

2 State of The Art In M&A Theory And Practice

Over the last 100 years, mergers and acquisitions have become more and more important in economic life. As organizations use M&As to secure their positions in an ever more competitive environment, a great deal of research has been conducted. This chapter will give a short introduction to the basic terminologies of M&A. It will furthermore explain the main concepts and theories.

2.1 Mergers and Acquisitions

2.1.1 Definition of the Term "Mergers & Acquisitions"

Although M&As play an essential role in economic life and have been increasingly investigated in research, there exists no set definition (Lucks & Meckl, 2002, p. 23). According to Picot, (2000, p. 15) M&As can be understood in a very broad sense. M&As may include a number of different transactions such as concentration of undertakings, sales and purchases of undertakings, cooperation, privatization, alliances, joint ventures, management buy-outs and buy-ins as well as going public (Picot, 2000, p. 15). Other researchers (Haspeslagh & Jemison, 1992, p. 57; Palter & Srinivasan, 2006, p. 19) argue that M&As can be seen as an instrument for managers to make decisions about reallocating resources. In order to avoid ambiguity and misunderstanding, this thesis will define M&A in a narrower sense as follows:

- **Merger** is the combination of one or more corporations with another corporation. Thereby the new combined company legally exists as a new company (Foster Reed, Reed Lajoux, & Nesvold, 2007, p. 3).
- **Acquisitions** describes the process whereby stocks or assets of a corporation come to be owned by the buyer (Foster Reed et al., 2007, p. 4; Jagersma, 2005, p. 14).

The model developed by Marks and Mirvis (2001, p. 12) helps to provide a clear understanding about the definition of M&A in a narrow sense, as shown in Figure 2.

Organizations can link together in variety of legal combinations. M&As can be seen as one type of strategic combination. These combinations vary in

their level of investment and their depth of commitment (Marks & Mirvis, 2001, p. 12).



Figure 2: Types of Strategic Combinations

Adopted from: (Marks & Mirvis, 2001, p. 12)

According to Figure 2, mergers and acquisitions ask for a higher degree of integration, investment and control. M&As allow the highest level of integration, but with integration the risk of failure rises (Colombo et al., 2007, p. 202). In addition M&As can be divided into three basic variations: the up-stream merger, the down-stream merger and the side-stream merger (Bouchoux, 2009, p. 400). In an **up-stream merger** the daughter merges with the parent company, which means that the parent absorbs the daughter, whereas the opposite happens in a **down-stream merger** (Strauch, 2012, p. 6). In a **side-stream merger** a sister company or entity merges on one level (Brähler, 2013, p. 218).

The strongest strategic combination is given when a company acquires another company through a share deal or an asset deal (Wirtz & Schilke, 2006, pp. 331–333). A share deal occurs when a company purchases shares of stocks in the targeted company whereas in an asset deal a company purchases the targeted company's assets (Mellen & Evans, 2010, p. 69; Wirtz & Schilke, 2006, pp. 331–333). The difference between mergers and acquisitions lies in the different consequences regarding legal obligations, acquisition procedures and tax liabilities (Glaum, Lindemann, & Friedrich, 2006, p. 291; Wirtz & Schilke, 2006, p. 332).

2.1.2 Classification of M&As

Depending on the degree to which the business activities of the acquired company are related to those of the acquiring company it is common to distinguish four main types of mergers and acquisitions (Cartwright & Cooper, 2012, p. 3; Lipczynski, Wilson, & Goddard, 2005, p. 258; Megginson, Smart, & Lucey, 2008, pp. 572–573):

- **Horizontal** mergers and acquisitions combine companies that are in the same industry or operate in a related line of business

(Kusstatscher & Cooper, 2005, p. 12). According to, Weston, Mitchell, and Mulherin (2004, pp. 6–7) companies engaging in horizontal M&As are able to generate economies of scale due to bigger company size. They are also able to increase their market share on grounds of reduced competition (Franck & Meister, 2006, p. 93).

- **Vertical** mergers and acquisitions are combinations of firms that operate in different stages of production such as client-supplier or buyer-seller relationships in order to create a more integrated company (Pepall, Richards, & Norman, 2011, p. 324; Prasanna, 2011, p. 828). The involved parties try to diminish transaction costs and uncertainty via downstream or upstream linkages in the value chain and as a result benefit from economies of scope (Sharan, 2011, p. 40).
- **Conglomerate** mergers and acquisitions occur very often for reasons of diversification. This form involves companies that operate in completely unrelated business areas (Kusstatscher & Cooper, 2005, p. 12).
- **Concentric** mergers and acquisitions are quite similar to conglomerate M&As with the difference being the combining companies come from related industries. The acquiring company seeks to expand into other fields of business activities (Becker, 2005, p. 65; Kusstatscher & Cooper, 2005, p. 13).

In addition there are two different takeover strategies: 'Friendly' or 'hostile' (Foster Reed et al., 2007, p. 6). In a **hostile** takeover the management and board of directors of the target company oppose the acquisition whereas in a **friendly** takeover the board of the target company agrees to the transaction (Machiraju, 2003, p. 78).

Depending on the economic area where the involved companies operate, it is either a domestic M&A or a cross-border M&A. If the involved parties are located in different countries or economies, it is called a cross-border M&A (OECD, 2006, p. 24). In a domestic M&A transaction, the involved companies are from the same country or operate in the same economic zone (OECD, 2006, p. 24).

2.1.3 The M&A Process

In order to understand how a merger affects the success of a transaction, it is crucial to analyze M&A from a process perspective (Haspeslagh & Jemison, 1991, p. 12). Several researchers divided the M&A process into different phases though they differ in their attribution. Calipha, Tarba, and Brock (2010, p. 5) shared the opinion that the M&A process is similar to the

stages of a marriage. They argued that M&As could be divided into four phases: the courtship, the marriage ceremony, the honeymoon phase of a merger, and the phase after the honeymoon. According to Picot (2005, p. 187) and other researchers (Appelbaum, Gandell, Yortis, Proper, & Jobin, 2000, pp. 651–655), a typical M&A process goes through three main phases: Planning implementation and integration. DePamphilis (2012, p. 135) goes so far as to identify ten stages due to an emphasis on a practitioners' perspective: business plan, acquisition plan, search, screen, first contact, negotiation, integration plan, closing, integration and evaluation. Following the structure of Appelbaum et al. (2000, pp. 651–655) the graph shown in Figure 3 gives an overview of the M&A process from the acquiring company's perspective.

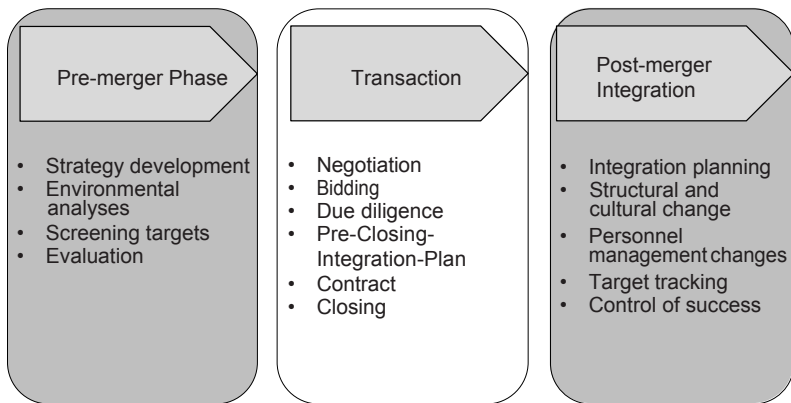


Figure 3: The M&A-Process

Adopted from: (Jansen, 2008, p. 249; Meckl & Weusthoff, 2008, p. 582)

The first step in the M&A process is called **Pre-merger Phase**. This phase covers all necessary preparation such as strategy analysis and evaluation of the company's goals (Jansen, 2008, pp. 249–250). After a company decides to engage in an M&A activity, the search for a suitable partner and the so called “screening,” begins (Meckl & Weusthoff, 2008, p. 583). In the screening phase potential target companies are evaluated and assessed, based on pre-defined criteria (Voss & Müller-Stewens, 2006, p. 13). Generally, key leaders are involved in the analyses procedure (McCarthy, Fiolet, & Dolfman, 2011, p. 19) as well as external advisors (Meckl, 2003, p. 65).

In the **Transaction Phase** the due diligence is of particular importance. The due diligence is an impartial and independent examination of the target company and is used to assess possible risks of the transaction and to improve the quality of the decision (DePamphilis, 2012, p. 180; Marks &

Mirvis, 2001, p. 83). After the due diligence the purchasing company is able to evaluate the purchase value, start negotiating and finally close the contract (Kusstascher & Cooper, 2005, p. 16).

Even though the transaction phase is decisive for the success of the post-merger phase, experts argue that the **Post-merger integration phase** is responsible for the success or failure of the merger (Appelbaum, Gandell, Shapiro, Belisle, & Hoeven, 2000, p. 678; Haspeslagh & Jemison, 1991, p. 11). In order to realize the potential synergies and achieve the expected added value, the merging companies have to integrate successfully. Hence integration is the key to post-merger success (S. A. Jansen, 2008, p. 318). Therefore, managers from both companies have to work together for the purpose of creating an atmosphere that allows transfer of resources and skills (Haspeslagh & Jemison, 1991, p. 106). The goal is to adapt, coordinate, change and to set up common structures and processes (S. A. Jansen, 2008, p. 249). Effective communication, understanding and respect are needed in order to create an atmosphere that promotes the transfer and integration of capabilities. Furthermore, effective communication and willingness to cooperate are crucial for making the merger or acquisition a success story (Appelbaum, Gandell, Yortis, et al., 2000, p. 658).

2.1.4 The Development of M&A

Over the last 100 years M&As have become the most common tool for non-organic growth (Adler, 1981, pp. 341). M&As represent a highly important growth strategy, as companies are facing a more and more complex and global business economy (Appelbaum, Lefrancois, Tonna, & Shapiro, 2007, p. 191; Cartwright & Cooper, 1993, p. 57; Melin, 1992, p. 111). Firms seeking a competitive advantage decide in favor of M&As, as it ensures survival and even promises rising profitability (Appelbaum et al., 2007, p. 191).

According to Mitchell & Mulherin (1996, pp. 193–196) economic, regulatory and technological shocks are the cause of merger waves. Regulatory shocks can occur through the elimination of regulatory barriers that might have prevented corporate combinations (Gaughan, 2011, p. 36). Other examples that influence the amount of M&A activity are globalization, free trade, industrial organization, economies of scale and scope and the widening of the gap in income and wealth (Weston et al., 2004, p. 3).

This sensitivity to external shocks makes M&As a cyclical market. The history of M&A activity can be traced back more than 100 years and is divided into six different periods, so-called waves (Kolev, Halebian, & McNamara, 2012, p. 20; Sundarsanam, 2003, p. 13):

The first merger wave (1890s-1905): Horizontal Consolidation

The first wave occurred in the US when companies created monopolies in order to ensure better control of their markets (Kolev et al., 2012, p. 12). Well-known companies such as General Electric, American Tobacco, DuPont and Eastman Kodak were formed in a friendly manner (Sundarsanam, 2003, pp. 14–15). The reason why they were classified as friendly is that there were no legal consequences for acquisitions and the transactions were mainly financed with cash (Kolev et al., 2012, p. 21). This M&A wave reflected a driver for efficiency, technological chance and migration (DePamphilis, 2012, p. 10). American industry was greatly restructured and mergers mainly took place between competitors (Sundarsanam, 2003, p. 5). This led to a high concentration on primary metals, mining and transportation (DePamphilis, 2012, p. 10). This effect, however, did not spill over to Continental Europe, Asia or the UK (McCarthy, 2013, pp. 13–14) and ended in 1905 due to fraudulent financing, the stock market crash in 1904 and the U.S. Supreme Court's upholding of the Sherman Antitrust Act (Wirtz, 2003, p. 89).

The Second Merger Wave (1916-1929): Increasing Concentration

The second merger wave occurred after the end of World War I during the postwar economic boom (DePamphilis, 2012, p. 14). Due to the formation of stronger number two companies, industries became more competitive as one single gigantic firm no longer dominated them (Sundarsanam, 2003, p. 15). A more stringent antitrust law led to fewer monopolies but more oligopolies and fostered many vertical mergers (Gaughan, 2011, pp. 42). In addition, many companies in unrelated industries merged and caused the first large-scale formation of conglomerates (Gaughan, 2011, p. 43). Still operating companies such as General Motors, John Deere and IBM were established during the second merger wave (Gaughan, 2011, p. 44). As opposed to the first wave, transactions were mainly financed with stock rather than with cash (Kolev et al., 2012, p. 21). The stock market crash in 1929 caused the end of the second merger wave (DePamphilis, 2012, p. 14).

The Third Merger Wave (1960s): The Conglomerate Era

As a consequence of the second merger wave, tougher antitrust laws were introduced and made acquisitions illegal. This led to a reduced degree of competition (Gaughan, 2011, p. 45) and formation of huge conglomerates, as this was the only alternative left (McCarthy, 2013, p. 18). Transactions were financed via exchange of shares (Wirtz, 2003, p. 89). The introduction of the Tax Reform Act in 1969 brought this era to an end as it stopped manipulative accounting practices (McCarthy, 2013, p. 18). As buyers often overpaid for companies they purchased and many acquisitions were fol-

lowed by poor financial performance, it is understandable why 60% of the cross-industry acquisitions were sold or divested by 1989 (Gaughan, 2011, p. 51).

The Fourth Merger Wave (1980s): The Entrenchment Era

The fourth wave was characterized by the breakup of many major conglomerates by corporate raiders using hostile takeovers (Kolev et al., 2012, p. 23) and leverage buyouts (LBOs) (DePamphilis, 2012, p. 14), that utilized mainly debt to finance the buyout (DePamphilis, 2012, p. 14). Transactions with the purpose to sell off numerous parts of the acquired firms, so-called bust-up takeovers (Sundarsanam, 2003, p. 17; Temple & Peck, 2002, p. 237) also resulted in the breakup of numerous conglomerates (DePamphilis, 2012, p. 14). The fourth wave may also be distinguished from the former waves by the size and prominence of the targets. In contrast to the previous periods the largest companies became targets of acquisition (Gaughan, 2011, p. 59). According to McCarthy (2013, p. 19) this was the birth of 'super capitalism' and this period became the wave of 'megamergers' (Gaughan, 2011, p. 59) and 'merger mania' (Wirtz, 2003, p. 89). During this period the number of \$100 million transactions increased substantially (Gaughan, 2011, p. 59). This 'megamergers' were driven by favorable economic conditions, increased deregulation, and financial innovations, such as junk bonds (Kolev et al., 2012, p. 23). The end of the fourth merger wave was caused by corporate scandals and the collapse of the stock market on the Black Monday in 1987 (McCarthy, 2013, p. 20).

The Fifth Merger Wave (1990s-2001): Age of the Strategic Mega-Mergers

The fifth merger wave was driven by deregulation, market liberalization and globalization (Andrade, Mitchell, & Stefford, 2001, pp. 104). Furthermore new growth opportunities were provided by changes in information technology, biotechnology and telecommunication (Sundarsanam, 2003, pp. 21). This wave was the first wave that can be considered as a global merger wave, since it was the first wave spreading from US to UK, Continental Europe and Asia (McCarthy, 2013, pp. 21). Friendly stock-swap mergers became the transaction method of choice in the fifth merger wave (Meggins et al., 2008, p. 562). To finance transactions, acquiring firms relied primarily on stock (Kolev et al., 2012, p. 25) leading to considerably less heavily leveraged combinations (Gaughan, 2011, p. 63). The dollar volume and number of transactions continued to set records through the end of 1990s before shrinking sharply when the Internet bubble burst on March 2000 (DePamphilis, 2012, p. 13).

The sixth Merger Wave (2003-2008): The Rebirth of Leverage

During the sixth merger wave The Federal Reserve introduced low interest rates with the aim to counteract the economic recession (Gaughan, 2013, p. 18; McCarthy, 2013, p. 24). This led to a quick recovery. By lowering interest rates the speculative bubble in real estate grew rapidly (McCarthy, 2013, pp. 24). This created worldwide additional demand for mortgage-backed securities and other debt securitization (Gaughan, 2011, p. 71). The characteristic of the sixth merger was that M&A transactions were purely cash-financed (McCarthy, 2013, pp. 25). Private equity buyers bought firms with the covert goal to divest them as soon as the market pushed the value of the firm. By 2007 it was not possible to have access to cheap debt and equity investors anymore (Gaughan, 2011, p. 72). This was caused by the sub-prime crisis (McCarthy, 2013, p. 27). As a consequence transactions were withdrawn which resulted in uncertainty and caused a domino effect that ended the sixth merger wave in 2008 (McCarthy, 2013, p. 27).

The following table summarizes all six-merger waves and its main characteristics:

M&A Waves				
Time period	Driving Forces	Type of M&A Activity	Key Impact and Transactions	Factors Contributing to End of Wave
First Wave: 1897-1904	• drive for efficiency • technological change • overcapacities • lax antitrust law enforcement	horizontal consolidation	• increasing concentration on primary metals, transportation and mining • rise in industry giants such as General Electric and American Tobacco	• fraudulent financing • 1904 stock market crash
Second Wave: 1916-1929	• stricter antitrust legislation • entry of United States (US) into World War I • post World War I boom	largely horizontal consolidation	• increased industry concentration • development of oligopolies • stricter antitrust laws forced companies to integrate vertically	• 1292 stock market crash • Clayton Antitrust Act
Third Wave: 1965-1969	• sustained economic growth • rising stock market • Celler-Kefauver	growth of conglomerates	• financial engineering leading to conglomeratization • increase of	• escalating purchase price • excessive leverage

M&A Waves				
	- Act tightened antitrust law - growth period in the		- earnings per share through acquisitions instead of reinvestments - involvement of large conglomerates due to prohibition of anticompetitive behavior and portfolio theory	
Fourth Wave: 1981-1989	- rising stock market - economic boom - Under-performance of conglomerates - favorable regulatory environment - weak dollar - focus on core competences - sophisticated US technology	- hostile takeover - takeover of US companies by European and Japanese companies	- Breakup of conglomerates - leverage buy-outs (LBO): purchase of company is primarily financed by debt	- widely publicized bankruptcy 1990 recession
Fifth Wave: 1992-2000	- internet revolution - economic recovery - privatization - low trade barriers - globalization	strategic mega mergers	- record levels of transactions in terms of numbers and prices - mega deals such as Daimler Chrysler merger or Exxon	- slumping economy and stock market in 2001-2002 - escalating terrorism
Sixth Wave: 2003-2008	- banks reduced lending - declining house prices, reduced value of assets - financing through debt syndication - low interest rates underpricing risk - rising stock market - high commodity pricing	- cross border transactions - horizontal mergers - growing influence of private equity investors	- increasing synchronicity among world's economy - leveraged buy-outs exploded in the US - financial investors lost their influence to strategic investors, governments and sovereign wealth funds	- loss of confidence in global capital market - economic slowdown in industrial nations

Table 1: M&A Waves

Adopted from: (DePamphilis, 2012, pp. 12–16; S. A. Jansen, 2008, pp. 63–72; Kolev et al., 2012, pp. 20–25)

2.1.5 Motives & Objectives for M&As

Previous research has placed a significant amount of effort on exploring the motives of firms engaging on M&A transactions. According to Lubatkin (1983, p. 218) the overall objective for merging and acquiring should be triggered by the goal to improve a firm's performance. Nevertheless M&A literature points out that motives of M&A are not always driven by this objective.

Existing literature provides typology of synergies in order to classify scarce resources (Chatterjee, 1986, p. 121). While many authors, like for example Lubatkin (1983, pp. 218–224), used varying levels of details in their typologies, Chatterjee (1986, pp. 120–122) was the first one classifying merger motives (McCarthy & Weitzel, 2013, p. 110) by holding a resource-based view. He illustrated three resource categories in order to explain M&A motives: **operational synergies** (leading to production and / or administrative efficiencies), **financial synergies** (leading to capital cost reduction), and **collusive synergy** (leading to market power) (Chatterjee, 1986, p. 121). Trautwein (1990, pp. 283) argues that the wave of mergers during recent years has drawn widespread attention, but the motives behind these mergers have received only modest attention. Even though, motives ultimately decide, whether a merger is going to be attempted or not (Trautwein, 1990, pp. 283). Being aware of the fact that mergers are driven by a complex pattern of motives, and that no single approach can render a full account, Trautwein (1990, pp. 283–290) tries to order the merger theories according to their plausibility and consistency with the evidence of merger motives. Therefore he (Trautwein, 1990, pp. 283–290) distinguishes between seven merger motives illustrated in the following table:

Motives			Theory	Description
M&A as rational choice	M&A benefits bidder's shareholders	Net gains through synergy	Efficient theory	M&A is planned and executed to achieve three types of synergies: financial, operational and managerial.
		Wealth transfers from customers	Monopoly theory	M&A is planned and executed in order to achieve market power. Horizontal and conglomerate M&A may allow firms to: cross-subsidize products, simultaneously limit competition in more than one market, and deter potential entrants from the markets
		Net gains through private infor-	Valuation theory/ Investment	Managers plan and execute M&A who have better information about the target's value than the

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Hauser, B.

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