

# Chapter 27

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## MERGER AND ACQUISITION: DEFINITIONS, MOTIVES, AND MARKET RESPONSES

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### Abstract

*Along with globalization, merger and acquisition has become not only a method of external corporate growth, but also a strategic choice of the firm enabling further strengthening of core competence. The mega-mergers in the last decades have also brought about structural changes in some industries, and attracted international attention. A number of motivations for merger and acquisition are proposed in the literature, mostly drawn directly from finance theory but with some inconsistencies. Interestingly, distressed firms are found to be predators and the market reaction to these is not always predictable. Several financing options are associated with takeover activity and are generally specific to the acquiring firm. Given the interest in the academic and business literature, merger and acquisition will continue to be an interesting but challenging strategy in the search for expanding corporate influence and profitability.*

**Keywords:** merger; acquisition; takeover; LBO; synergy; efficiency; takeover regulations; takeover financing; market reaction; wealth effect

### 27.1. Introduction

Merger and acquisition (M&) plays an important role in external corporate expansion, acting as a

strategy for corporate restructuring and control. It is a different activity from internal expansion decisions, such as those determined by investment appraisal techniques. M& can facilitate fast growth for firms and is also a mechanism for capital market discipline, which improves management efficiency and maximises private profits and public welfare.

### 27.2. Definition of “Takeover”, “Merger”, and “Acquisition”

Takeover, merger, and acquisition are frequently used synonymously, although there is clearly a difference in the economic implications of takeover and a merger (Singh, 1971: Conventions and Definitions). An interpretation of these differences defines takeover and acquisition as activities by which acquiring firms can control more than 50% of the equity of target firms, whereas in a merger at least two firms are combined with each other to form a “new” legal entity. In addition, it has been suggested that imprudent takeovers accounted for more than 75% of corporate failure in listed manufacturing firms in the United Kingdom over the periods 1948–1960 and 1954–1960 (Singh, 1971). In contrast, conglomerates resulting from mergers increased industry

concentration during the same periods. Because of the different economic outcomes, distinguishing between these may be useful.

Other writers too have required a more careful definition of terms. Hampton (1989) claimed that “a merger is a combination of two or more businesses in which only one of the corporations survives” (Hampton, 1989, p. 394). Using simple algebra, Singh’s (1971) concept of merger can be symbolized by  $A + B = C$ , whereas Hampton’s (1989) can be represented by  $A + B = A$  or  $B$  or  $C$ . What is important is the different degrees of negotiating power of the acquirer and acquiree in a merger. Negotiating power is usually linked to the size or wealth of the business. Where the power is balanced fairly equally between two parties, a new enterprise is likely to emerge as a consequence of the deal. On the other hand, in Hampton’s (1989) definition, one of the two parties is dominant.

The confusion worsens when the definition replaces the word ‘negotiating power’ with ‘chief beneficiary’ and ‘friendliness’ (Stallworthy and Kharbanda, 1988). This claim is that the negotiating process of mergers and acquisitions is usually ‘friendly’ where all firms involved are expected to benefit, whereas takeovers are usually hostile and proceed in an aggressive and combative atmosphere. In this view, the term ‘acquisition’ is interchangeable with ‘merger’, while the term ‘takeover’ is closer to that of Singh’s (1971).

Stallworthy and Kharbanda (1988, p. 26, 68) are not so concerned with the terminology and believed that it is meaningless to draw a distinction in practice. They also claim that the financial power of firms involved is the real issue. If one party is near bankruptcy, this firm will face very limited options and play the role of target in any acquisition activity. Rees (1990) disagrees and argues that is unnecessary to distinguish between terms because they arise from a similar legal framework in the United Kingdom.

### 27.3. Motives for Takeover

The rationale for takeover activity has been discussed for many years (see Brealey et al., 2001,

p. 641; Ross et al., 2002, p. 824). Unfortunately, no single hypothesis is sufficient to cover all takeovers and it is because the motives for takeovers are very complicated that it is useful to develop some framework to explain this activity. Of the numerous explanations available, the following are the most common in the literature, which has prompted the development of some hypotheses to explain takeover activities. Of these, eight broad reasons for takeover have emerged:

- Efficiency Theory
- Agency Theory
- Free Cash Flow Hypothesis
- Market Power Hypothesis
- Diversification Hypothesis
- Information Hypothesis
- Bankruptcy Avoidance Hypothesis
- Accounting and Tax Effects

Each are discussed in the next section, and clearly many are not mutually exclusive.

#### 27.3.1. Efficiency Theories

Efficiency theories include differential efficiency theory and inefficiency management theory. Differential efficiency theory suggests that, providing firm  $A$  is more efficient than firm  $B$  and both are in the same industry,  $A$  can raise the efficiency of  $B$  to at least the level of  $A$  through takeover. Inefficiency management theory indicates that information about firm  $B$ ’s inefficiency is public knowledge, and not only firm  $A$  but also the controlling group in any other industry can bring firm  $B$ ’s efficiency to the acquirer’s own level through takeover. These two theories are similar in viewing takeover as a device to improve the efficiency problem of the target firm. However, one difference is that firm  $B$  is not so inefficient that it is obvious to the firms in different industries in the first, but it is in the second. Thus, Copeland and Weston (1988) concluded that differential efficiency theory provides a theoretical basis for horizontal takeovers while inefficiency

management theory supports conglomerate takeovers.

In the economics literature, efficiency assumes the optimal allocation of resources. A firm is Pareto efficient if there is no other available way to allocate resources without a detrimental effect elsewhere. However, at the organizational level, a firm cannot be efficient unless all aspects of its operations are efficient. Therefore, in this literature a simplified but common definition of efficiency is that 'a contract, routine, process, organization, or system is efficient in this sense if there is no alternative that consistently yields unanimously preferred results' (Milgrom and Roberts, 1992, p. 24). According to this definition, to declare a firm inefficient requires that another is performing better in similar circumstances, thus avoiding the problem of assessing the intangible parts of a firm as part of an efficiency evaluation.

The idea of efficiency in the takeover literature arises from the concept of synergy, which can be interpreted as a result of combining and coordinating the good parts of the companies involved as well as disposing of those that are redundant. Synergy occurs where the market value of the two merged firms is higher than the sum of their individual values. However, as Copeland and Weston (1988, p. 684) noted, early writers such as Myers (1968) and Schall (1972), were strongly influenced by Modigliani–Miller model (MM) (1958), who argued that the market value of two merged companies together should equal the sum of their individual values. This is because the value of a firm is calculated as the sum of the present value of all investment projects and these projects are assumed to be independent of other firms' projects. But this *Mue* Additivity Principle is problematic when applied to the valuation of takeover effects. The main assumption is very similar to that required in the MM models, including the existence of a perfect capital market and no corporate taxes. These assumptions are very unrealistic and restrict the usefulness of the *Mue* Additivity Principle in practice. In addition, the social gains or losses are usually ignored in those studies. Apart from those

problems, the value creation argument has been supported by empirical studies. For example, Seth (1990) claimed that in both unrelated and related takeovers, value can be created to the same degree.

Synergy resulting from takeover can be achieved in several ways. It normally originates from the better allocation of resources of the combined firm, such as the replacement of the target's inefficient management with a more efficient one (Ross et al., 2002, p. 826) and the disposal of redundant and/or unprofitable divisions. Such restructuring usually has a positive effect on market value. Leigh and North (1978) found that this post-takeover and increased efficiency resulted from better management practices and more efficient utilisation of existing assets.

Synergy can also be a consequence of "operational" and "financial" economies of scale through takeovers (see Brealey et al., 2001, p. 641; Ross et al., 2002, p. 825). Operational economies of scale brings about the 'potential reductions in production or distribution costs' (Jensen and Ruback, 1983, p. 611) and financial economies of scale includes lower marginal cost of debt and better debt capacity. Other sources of synergy are achieved through oligopoly power and better diversification of corporate risk. Many sources of synergy have been proposed and developed into separate theories to be discussed in later sections.

Finally, efficiency can be improved by the introduction of a new company culture through takeover. Culture may be defined as a set of secret and invisible codes that determines the behavior patterns of a particular group of people, including their way of thinking, feeling, and perceiving everyday events. Therefore, it is rational to speculate that a successful takeover requires the integration of both company cultures in a positive and harmonious manner. Furthermore, the stimulation of new company culture could itself be a purpose of takeover, as Stallworthy and Kharbanda (1988) noted, and the merger of American Express and Shearson Loeb Rhoades (SLR) is a good example of this.

However, disappointing outcomes occur when a corporate culture is imposed on another firm following takeover conflict. This can take some time and the members of both organisations may take a while to adjust. Unfortunately, the changing business environment does not allow a firm much time to manage this adjustment and this clash of corporate cultures frequently results in corporate failure. Stallworthy and Kharbanda (1988, p. 93) found that, “it is estimated that about one-third of all acquisitions are sold off within five years . . . the most common cause of failure is a clash of corporate cultures, or ‘the way things are done round here’.”

### 27.3.2. *Agency Theory*

Agency theory is concerned with the separation of interests between company owners and managers (Jensen and Meckling, 1976). The main assumption of agency theory is that principals and agents are all rational and wealth-seeking individuals who are trying to maximize their own utility functions. In the context of corporate governance, the principal is the shareholder and the agent is the directors/senior management. The neoclassical theory of the firm assumes profit maximization is the objective, but more recently in the economics literature other theories have been proposed, such as satisficing behavior on the part of managers, known as behavioral theories of the firm. Since management in a diversified firm does not own a large proportion of the company shares, they will be more interested in the pursuit of greater control, higher compensation, and better working conditions at the expense of the shareholders of the firm. The separation of ownership and control within a modern organization also makes it difficult and costly to monitor and evaluate the efficiency of management effectively. This is known as “moral hazard” and is pervasive both in market economies and other organizational forms. Therefore, managing agency relationships is important in ensuring that firms operate in the public interest.

A solution to the agency problem is the enforcement of contractual commitments with an incentive scheme to encourage management to act in shareholders’ interests. It can be noted that management compensation schemes vary between firms as they attempt to achieve different corporate goals. One of the most commonly used long-term remuneration plans is to allocate a fixed amount of company shares at a price fixed at the beginning of a multiyear period to managers on the basis of their performance at the end of the award period. By doing so, managers will try to maximize the value of the shares in order to benefit from this bonus scheme, thereby maximizing market value of the firm. Therefore, the takeover offer initiated by the firm with long-term performance plans will be interpreted by the market as good news since its managers’ wealth is tied to the value of the firm, a situation parallel to that of shareholders. Empirically, it can be observed that “the bidding firms that compensate their executives with long-term performance plans, experience a significantly favorable stock market reaction around the announcements of acquisition proposals, while bidding firms without such plans experience the opposite reaction” (Tehrani et al., 1987, p. 74). Appropriate contracting can certainly reduce agency problems.

However, contracting may be a problem where there is information asymmetry. Managers with expertise can provide distorted information or manipulate reports to investors with respect to an evaluation of their end of period performance. This phenomenon is “adverse selection” and reflects information asymmetry in markets, a problem that is exacerbated when combined with moral hazard. Milgrom and Roberts (1992, p. 238) concluded that “the formal analysis of efficient contracting when there is both moral hazard and adverse selection is quite complex.”

Another solution may be takeover. Samuelson (1970, p. 505) claimed that “takeovers, like bankruptcy, represent one of Nature’s methods of eliminating deadwood in the struggle for survival.” An inefficient management may be replaced following

takeover, and according to Agrawal and Walkling (1994), encounters great difficulty in finding an equivalent position in other firms without considerable gaps in employment. In this way, takeover is regarded as a discipline imposed by the capital markets. Jensen and Ruback (1983) claimed that the threat of takeover will effectively force managers to maximize the market value of the firm as shareholders wish, and thus eliminate agency problems, or their companies will be acquired and they will lose their jobs. This is consistent with the observations of some early writers such as Manne. (1965).

Conversely, takeover could itself be the source of agency problems. Roll's (1986) hubris hypothesis suggests that the management of the acquirer is sometimes over-optimistic in evaluating potential targets because of information asymmetry, and in most cases, because of their own misplaced confidence about their ability to make good decisions. Their over-optimism eventually leads them to pay higher bid premiums for potential synergies, unaware that the current share price may have fully reflected the real value of this target. In fact, acknowledging that takeover gains usually flow to shareholders, while employee bonuses are usually subject to the size of the firm, managers are encouraged to expand their companies at the expense of shareholders (Malatesta, 1983). The hubris theory suggests that takeover is both a cause of and a remedy for agency problems. Through takeover, management not only increase their own wealth but also their power over richer resources, as well as an increased view of their own importance. But a weakness in this theory is the assumption that efficient markets do not notice this behavior. According to Mitchell and Lehn (1990), stock markets can discriminate between "bad" and "good" takeovers and bad bidders usually turn to be good targets later on. These empirical results imply that takeover is still a device for correcting managerial inefficiency, if markets are efficient. Of course, good bidders may be good targets too, regardless of market efficiency. When the market is efficient, a growth-oriented company can become an attract-

ive target for more successful or bigger companies who wish to expand their business. When firms are inefficient, a healthy bidder may be mistaken for a poor one and the resulting negative reaction will provide a chance for other predators to own this newly combined company. In these cases, the treatment directed towards target management may be different since the takeover occurs because of good performance not poor. In either case, Mitchell and Lehn (1990) admitted on the one hand that managers' pursuit of self-interest could be a motive for takeover but on the other they still argue that this situation will be corrected by the market mechanism.

### *27.3.3. Free Cash Flow Hypothesis*

Closely connected to agency theory is the free cash flow hypothesis. Free cash flow is defined as "cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital (Jensen, 1986, p. 323)." Free cash flow is generated from economic rents or quasi rents. Jensen (1986) argued that management is usually reluctant to distribute free cash flow to shareholders primarily because it will substantially reduce the company resources under their control while not increasing their own wealth since dividends are not their personal goal but bonus schemes. However, the expansion of the firm is a concern in management remuneration schemes so that free cash flow can be used to fund takeover, and thus grow the company. In addition, because fund-raising in the market for later investment opportunities puts management under the direct gaze of the stock market, there is an incentive for management to hold some free cash flow or internal funds for such projects (Rozeff, 1982; Easterbrook, 1984). Consequently, managers may prefer to retain free cash to grow the company by takeover, even though sometimes the returns on such projects are less than the cost of capital. This is consistent with the empirical results suggesting that organizational inefficiency and over-diversification in a firm are normally the

result of managers' intention to expand the firm beyond its optimal scale (Gibbs, 1993). Unfortunately, according to agency theory, managers' behaviors with respect to the management of free cash flow are difficult to monitor.

Compared with using free cash in takeovers, holding free cash flow too long may also not be optimal. Jensen (1986) found that companies with a large free cash flow become an attractive takeover target. This follows simply because takeover is costly and acquiring companies prefer a target with a good cash position to reduce the financial burden of any debt that is held now or with the combined company in the future. Management would rather use up free cash flow (retention) for takeovers than keep it within the firm. However, Gibbs (1993, p. 52) claims that free cash flow is only a "necessary condition for agency costs to arise, but not a sufficient condition to infer agency costs". In practice, some methods such as reinforcement of outside directors' power have also been suggested as a way to mitigate the potential agency problems when free cash flow exists within a firm. Apart from this legal aspect, management's discretion is also conditioned by fear of corporate failure. In a full economic analysis, an equilibrium condition must exist while the marginal bankruptcy costs equal the marginal benefits that management can gain through projects. Again, the disciplinary power of the market becomes a useful weapon against agency problem regarding the management of free cash flow.

#### *27.3.4. Market Power Hypothesis*

Market power may be interpreted as the ability of a firm to control the quality, price, and supply of its products as a direct result of the scale of their operations. Because takeover promises rapid growth for the firm, it can be viewed as a strategy to extend control over a wider geographical area and enlarge the trading environment (Leigh and North, 1978, p. 227). Therefore the market power hypothesis can serve as an explanation for horizontal and vertical takeovers.

Economic theory of oligopoly and monopoly identifies the potential benefits to achieving market power, such as higher profits and barriers to entry. The market power hypothesis therefore explains the mass of horizontal takeovers and the increasing industrial concentration that occurred during the 1960s. For example, in the United Kingdom, evidence shows that takeovers "were responsible for a substantial proportion of the increase in concentration over the decade 1958–1968 (Hart and Clarke, 1980, p. 99)."

This wave of horizontal takeovers gradually decreased during recent years, primarily because of antitrust legislation introduced by many countries to protect the market from undue concentration and subsequent loss of competition that results. Utton (1982, p. 91) noted that tacit collusion can create a situation in which only a few companies with oligopolistic power can share the profits by noncompetitive pricing and distorted utilization and distribution of resources at the expense of society as a whole. In practice, antitrust cases occur quite frequently. For example, one of the most famous antitrust examples in the early 1980s was the merger of G.Heileman and Schlitz, the sixth and fourth largest companies in the US brewing industry. The combined company would have become the third largest brewer in the United States, but this was prohibited by the Department of Justice on anti-competitive grounds. Similarly, in the United Kingdom, GEC's bid for Plessey was blocked by the Monopolies and Mergers Commission (MMC) in 1989 on the grounds of weakening price competition and Ladbroke's acquisition of Coral in 1998 was stopped for the same reason. At an international level, the US and European antitrust authorities were ready to launch detailed investigations in 1998 into the planned takeover of Mobil, the US oil and gas group, by Exxon, the world's largest energy group. More recently, irritated by antitrust lawsuits against him, Bill Gates of Microsoft accused the US government of attempting to destroy his company. However, horizontal takeovers are not the only target of the antitrust authorities and vertical and conglomerate

takeovers are also of concern. This is because a “large firm’s power over prices in an individual market may no longer depend on its relative size in that market but on its overall size and financial strength (Utton, 1982, p. 90).”

### 27.3.5. *The Diversification Hypothesis*

The diversification hypothesis provides a theoretical explanation for conglomerate takeovers. The diversification of business operations, i.e. the core businesses of different industries has been broadly accepted as a strategy to reduce risk and stabilise future income flows. It is also an approach to ensure survival in modern competitive business environments. In the United Kingdom, Goudie and Meeks (1982) observed that more than one-third of listed companies experiencing takeover in mainly manufacturing and distribution sectors during 1949–1973 could be classified as conglomerates. Since then, conglomerate takeover has become widespread as an approach to corporate external growth (Stallworthy and Kharbanda, 1988; Weston and Brigham, 1990).

Although different from Schall’s (1971, 1972) *Mue Additivity Principle*, Lewellen’s (1971, 1972) coinsurance hypothesis provides a theoretical basis for corporate diversification. This argues that the value of a conglomerate will be greater than the sum of the value of the individual firms because of the decreased firm risk and increased debt capacity (see also Ross et al., 2002, pp.828–829, 830–833). Appropriate diversification can effectively reduce the probability of corporate failure, which facilitates conglomerate fund raising and increases market value. Kim and McConnell (1977) noted that the bondholders of conglomerates were not influenced by the increased leverage simply because the default risk is reduced. This result remains valid even when takeovers were financed by increased debt. Takeover can also result in an increased debt capacity as the merged firm is allowed to carry more tax subsidies, and according to the MM Proposition (1958, 1963), the tax shield provided by borrowings is a dominant factor in

firm valuation. In summary, the potentially higher tax deductions, plus the reduced bankruptcy costs, suggest that conglomerates will be associated with higher market values after takeovers.

Corporate diversification can also improve a firm’s overall competitive ability. Utton (1982) stated that large diversified firms use their overall financial and operational competence to prevent the entry of rivals. One way to achieve this is through predatory pricing and cross subsidization, both of which can effectively form an entry barrier into the particular industry, and force smaller existing competitors out of the market. Entry via takeover reveals the inefficiency of incumbents as entry barriers are successfully negotiated. McCardle and Mwanathan (1994, p. 5) predicted that the stock prices of such companies should suffer. In fact, many writers had discussed this “build or buy” decision facing potential entrants (Fudenberg and Tirole, 1986; Harrington, 1986; Milgrom and Roberts, 1982). McCardle and Mwanathan (1994) used game theory to model the market reaction to direct/indirect entry via takeover. From these game theoretic models, there are indications that corporate diversification will not cause an increase in market value for the newly combined firm as opposed to Lewellen’s (1971, 1972) coinsurance hypothesis, weakening the justification of diversification as a motive for takeover.

### 27.3.6. *The Information Hypothesis*

The information hypothesis stresses the signaling function of many firm-specific financial policies and announcements. It argues that such announcements are trying to convey information still not publicly available to the market and predict a revaluation of the firm’s market value, assuming efficient markets. Takeovers have the same effect. Both parties release some information in the course of takeover negotiations and the market may then revalue previously undervalued shares.

This hypothesis has been supported by numerous event studies, demonstrating substantial wealth changes of bidders and targets (see the

summary paper of Jensen and Ruback, 1983). Sullivan et al. (1994, p. 51) also found that the share prices of the firms involved in takeover “are revalued accordingly as private information is signaled by the offer medium that pertains to the target firm’s stand-alone value or its unique synergy potential”. Bradley et al. (1983) proposed two alternative forms of the information hypothesis. The first is referred to as the “kick-in-the-pants” hypothesis, which claims that the revaluation of share price occurs around the firm-specific announcements because management is expected to accept higher-valued takeover offers. The other is the “sitting-on-a-gold-mine” hypothesis asserting that bidder management is believed to have superior information about the current status of targets so that premiums would be paid. These two explanations both stress that takeover implies information sets which are publicly unavailable and favor takeover proposals. It is also noted that these two forms of information hypothesis are not mutually exclusive, although not all empirical research supports the information hypothesis (Bradley, 1980; Bradley et al., 1983; Dodd and Ruback, 1977; Firth, 1980; *M* Horne, 1986).

Finally, the information hypothesis is only valid where there is strong-form market efficiency. Ross’s signaling hypothesis (1977) points out that management will not give a false signal if its marginal gain from a false signal is less than its marginal loss. Therefore, it cannot rule out the possibility that management may take advantage of investors’ naivety to manipulate the share price. The information hypothesis only suggests that takeover can act as a means of sending unambiguous signals to the public about the current and future performance of the firm, but does not take management ethics into account.

### 27.3.7. *The Bankruptcy Avoidance Hypothesis*

The early economic literature did not address bankruptcy avoidance as a possible motivation for takeover, largely because of the infrequent examples of the phenomenon. However, some writers

(for example, Altman, 1971) suggest the potential link between takeover and bankruptcy in financial decisions. Stiglitz (1972) argued that enterprises can avoid the threat of either bankruptcy or takeover through appropriately designed capital structures and regards takeover as a substitute for bankruptcy. Shrieves and Stevens (1979) also examined this relationship between takeover and bankruptcy as a market disciplining mechanism and found that a carefully timed takeover can be an alternative to bankruptcy.

However, intuition suggests that financially unhealthy firms are not an attractive target to potential predators. One way to resolve this dilemma is to consider the question from the bidder and target perspectives separately. To acquirers, the immediate advantages of a distressed target are the discounted price and lack of competition from other predators in the market. Much management time and effort is involved in searching and assessing targets, as well as the negotiation and funding process. This is much less for a distressed target than for a healthy one (Walker, 1992, p. 2). In addition, there may be tax benefits as well as the expected synergies. From the target shareholders’ viewpoint, the motivation is more straightforward. Pastena and Ruland (1986, p. 291) noted that “with respect to the merger/bankruptcy choice, shareholders should prefer merger to bankruptcy because in a merger the equity shareholders receive stock while in bankruptcy they frequently end up with nothing.”<sup>1</sup> However, while the bankruptcy avoidance hypothesis can be justified from the bidder and target shareholder perspectives, it fails to take the agency problem into account. Ang and Chua (1981) found that managers of a distressed company tended to stay in control if there was a rescue package or the firm was acquired.

However, not all distressed firms welcome acquisition as a survival mechanism and Gilson (1989) suggested that agency problems may not be the reason for the management of a distressed firm to reject a takeover offer. Managers dismissed from failing firms that filed for bankruptcy or private debt restructuring during 1979–1984, were

still unemployed three years later, while those still in post were on reduced salary and a scaled-down bonus scheme (Gilson and Msuypens, 1993). Clearly, bankruptcy is costly to managers as well as other stakeholders.

If takeover can serve as a timely rescue for distressed companies, bankrupt firms present similar characteristics as distressed targets. In a two-country study, Peel and Wilson (1989, p. 217) found that in the United Kingdom, factors associated with corporate failure are similar to those in acquired distressed firms. These include longer time lags in reporting annual accounts, a going-concern qualification, and a high ratio of directors' to employees' remuneration, while neither company size or ownership concentration was important. However, in the United States, different factors were identified, with the differences attributed to the variation between the UK and US business environment.

Finally, although the benefits of acquiring distressed companies have been identified, Walker (1992) argued that there are economic advantages to acquiring distressed firms after their insolvency, as many problems will be solved by receivers at the time they are available for sale. Clearly, this weakens the validity of the bankruptcy avoidance hypothesis.

#### 27.3.8. Accounting and Tax Effects

Profiting from accounting and tax treatments for takeover could be another factor influencing the takeover decision. Two accounting methods are at issue: the pooling of interests and the purchase arrangements. Copeland and Weston (1988) defined them as follows,

*In a pooling arrangement the income statements and balance sheets of the merging firms are simply added together. On the other hand, when one company purchases another, the assets of the acquired company are added to the acquiring company's balance sheet along with an item called goodwill...[which is] the difference between the purchase price and the book value*

*of the acquired company's assets...[and, by regulation, should] be written off as a charge against earnings after taxes in a period not to exceed 40 years. (Copeland and Weston, 1988, p. 365)*

Thus, the difference between the pooling and purchase methods lies in the treatment of goodwill, which is not recognized in the former but is in the latter. Not surprisingly, these two accounting treatments have different effects on company's postmerger performance. It is observed that "when the differential is positive (negative), the pooling (purchase) method results in greater reported earnings and lower net assets for the combined entity...the probability of pooling (purchase) increases with increases (decreases) in the differential (Robinson and Shane, 1990, p. 26)." After much debate, the pooling method was prohibited in the United States in 2001, which abolishes the accounting effects as a reason for merger and acquisition.

However, takeover can be motivated by tax considerations on the part of the owner. For example, a company paying tax at the highest rate may acquire an unsuccessful company in an attempt to lower its overall tax payment (Ross et al., 2002, p. 827). This may extend to country effects in that a firm registered in a low-corporate tax region will have a reduced tax liability from assets transferred associated with a takeover. The globalization of business increases the opportunity for cross-border takeovers, which not only reflect the tax considerations but have longer-term strategic implications.

#### 27.4. Methods of Takeover Financing and Payment

A takeover can be financed through borrowings (cash) or the issue of new equity, or both (see Brealey et al., 2001, pp. 645–648; Ross et al., 2002, pp. 835–838). The sources of debt financing include working capital, term debt, vendor take-back, subordinated debt, and government contributions, while equity financing consists of mainly

preferred and common shares, and also retained earnings (Albo and Henderson, 1987). The financing decision is specific to the acquiring firm and considerations such as equity dilution, risk policy, and current capital structure. Of course, the interrelation between the participants in the capital markets and the accessibility of different sources of financing is critical to any financing decision.

In debt financing, borrowers' credibility is the main concern of the providers of capital in determining the size and maturity of the debt. Some additional investigation may be conducted before a particular loan is approved. For example, lenders will be interested in the value of the underlying tangible assets to which an asset-based loan is tied or the capacity and steadiness of the cash flow stream of the borrower for a cash flow loan.

Equity financing can be divided into external and internal elements. External equity financing through the stock market is bad news as issuing new equity implies an overvalued share price, according to the signaling hypothesis. In contrast, debt financing is regarded as good news because increasing the debt-to-equity ratio of a firm implies managers' optimism about future cash flows and reduced agency problems. Therefore, debt financing is welcomed by the stock market as long as it does not raise gearing levels too much.

Reserves are an internal source of equity financing, and is the net income not distributed to shareholders or used for investment projects, which then become part of owners' future accumulated capital. Donaldson (1961) and Myers (1984) suggest that a firm prefers reserves over debt and external equity financing because it is not subject to market discipline. This ranking of preferences is called the "the pecking order theory". However, given possible tax advantages, debt financing increases the market value of the firm to the extent that the marginal gain from borrowings is equal to the marginal expected loss from bankruptcy. The contradictory implications arising from these hypotheses results from the fundamentally different

assumptions on which they are based. The pecking order theory of funding preference emphasizes agency theory, while the static trade-off argument that determines optimal capital structure assumes that managers' objectives are to maximize the market value of the firm. As to external equity financing, since this is a negative signal to the market and subject to unavoidable scrutiny, it is the last choice of funding for predators.

However, distressed acquirers have fewer options. Firstly, they may not have sufficient reserves for a takeover and may have to increase their already high gearing levels. They are also unwilling to issue new stocks, as this will jeopardize the current share price. Alternatively, they can initiate takeovers after resolving some problems through a voluntary debt restructuring strategy. Studies on the relationship between troubled firms and their debt claimants suggest that distressed firms have a better chance of avoiding corporate failure if the restructuring plan fits their current debt structure (Asquith et al., 1994; Brown et al., 1993; Gilson et al., 1990; John et al., 1992). Finally, distressed acquirers can finance takeovers by selling off part of the firm's assets. Brown et al. (1994) noted that such companies can improve the efficiency of their operations and management and repay their debts by partial sale of assets.

A growing literature on method of takeover payment shows the existence of a relationship between methods of takeover payment and of financing for takeover. Most of the research focuses on the common stock exchange offer and cash offer (Sullivan et al., 1994; Travlos, 1987). Those studies imply that wealthy firms initiate a cash offer but distressed ones prefer an all-share bid. However, it is not only the users that differentiate cash offers from all-share offers. As Fishman (1989, p. 41) pointed out, "a key difference between a cash offer and a (risky) securities offer is that a security's value depends on the profitability of the acquisition, while the value of cash does not." Therefore, it is reasonable to assume that the "costs" of using a cash offer are lower than those using an all-share offer, given conditions of infor-

mation asymmetry. In addition, cash offers are generally accepted in “preempt competition,” in which high premiums must be included in cash offers to “ensure that sufficient shares are tendered to obtain control (Hirshleifer and Titman, 1990, p. 295).”

### 27.5. Market Reaction to Acquiring Firms

Compared to research on the wealth effects of takeover on target shareholders, research on the effects on bidder shareholders is limited. Moreover, the results for target shareholders are more consistent (see Brealey et al., 2001, p. 652, 657; Ross et al., 2002, pp. 842–845) whereas those for bidder shareholders are still inconclusive. Halpern (1983, pp. 306–308) noted

*The one consistent finding for all merger and takeover residual studies is the presence of large and significant positive abnormal returns and CAR's for the target firm's shareholders regardless of the definition of the event date... From the discussion of the abnormal returns to bidders it appears that tender offers are wealth maximising events. For mergers, the results are more ambiguous but leaning toward to the same conclusion.*

Jensen and Ruback (1983), Langetieg (1978), Bradley (1980), Dodd (1980), and Malatesta (1983) use using event study methods to examine the market reaction to acquiring firms and concur with this result. More recently, Lin and Piesse (2004) argue that such ambiguities result from ignorance of the distortion effects of distressed acquirers in many samples and find the stock market reacts differently to nondistressed and distressed bidders, given semi-strong efficiency. Therefore, a sample that does not separate the two groups properly will inevitably result in confusing results, despite the noise that frequently accompanies takeover activity.

The long-term performance of acquiring firms is also a concern. Agrawal et al. (1992) found that after a failed bid, shareholders in the United States generally suffered a significant loss of about 10%

over the following 5 years. Gregory (1997) came to the same conclusion despite known differences in the US and UK business environments, claiming this supported Roll's (1986) hubris hypothesis and agency theory.

### 27.6. Conclusion

Corporate mergers and acquisitions in industrialized economies are frequent and it is accepted that large mergers in particular have huge wealth redistribution effects as well as raising concerns for corporate governance and takeover codes. This activity is an useful corporate strategy, used by organizations to achieve various goals, and also acts as a mechanism for market discipline. A number of motivations for takeover have been discussed, although these are not mutually exclusive, while others are omitted altogether.

This paper has reviewed studies on merger motives, financing and payment methods, wealth creation, and distribution between bidders' and target shareholders and the impact of takeovers on the competitors of predator and target companies (Chatterjee, 1986; Song and Walkling, 2000). The growing scope for studies on takeover activity suggests that acquisition is an increasingly importance corporate strategy for changing business environments, and has implications for future industrial reorganization and the formation of new competitive opportunities.

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## NOTES

- Especially in a competitive bidding situation, target shareholders usually receive a premium on the market price of their shares, although competition for distressed companies is rare

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