Ross School of Business at the University of Michigan

Independent Study Project Report

TERM : **Fall 1999**

COURSE : **FIN 399**

PROFESSOR : **Tyler Schumway**

STUDENT : **Wing Sze Wong**

TITLE : **Mergers and acquisition, from an acquirer's view**

Individual Finance Research 399

Wing Sze Wong

--Mergers and Acquisitions, from an Acquirer's view—

Evaluation Form
Finance Research 399
Wing Sze Wong

Prof. Tyler Shumway

-Mergers and Acquisitions, from an Acquirer's View-

Helen has done a nice job discussing the pros and cons of acquisitions from the perspective of the acquiring firm. Her analysis reflects her learning both in courses at the University of Michigan and in her summer internship job.

Tyler Shumway
Assistant Professor
of Finance

The tremendous popularity of mergers and acquisitions of the 1980s is continuing through the 1990s. Mergers and acquisitions have become a trend among firms striving for corporate growth, synergies and an increase in firm value. It is this popularity that brings about my motive in doing the research in the M&A area.

A M&A transaction usually involves two parties, the acquirer and the target. In my research, I focused on the acquirer's view and observed changes from its perspective. I will start off by investigating an acquirer's motives for acquisition, followed by a depiction of the different types of potential targets. In the second part of my research paper, I anticipate to analyze the changes in stock price of an acquirer due to the acquisition. While most of the firms think that M&A transactions are always beneficial for the well-being of a firm, I would testify this common notion by investigating the success and failure of some of the transactions happened in the last year.

Driving Forces for Acquisitions

Quest for Corporate Growth

Internal and external corporate growth has long been a preoccupation of the financial and business communities of the world. Pressures in the international business arena to become global via larger core business, increasing numbers of product lines, reducing per-unit distribution costs, and expanding manufacturing and service facilities in multiple locations. If a company is identified as a growth company, it becomes more attractive to the investment community. Growth companies command highprice-earnings ratios, their value on the market is also greater,

Operating Synergy

When firms merged, resources of both the targeted firm and the acquirer may become more valuable and utilizable than before because of the economy of scale. When the combined value of the merged firm is greater than some of the values of the two firms, we can conclude that the merger brings about synergy. This synergy leads to enhanced revenues and cost reductions.

Financial Synergy

Diversification resulted from mergers allows for more guaranteed cashflows and reduces the business risk of a firm as a whole. Risk of bankruptcy is reduced and cost of debt requested by the debtors will be lowered. The company is able to issue more debt and thus the debt-equity ratio of the merged firm can be raised, changing the capital structure of the company.

Types of Targets

Companies in a different Industry

Targets of different acquirers are different because of the above various forces. However, they can be generally categorized into three types. The first type of targets are firms which lie in a industry different from the acquirer. The acquirer may begin with the identification of a fragmented industry with a number of small to medium sized players, none of which are dominant. The acquirer then purchases a company in the targeted industry. By taking such an approach, it not only allows the acquirer to step into a new industry and test for profitability in a new area, the targeted company also serves as a "platform" for further leveraged acquisitions of firms in the same industry.

Companies in the same Industry

Another type of targets are those having the same industry focus as the acquirer. This kind of acquisition is mainly for increasing market share and thus the power in a specific industry. The target may also serve for the purpose of supplying significant industry knowledge as well as experienced operating management teams. For other cases, the target may share the same kind of operation or production procedures. By combining the two firms, economy of scale can be achieved and redundant operation can be cut off. The operation synergy I stated in the above is the result.

Companies in the supply chain or distribution networks

Companies which are suppliers or distributors of the others are always the targets. Vertical integration via the acquisition of these companies results in a higher control over the production and distribution process before the product reaches the customers. By exerting control over the suppliers, quality of the supplies and flexibility in production deadlines are quaranteed. Similarly, acquiring a distributor allows for control over the distribution channels. But most importantly, the goal of either kind of vertical integration is to lower cost.

Others

Many acquirers are using other strategies to differentiate themselves from their competitors and to develop a source of comparative advantage. For instance, they may buy undermanaged divisions or subsidiaries of large companies. Others may focus on out-of-favor industries, Their contributions in such cases are typically to provide additional equity capital for growth or to assist private companies in making a transition of ownership. Finally, a number of firms have also begun to look outside the US for investment opportunities.

When we chase the price direction of the stocks around the time of merger, there seems to be a common trend that prices of the acquirers drop observably while those of the targets rise. I have investigated the top ten biggest deals for 1998 and their pric changes during the date of the merger announcement was made (see the Table 1 below). The targets in average had a 10.16% increase in price, while the acquirers encountered a average price drop of 5.12%.

Table *1*

Announcement Date	Target	Acquirer	Announced Price (in million)	Price Change on the Date of Announcement	
				Target	Acquirer
12/1/98	Mobil Corp.	Exxon Corp.	80,008	9.73%	-4.50%
7/28/98	GTE Corp.	Bell Atlantic Corp.	71,109	3.30%	-1.53%
4/6/98	Citicorp	Travelers Group Inc.	69,560.86	18.34%	--
5/11/98	Ameritech Corp.	SBC Comm.	69,181	4.84%	-8.41%
4/13/98	BankAmerica Co.	Nationsbank Corp.	56,484.96	5.48%	--
6/24/98	TCI Group Inc.	AT&T Corp.	48,000	8.41%	-8.22%
6/8/98	Norwest Bank	Wells Fargo	33,192.21	--	-7.24%
4/13/98	First Chicago NBD	Bank One Corp.	29,361	13.33%	-1.72%
6/19/98	General Re Corp	Berkshire Hathaway Inc.	48,000	17.82%	-4.20%

Average price increase for targets on the date of merger: +10.16%
Average price decrease for acquirers on the date of merger: -5.12%

The abrupt drop in price is mainly due to the negative market response to the announcement of the merger. There may be a couple reasons explaining for this negative response. In the below, I will discuss some of my arguments in details:

Increase in debt or decrease in firm's retained earnings

Buying up a company requires a lot of money. For instance, the deals included in the above tables all have a price exceeding $20,000 million. This amount of money may arise from a big chunk of the acquirer's retained earnings. Therefore the market may not positively support the merger as the acquiring firm is giving out too much money which is viewed to be affecting the firm's future performance.

If the acquiring firm is short of retained earnings enough for paying for the acquisition price, it needs to borrow money from the outside by obtaining loans or issuing bonds. The debt ratio of the company thus increases and a higher debt-return rate will be requested by the debt holders. An increase the firm's cost of capita(ie.cost of debt + cost of equity) is therefore resulted. Since we obtain the price of stock by discounting the value with the cost of capital, an increase in the cost of capital leads to a drop in stock price.

Lemon Problem and Agency Cost Issue

The drop of price also brings my attention to the possibility of the Lemon Problem. Potential investors know that a company's management has both the ability and the incentive to present the company more favourably than the facts warrant. It is due to the agency cost problem in which it points out that management and the investors always have disparity in goals and preferred ways of operating businesses. The investors may think that management's decision in buying up another company is because of the management's own benefits. The investors may also wonder if the acquisition is needed for profitable growth opportunities of the company. Thus they would expect the acquisition transaction to be overpriced and hold a negative response to the transaction. Stock price of the acquiring firm is therefore affected and a huge drop in price may seem inevitable.

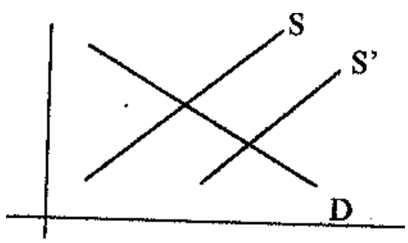
EPS dilution

When the acquisition is transacted by issuing stocks to the acquired firm by the acquirer, stockholders of the acquirer may expect that issue of new equity would depress stock price. It is expected that the increase in the number of shares outstanding would dilute any reported earnings. The earnings for each share of stock thus is reduced and this expected fall in EPS makes the stock look less attractive.

Price pressure resulted in the increase of equity supply

Because of the increase in the number of new shares, there is an increase in the supply of the company's equity, i.e. a downward shift of the supply curve(see Figure 1 below). With the demand curve of the company's equity sloping downward, the shift in the supply curve results in a drop in price of the equity.

Figure 1



The ultimate goal of any mergers and acquisitions is always the increase in the price and value of the merged firm. There are always good mergers after which the three goals of corporate growth, financial synergy, and operating synergy are attained and thus a continuous increase in the price of the stock is resulted. For instance, the acquisition of Bell Atlantic and GTE Corp. are one of the successful ones. Both of the stocks find their prices increased by about $20 after the course of acquisition. The prices dropped during August and September due to the Asian economic crisis and crashes in those markets. However, their droppings were the least when comparing to their peers. Also, the stocks bounced back very quickly by the end of September and continued to rise thereafter, with the fact that the US market was still very volatile at that time. This shows that the investors are confident about the company's future performance and thus put a high regard on it. (See Figure 2 and 3)

However, there are some mergers or acquisitions that would fall short of the managers and investors' expectation. They may not be successful since the stock price decreases instead of increases as a result of the merger. For instance, the Bank One Corp. stock dropped from a price of $66 to $55 in less than two months after the acquisition of First Chicago NBD in April 1998. The price flowed at the level of $55 for a long period of time with no observable sign to rebound (See Figure 4). I would ascribe an unsuccessful merger like this to the following reasons:

Overpaying

Overpaying may be the worst and most frequent mistake made by acquirers. The acquirer used to presume that future growth in value of the target business will overcome the initial overpricing. Optimism abounds in projecting revenues, profits, and cash flow. Too often, the buyer is even more optimistic than the seller about the growth prospects of the business and the industry. The latter situation is particularly in evidence when the targeted company is in a similar business or the same business niche. The buyer assumes too quickly and too often that he or she knows that business and is confident of being able to grow it profitably.

Buying the wrong business

Though it may not be the case for Bank One Corp., it is true for others if the target is a company with a different industry focus. The acquirer's managers may lack the knowledge in target's business and market niches. It may result in losing customers of target's business or running the business at a high cost. Sometimes, the acquirer may also get too diversified that they lose focus in their original business. All these increase the total cost and lead to a downfall of the acquirer.

Underestimating the funding needed to attain the projected growth

The funding needed for additional working capital, property, plant, and equipment, or research and development to attain the projected growth may be underestimated. This is surprisingly true for a number of acquisitions of businesses related to the main business of the buyer. Because that acquirer may assume that it knows all about the industry niche, the particular customers of the target's business, or industry trends. These acquirers stop questioning and start buying before all important and relevant facts become known.

Imposing acquirer's standards on the target's employees

The acquirer's standards in operating and reporting procedures are imposed on the seller's employees. These standards are not understood, implemented fully, and may not apply.

This leads to questions of whether the buyer's proposed procedural changes are necessary and important, whether the target business would be better because of the changes.

Target's management team replaced by the acquirer's

Some buyers insist on placing one or more of their own key people into top management positions of the acquired business. This lack of concern for the human factor in acquisitions is a sure way to fail quickly. Putting new people to the acquired company shakes the organizational structure. Lower level employees of the acquired company may lose confidence and loyalty for the company when the senior people they trust and look up to are forced to leave the company.

Incompatible business culture

The business culture of a company and its management represent the single biggest impact on whether a business will be successful in the urge to merge. Companies exert major influences on the lives of all owners, managers, employees, and even customers and vendors. The culture of each person and that of the company mutually shape the future life of the others. If the two merged companies found to have different cultures and employees do not fit in with each other, employees' efficiency is substantially reduced and any forms of communications and co-ordination problems will take place,

Although the stock price may be depressed by the acquisition and there are quite a few mergers out there in the market place which are found to be unsuccessful, I believe that the trend of mergers and acquisitions will continue as long as the market is not fully consolidated. The benefits I discussed in the first part of the paper, the corporate growth, financial and operation synergies, are far too attractive. Though it may not be the desire of the stockholders to merge, managers will insist in doing so as long as there is room for the above benefits.

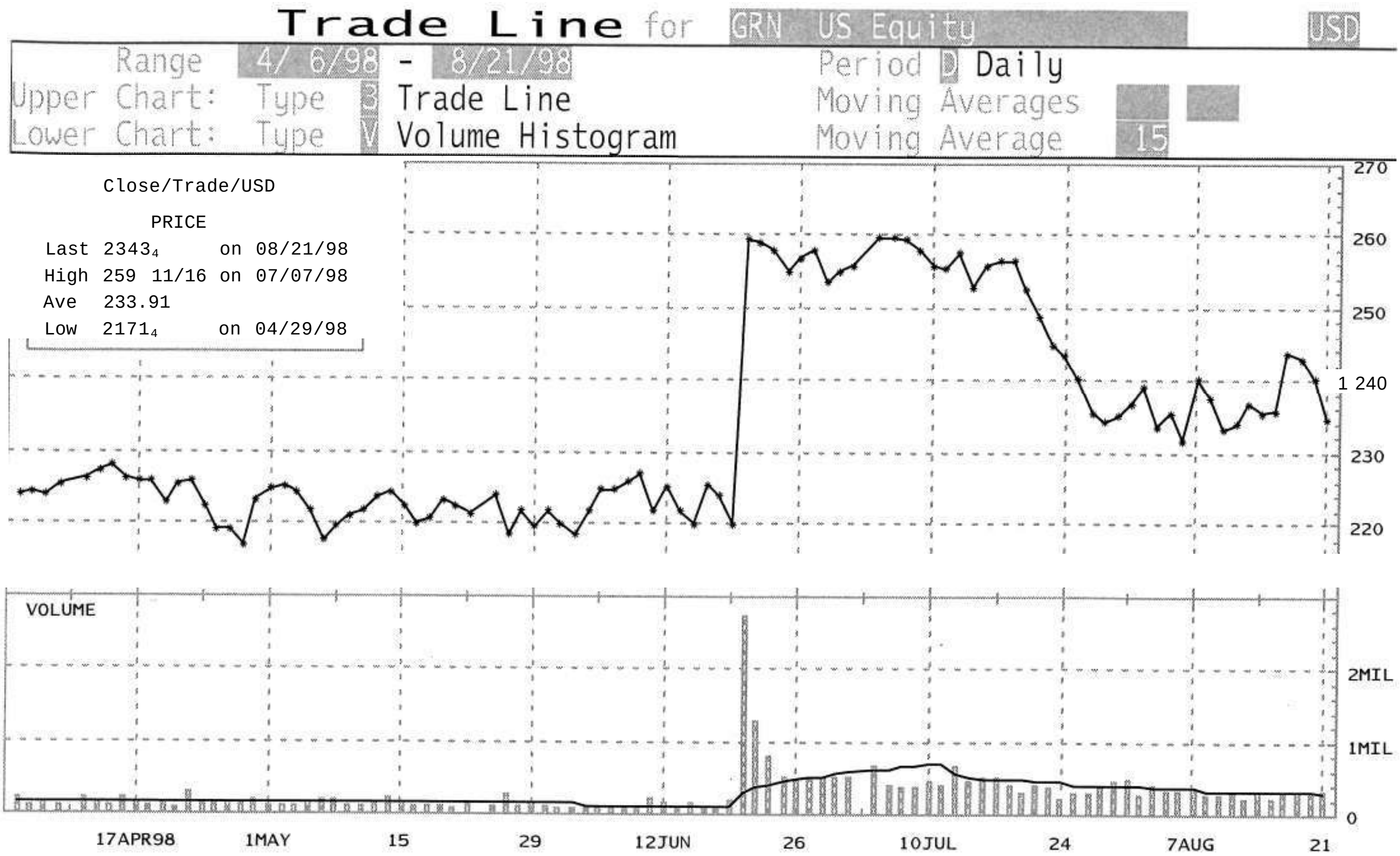
Figure 2 and 3

Bell Atlantic Corp.(BEL) announced to acquire GTE Corp. (GTE) on July 28,1998. Both of the stocks show a steady upward trend thereafter. They both do not seem to be very much affected by the Asian market crisis occurred in September and October.

Figure 4

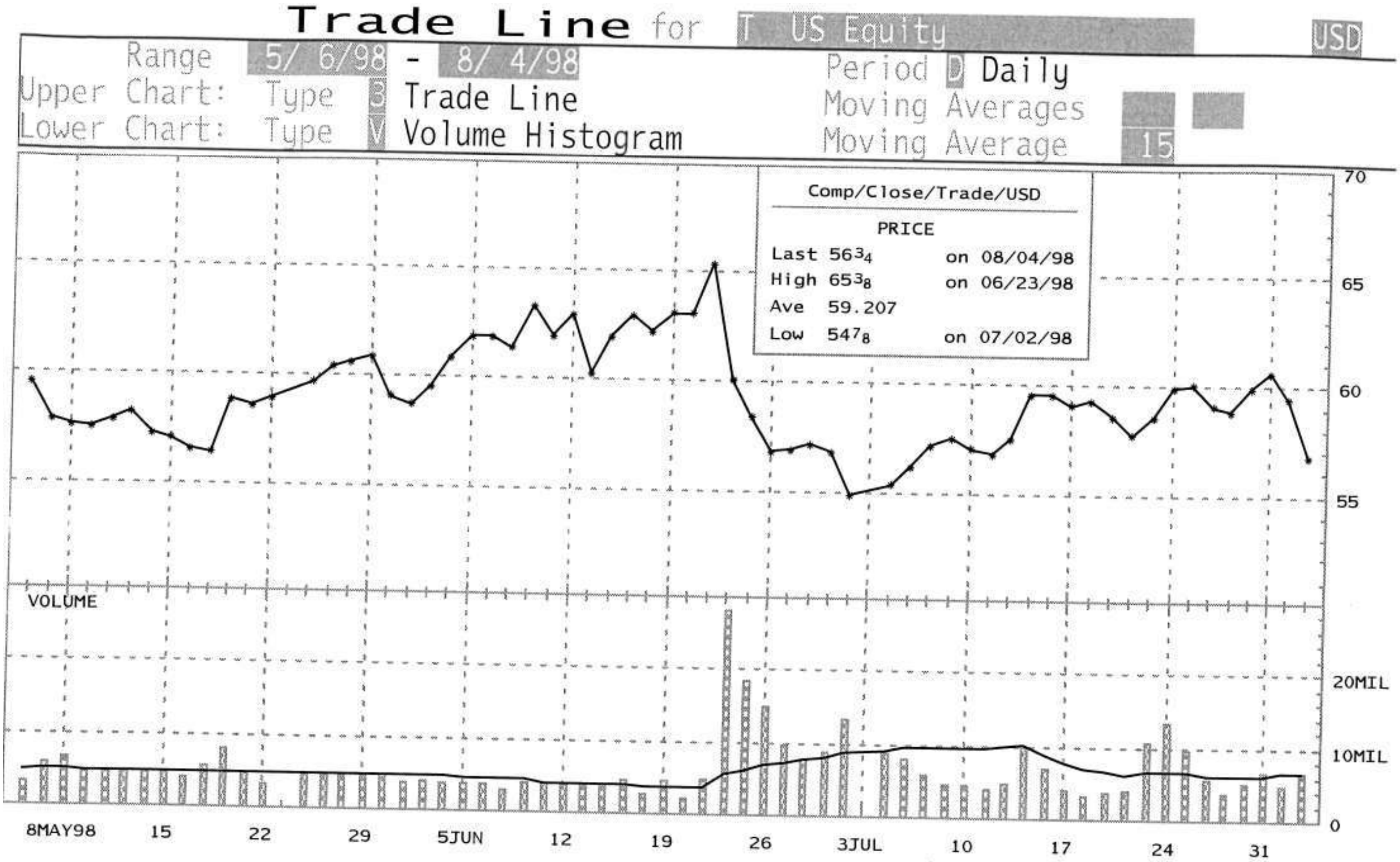
Stock of Bank One Corp. dropped from a price of $66 to $55 in less than two months after the acquisition of First Chicago NBD in April 1998. The price flowed at the level of $55 for a long period of time with no observable sign to rebound. This shows the failure of the acquisition.

General Re Corp. -A typical example of a target showing abrupt increase in price and trading volume on the day of announcing the acquisition.



Another example: TCI Group Inc., with a 8.41% increase in price.

AT&T Corp. as the acquirer, found the price dropped by 8.22% on the announcement date.



Though there is not an obvious price increase as what could be found in other targets, Ameritech did encounter a tremendous increase in volume on the day of announcement.