

# Mergers & Acquisitions

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#### **Abstract**

This paper describes the past, present, and possible future development of mergers and acquisitions (M&As). Based on historical data, mainly since the last decade, it is clear that M&As are playing a critical role in the area of foreign direct investment. Both in terms of volume of realized M&As and the number of contracts show that the majority of these operations were concentrated in the developed countries, particularly, in the USA. During the global financial crisis and the global recession there was a rapid reduction of foreign direct investment and also in M&As.

The paper also analyzes the development of M&As in different regions. South Asia did not play a significant role in terms of M&As during the last decade in comparison with North America and Europe. Based on the official data and analysis paper, we came to the conclusion that M&As have future potential in these regions. There are at least two reasons for that. First, strong economic growth driven by export generates a huge volume of financial resources which might be disposable for M&As. Second, in this region the Sovereign Wealth Funds have been created, which have accumulated huge financial assets, potentially for both foreign direct investment and M&As. There could be a new trend of M&As in the decade ahead, which might be very interesting for future research.

Classification JEL G3, G18, G24

Key words: equal merger, foreign direct investment, M&As

#### **Introduction**

M&As are playing a crucial role in the area of foreign direct investment. Since the 80s, the last century share of M&As has significantly increased. The main goal of M&As is the generation of synergies that might foster corporate growth, increase market share, boost profitability and improve the value of shareholder's wealth. In order to better understand the present role and trend of M&As, it is important to briefly rethink the theoretical approach.

#### **Theoretical approach**

The key principle of the strategy for M&As is to create shareholder's value over and above the sum of both previous companies. Obviously, two companies together are more valuable than two companies, which are separate. Merged companies could reach high efficiency and become more competitive. The newly created company could be better in terms of cost-efficiency or even achieve higher market share. If a company does not have future potential, a merger is a possible solution.

#### **Classification of Mergers & Acquisitions**

Mergers have developed through history. At present, the following structures of M&As exist:

1. Horizontal merger - when two companies are in direct competition and have the same products and markets. They involve companies within the same business activity. Usually they are regulated by the competition authority. The main reason: economies of scale synergies.
2. Vertical merger - when customer and company or supplier and company are at a different stage of the production chain. The main reason is to enhance efficiency through cost-cutting and communication improvement.
3. Market-extension merger - when two companies are selling the same product in different markets.
4. Product-extension merger – when two companies are selling different but related products in the same market.
5. Conglomeration – when two companies have unrelated businesses. The main reason: product and or geographic expansion.

Based on literature, using M&As have the following benefits:

- a) Staff reduction. For a new company, this will create additional saving in terms of reducing staff in accounting, marketing, and other departments.
- b) Economies of scale are key. The bigger the company, the lower the costs are for placing new orders in the international markets. In addition, there is a potential advantage for a new merger company that it might receive a better position in the market, in particular, it could create favorable conditions to negotiate prices in the international markets.
- c) Acquiring new technology. In order to be more competitive in the international market, establishing the framework for a new technology is needed.
- d) Access to markets. Usually a newly created company will reach new markets and grow in terms of revenues and profits. Bigger companies also have a better access to investment than smaller ones.

Since M&As are globally realized, the legal framework is very important. In the European Union, member countries has been adopted the EU Takeover Directive, 2004/25/EG (adopted in 2004). The EU Takeover Directive, after many years of controversy, has provided a framework for implementation of takeover rules by member states that rests on three key pillars:

1. The mandatory bid rule;
2. The board neutrality during takeover contests The board neutrality rule requires the target's board to remain passive and not to engage in any defensive strategy during the takeover contests and to seek the shareholders' approval before taking any action, other than searching for alternative bids;
3. The use of breakthrough rule, which aims at invalidating a variety of defensive tactics - such as poison pills, limitations on voting rights - that can result in the frustration of the takeover bid.

M&As are two different strategies. In real life there are some examples of equal mergers<sup>1</sup>, but also many of mergers that are not equal. Therefore, when one company takes over another company and establishes itself as a new owner it is called an acquisition rather than a merger.

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<sup>1</sup> Mergers are usually realized when two companies almost about the same size are decided to operate as a new single company. In a real life is typical example in an automotive industry e.g., both Daimler - Benz and Chrysler. These two giant companies created DaimlerChrysler.

Between academia, research and policymakers there is a generally accepted agreement that M&As have some benefits which offer the following benefits:

- better diversification of product and service,
- increased the plant capacity,
- increased market share,
- utilization of research and development (R&D) and
- reduction of potential financial risk.

For M&As, it is very important to analyze the potential return. For this purpose there is a well-known theoretical approach to calculate the return from M&As. One of the approaches for calculating the effect of the returns from M&As is to calculate the Cumulative Abnormal Returns (CAR), if any.

To get the CAR we need to:

1. Calculate a predicted return -  $\hat{R}_{it}$

$r_{it}$  - Abnormal Returns for  $t$ -day and  $i$ - firm:  $r_{it} = R_{it} - \hat{R}_{it}$

2. Calculate the Average Abnormal Returns (AR) for each day and each firm:

$$AR_t = \frac{\sum_i r_{it}}{N}$$

3. Finally compute the CAR as:

$$CAR = \sum_t AR_t$$

### **Why are some M&As a failure?**

There are many examples of mergers that have boosted the performance of a company and increased the value of its shareholders. In this regard, for M&As it is critical to set up realistic goals. The main goal of M&As is to get a higher return for the new firm, which is a combination of the two previous firms. There are many successful examples of M&As. However, there are examples of some M&As that have failed<sup>2</sup>. Therefore, it is necessary to point out why some M&As fail.

Some clear risks for failure of M&As:

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<sup>2</sup> Some failed M&As include M&As that cannot create value and fail miserably. In 1987, the professor of Harvard, Michael Porter, father of a new theory of comparative advantage found that around 50% to 60% of M&As ended in failure. In 2004, the global well-known consulting firm McKinsey also found that only 23% of acquisitions ended in a positive note on investment. There are several explanations for failure of M&As. Let's find out why the majority of the M&As fail.

- If a merger or acquisition is assuming the stock market will be bullish, this approach might be risky.
- If the top management follows their own interest, instead of concentrating on corporate strategy and focusing on the main organizational goals.
- Failure may also occur if a merger takes place as a defensive measure to neutralize the adverse effects of globalization and a dynamic corporate environment.
- There are some evident failures related to when two merging companies have widely different corporate cultures.

Based on complex analysis research, academia and policy makers came to the conclusions on how to avoid potential failures of M&As. There is a general agreement on the main factors, which have significantly negatively influenced M&As. Therefore, several initiatives can be undertaken in order to prevent the failure of M&As in the future. The most important are:

- Communication across all levels – employees, stakeholders, customers, suppliers and government leaders, is crucial.
- Decision-making bodies, i.e., managers have to be transparent and should always tell the truth. This is a requirement for maintaining a healthy environment.
- Therefore, the top management should be committed to providing transparent information, but should also communicate closely with all employees.
- In addition, the top management should identify employees, in particular, talents in both the organizations, who may play major roles in the restructuring of the organization. In this regard, management should attempt to retain those talents.

M&As may seem to be beneficial, resulting in the amalgamation of two firms, of companies, or of conglomerates when there is clear evidence that costs have been cut and revenues increased. In order to avoid a potential failure, taking into consideration all the above-mentioned factors is needed. For better understanding of the past and present trend of M&As, it is necessary to analyze the development as preconditions for future potential trends.

## **Development of M&As**

M&As as a part of foreign direct investment have significantly contributed to the process of financial globalization. Although there are some open questions regarding the comparison of the development of M&As and foreign direct investment, e.g., green field investment, research academia and policy makers came to the conclusion that M&As have some advantages in comparison with green field investment. Therefore, obviously, M&As have started to dominate in the area of foreign direct investment. In order to better understand the past, present and future trends of M&As, it is important to analyze historical development.

### **Developments of M&As between 2001 – 2011 (January)**

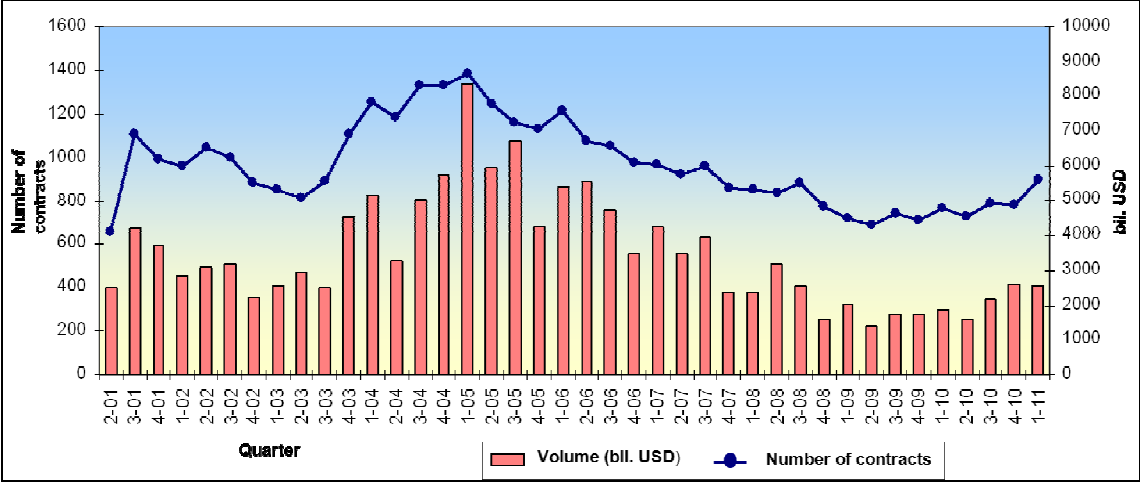
During the last decade, M&As have significantly decreased (see graph 1)<sup>3</sup>. They have reached remarkable progress in terms of not only volume, but also in terms of the number of contracts.

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<sup>3</sup> In this period, were realized a total of 240,421 contracts for M&As with a volume of USD 22,349 billion.

The peak of this development was in the first and second quarters of 2005. The overall volume reached more than USD 8 trillion. In the second half of the last decade, there has been a gradual decrease in the volume of M&As. The lowest level was reached during the period in the second quarter of 2009 when the global recession culminated. In line with slow and an uneven global recovery, there is a sign of increasing appetite for M&As.

Graph 1: Developments of M&As between 2001 – 2011 (January)



Source: NBS based on Bloomberg data

During the last decade, the development of M&As was different in various regions (see graph 2).

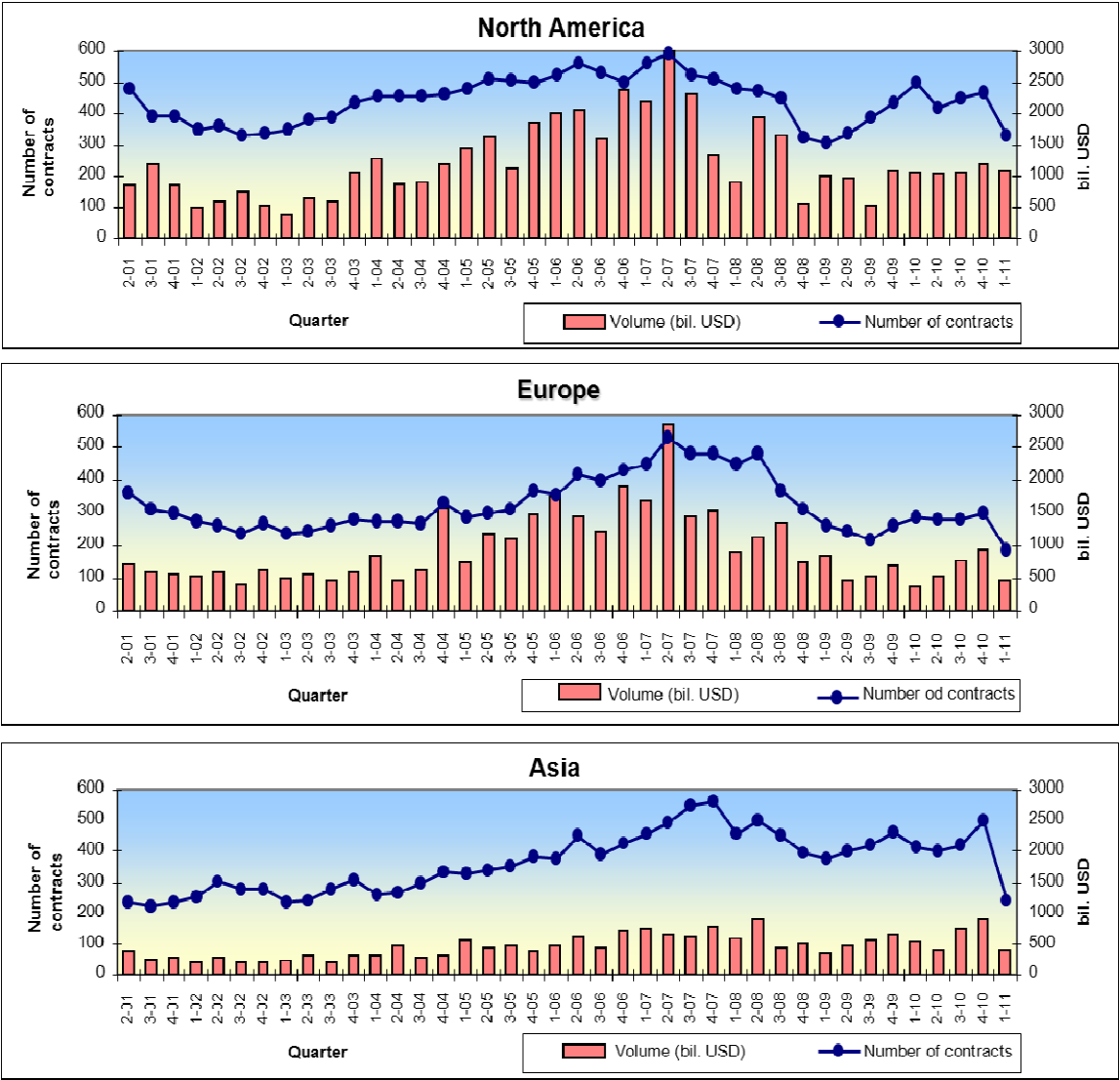
In both North America and Europe, the highest volume of M&As was in the second quarter of 2007 (USD 3 trillion and 2.65 trillion respectively). In this period, when the global financial crisis appeared (second half of 2007) there has been significantly reduction in both the volume and the number of contracts in both North America and Europe. However, this unfavorable trend of M&As has continued until the third quarter of 2009 in North America. In Europe, there was a slightly different development.

The lowest volume M&As were in the first quarter of 2010 and then gradually have been increased and again significantly reduced in the first quarter of 2011. This relatively negative trend was also related to the debt crisis in eurozone. Although on one side there were similar situations in terms of the number of contracts in the first half of the decade. On the other hand, there were different situations in both North America and Europe. When the global recession was almost over, in the second quarter of 2009, there was a remarkable increase in the number of contracts in North America, but only mildly in Europe. Due to uncertainty and risks of the global recovery, mainly in the USA and Europe, in the fourth quarter there was again a trend of reducing number of contracts.

The chart clearly describes that the situation was different in Asia. In comparison with both North America and Europe, the volume of M&As was significantly lower in Asia. The highest volume of M&As was in the second quarter of 2008 and fourth quarter of 2010. Despite the fact that there was a different volume of M&As between North America and Europe in comparison with Asia, in terms of number of contracts, the trend was almost similar. In reality, that means that in Asia M&As have lower volume than in other regions

i.e., North America and Europe. However, what was similar in all three regions was the trend of significantly reducing number of contracts in the fourth quarter of 2010 and first quarter of 2011. The highest saving was in Asia.

Graph 2: Developments of M&As in different regions 2001 – 2011 (January)

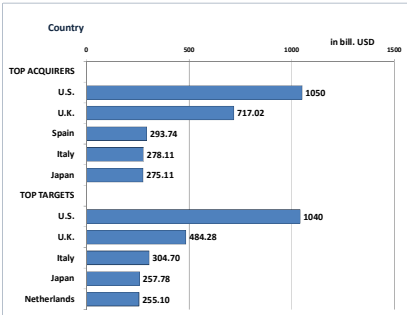


Source: NBS, based on Bloomberg data

**M&As in the financial sector**

The significant growth of M&As is not only global, but also in the financial sector. This part will analyze the latest development, i.e., after the global financial crisis in 2009-2011 (the beginning of March). The top acquirers and top targets in terms of value of M&As is in the banking industry located in USA. This is understandable, because the banking sector is the biggest in the world (see graph 3). The second largest country in terms of both acquirers and top targets in the banking industry is in the UK.

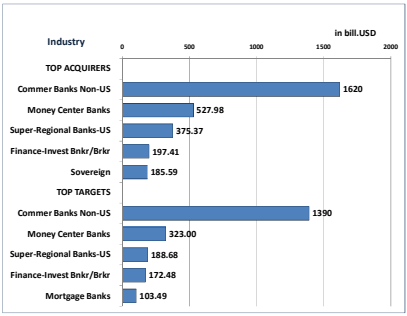
Graph 3: The top acquirers and top targets in terms of value of M&As



Source: NBS, based on Bloomberg data

The position of the top acquirers and top targets in the banking industry is described by the graph 4. The most demanding acquirers are non-US commercial banks, then money center banks. A similar situation is in terms of individual banks, super regional banks–US, finance investment brokerages and sovereigns. In terms of target situation, it is similar to that of acquirers

Graph 4: The top acquirers and top targets in the banking industry

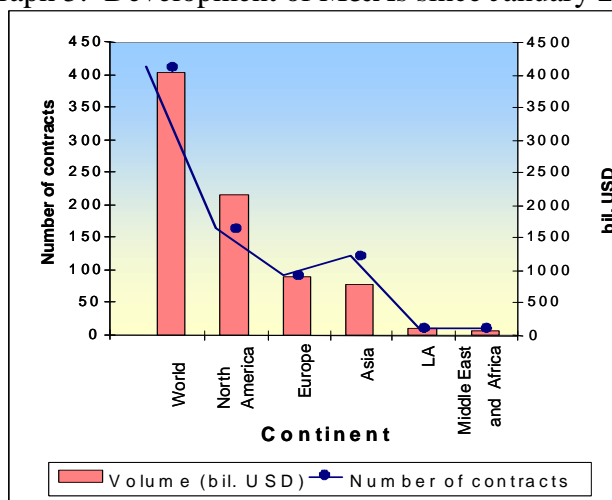


Source: NBS, based on Bloomberg data

## Latest Development of M&As

Since January 1, 2011 until March 7, 2011 there has been a continued dynamic trend with M&As<sup>4</sup>. Based on data published by Bloomberg, the total amount during the above-mentioned period accounts for 404.74 billion USD with 4,107 contracts (see graph 5). The biggest volume of M&As were in North America (volume USD 216.66 billion with 1,646 contracts), then in Europe (volume USD 89.78 billion with 924 contracts), Asia (volume USD 78.19 billion with 1,220 contracts), Latin America (volume USD 11.37 billion with 121 contracts) and Middle East and Africa only (volume USD 7.84 billion with 1,646 contracts).

Graph 5: Development of M&As since January 2001 – until March 7, 2011



Source: NBS, based on Bloomberg data

## Conclusion

There is a general agreement that one size does not fit all. This is also related to M&As. Many companies find that the best way to get ahead is to expand ownership boundaries through M&As. Based on theory, which has been confronted with real practice, M&As create favorable conditions for economies of scale, expanding operations, improved cost-efficiency and increased competitiveness. However, there are some cases of failure of M&As. In many of these cases the behavior of human beings is closely related to the problem of governance.

M&As cover all sectors and all industries. During this decade, there has been significant increase in the role of M&As, particularly in the financial sector. The mortgage crisis in the USA caused the global financial crisis. These crises led to a new wave of M&As in the financial sector, in particular in the banking industry.

The global recession has a negative effect on the financial sector. The present stage of the global recovery is characterized by a certain level of uncertainty. This uncertainty is strongly

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<sup>4</sup> Global M&As soared 23% to \$2.4 trillion in 2010. They are projected to reach \$3 trillion in 2011, and totaled \$473 billion in the year's first two months alone. At the end of the last year and at the beginning of this year North America's deal making is going to dominate.



related to the situation in the balance sheet of different banks. Putting the global economy to a strong, stable and balanced economic growth, restructuring the banking sector, including the cleaning up of bad debts is needed. One of the ways of doing it is M&As.

The global financial crisis and the global recession significantly influenced the saving in individual countries. On one hand, the industrial countries now suffer from lack of saving while new emerging market countries have huge saving and disposable financial resources. Relatively strong economic growth driven by export mainly in emerging economies led to a huge accumulation of foreign exchange reserves. In many emerging economies, in particular, China, Singapore, etc. have been established the Sovereign Wealth Funds. Those funds were playing a critical role in providing additional liquidity to the global financial sector before the outbreak of the global financial crisis. In addition, the Sovereign Wealth Funds have significantly contributed to the process of financial globalization, including M&As. The market value of these funds has a trend unprecedented in history. A huge increase of volume of Sovereign Wealth Funds will probably play an unpredictable role in the flows of foreign direct investment, but particularly in M&As.

The increasing role of Sovereign Wealth Funds is a new phenomenon in the process of financial globalization at the beginning of the 21 century. In real economic life, the Sovereign Wealth Funds can not only realize M&As, but might also follow strategic takeover of private entities. This is an unprecedented trend during modern economic history. A few years ago, neither research and academia nor policymakers expected this trend. This might raise the question: which trend in the governance of M&As will we have in the second half of this decade, by which time Sovereign Wealth Funds could reach a market value of 15 trillion of USD?

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