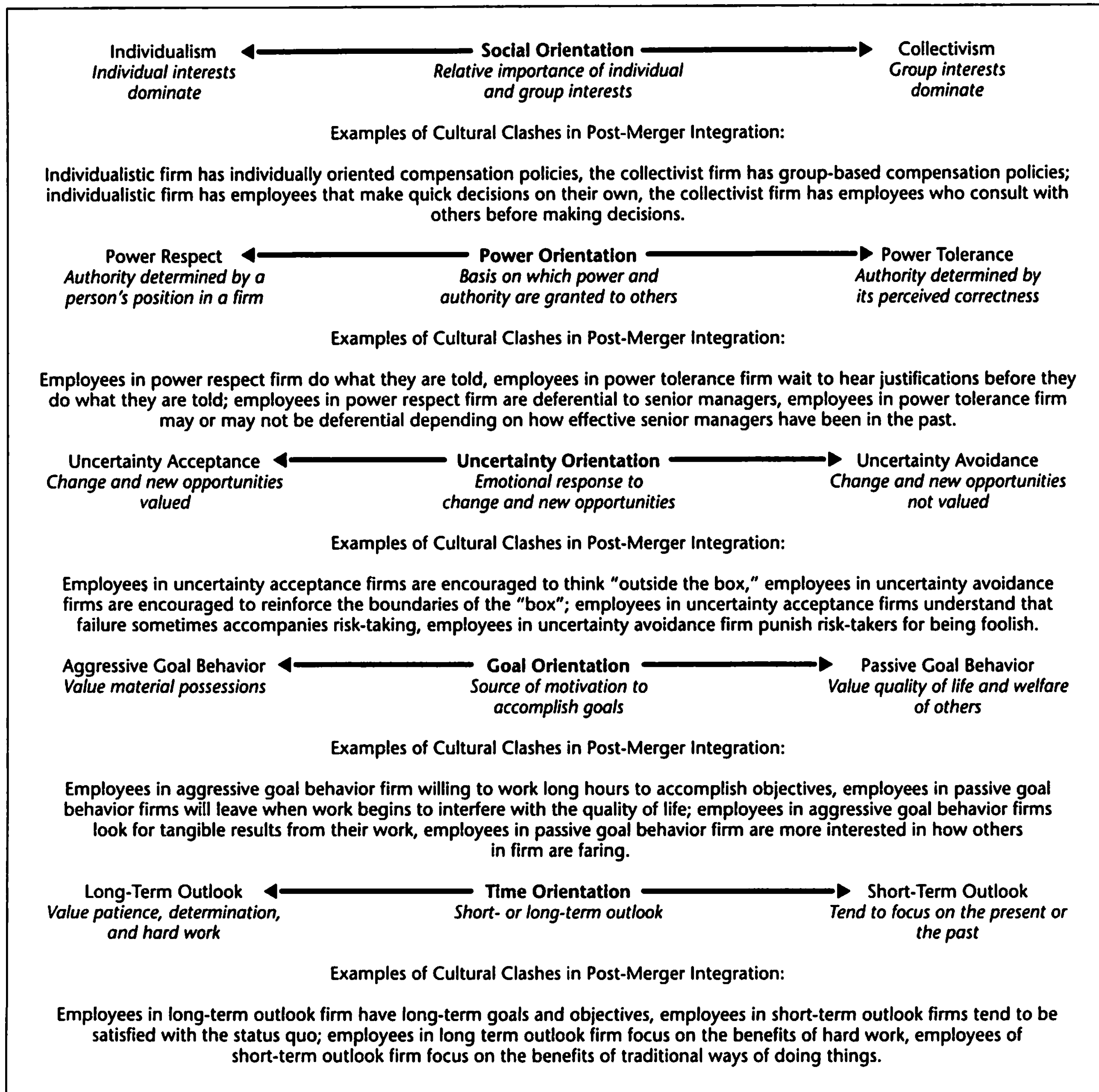


Figure 10.1 Dimension of Culture and Their Implications for Integration in International Acquisition

Source: Hofstede G. (1980). *Culture's consequences: International differences in work-related values*. Copyright © 1980 Sage Publications. (Thousand Oaks, CA: Sage Publications).

Of course, acquiring firms can engage in specific activities to modify some aspects of the culture of the firms they acquire. However, to the extent that the organizational cultures of these acquired firms reflect differences in national cultures, there are few things that can be done to modify them. In such settings, acquiring firms must look to sources of value creation in an acquisition that do not depend on the integration of the organizational cultures of the bidding and target firms.

SUMMARY

Firms can use mergers and acquisitions to create corporate diversification and vertical integration strategies. Mergers or acquisitions between strategically unrelated firms can be expected to generate only competitive parity for both bidders and targets. Thus, firms contemplating merger and acquisition strategies must search for strategically related targets.

Several sources of strategic relatedness have been discussed in literature. On average, the acquisition of strategically related targets does create economic value, but most of that value is captured by the equity holders of target firms. The equity holders of bidding firms generally gain competitive parity even when bidding firms acquire strategically related targets. Empirical research on mergers and acquisitions is consistent with these expectations. On average, acquisitions do create value, but that value is captured by target firms, and acquisitions do not hurt bidding firms.

Given that most mergers and acquisitions generate only zero economic profits for bidding firms, an important question becomes: "Why are there so many mergers and acquisitions?" Explanations include (1) the desire to ensure firm survival, (2) the existence of free cash flow, (3) agency problems between bidding firm managers and equity holders, (4) managerial hubris, and (5) the possibility that some bidding firms might earn economic profits from implementing merger and acquisition strategies.

To gain competitive advantages and economic profits from mergers or acquisitions, these strategies must be either valuable, rare, and private or valuable, rare, and costly to imitate. In addition, a bidding firm may exploit unanticipated sources of strategic relatedness with a target. These unanticipated sources of relatedness can also be a source of economic profits for a bidding firm. These observations have several implications for the managers of bidding and target firms.

Organizing to implement a merger or acquisition strategy can be seen as a special case of organizing to implement a corporate diversification or vertical integration strategy. However, historical differences between bidding and target firms may make the integration of different parts of a firm created through acquisitions more difficult than if a firm is not created through acquisitions. Cultural differences between bidding and target firms are particularly problematic. Bidding firms need to estimate the cost of organizing to implement a merger or acquisition strategy and discount the value of a target by that cost. However, organizing to implement a merger or acquisition can also be a way that bidding and target firms can discover unanticipated economies of scope.

Post-merger integration challenges are likely to be particularly important for mergers and acquisitions in an international context. Important differences between the country cultures of different firms can raise the cost of post-merger integration. In these settings, it may be necessary for acquiring firms to find economies of scope to exploit that do not require the integration of cultures.