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THE MARKET FOR MERGERS AND THE BOUNDARIES OF THE FIRM

KEVIN GARDINER*

After the spectacular boom and bust of the millennium, global merger and acquisition activity has been gathering momentum again. In 2005, the value of deals announced rose by some 30 percent, to a level more than two-and-a-half times its 2002 nadir. Relative to market capitalisation, the value of M&A was up by 15 percent and 67 percent over the same periods. Cross-border deals have risen by more than the average. By region, growth has been fastest – though from much lower levels – in Asia, which largely missed the millennium frenzy.

As yet, there seem to be few obvious signs of excess. As a proportion of market capitalisation, the value of deals announced in 2005 was just half that in 1999. The proportion of stock-financed deals is relatively low; bid premia are unremarkable; and the exotic, cross-industry, epoch-defining “blockbuster” deal is conspicuous by its absence.

In this article we take a quick look at the likely drivers of M&A activity, at its possible worth to share-

holders, and at the room for further consolidation going forward. We conclude that corporate capacity and incentives to merge and acquire are still high, and that the “value destruction” case against M&A has been overstated.

The drivers of M&A

We can identify four drivers of M&A activity that are perhaps each necessary but not sufficient conditions for a merger wave to commence. They are (in no particular order):

- A persuasive rationale for merger
- Business confidence
- The availability of finance
- Favourable valuations

A persuasive rationale for merger

By buying or merging with a peer, a company is altering the boundaries of its day-to-day business. There are many reasons for doing this – some more compelling than others.

The micro case: Most obviously, perhaps, there is what we might think of as the conventional, micro case for merger, namely the search for company-specific integration gains and the creation of improved market power.

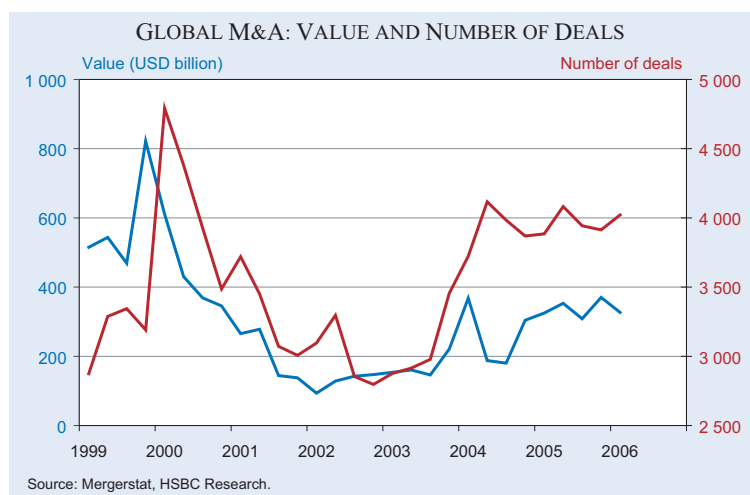
The efficiency gains that can follow a successful acquisition or merger include the elimination of duplicated costs; the realisation of returns to scale; enhanced bargaining power with suppliers and customers (subject to antitrust law); and lowered effective tax rates. These things

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Efficiency gains are an obvious motive for M&A

Figure 1



raise not just the acquirer's headline earnings but economic value added in the combined entity.

The macro case: There is a deeply-rooted belief, held by many managers and investors, that organic profit growth is more difficult to achieve in a low-inflation, "globalised" world. Growth by acquisition thus starts to look more attractive.

Some slow-growing sectors have indeed followed this strategy: tobacco, food retailing and utility industries, for example. But in aggregate, it is not clear whether this belief is justified. There is nothing intrinsic to either disinflation or globalization that requires trend growth to slow or profitability to fall.

A low inflation environment and globalisation are conducive to growth

Indeed, to the extent that the taming of inflation has fostered a smoother business cycle, it might be a positive development for growth – it is surely no coincidence that the slowest growth years in recent history were the inflationary 1970s.

The history of the twentieth century as a whole suggests that a more integrated global economy grows more quickly, not more slowly – the emergence of new markets and of diversified supply chains is generally good for business. Nor is there much evidence of either a material slow-down in volume growth or of any trend decline in profitability in the last two decades (see charts). But the belief is ingrained, and will surely persist for a while yet.

Special cases – regulatory and national strategic concerns: Changes in the regulatory environment can be a potent driver of merger activity. For example, the relaxation of controls on UK broadcasting ownership

triggered a wave of (ongoing) consolidation among television and radio companies. Elsewhere, banks, insurers and asset gatherers across Europe are watching carefully the piecemeal progress towards the creation of a genuine single market in EU financial ser-

Figure 2

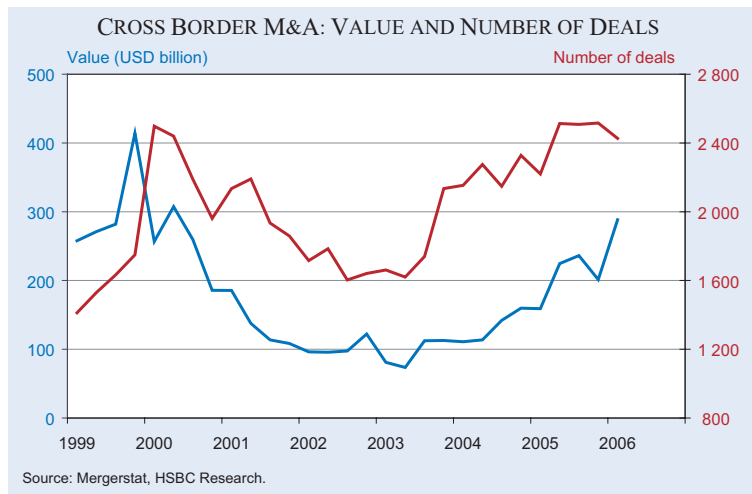


Figure 3

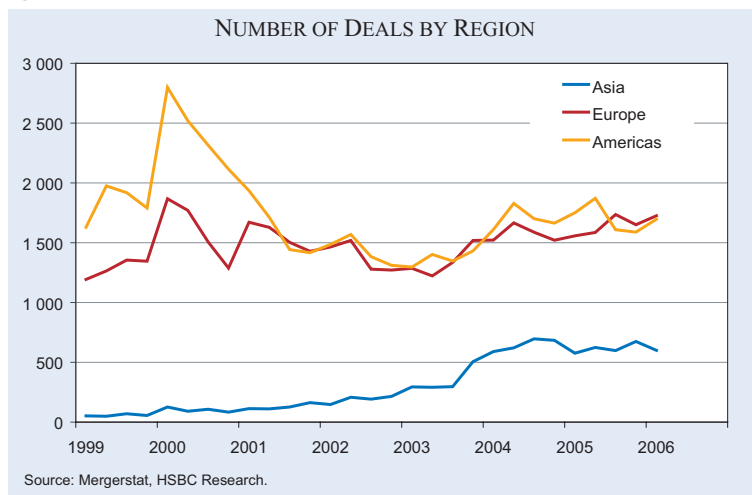


Figure 4

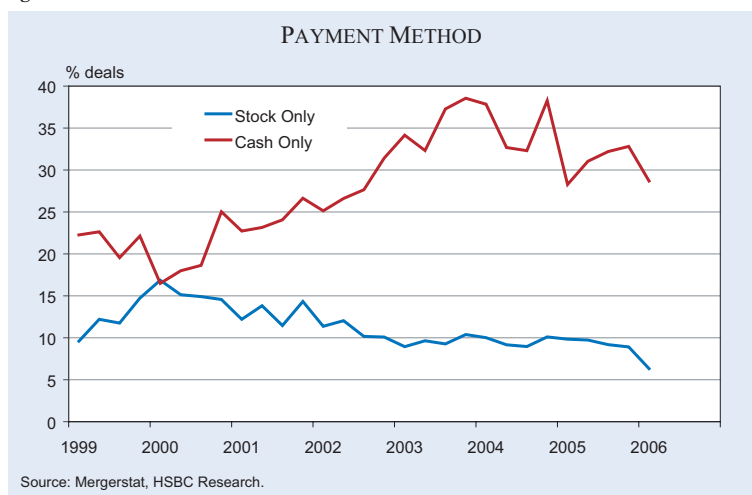
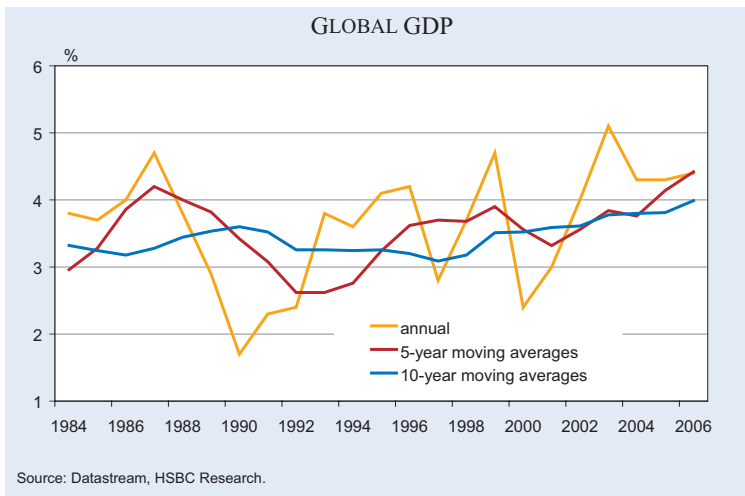


Figure 5

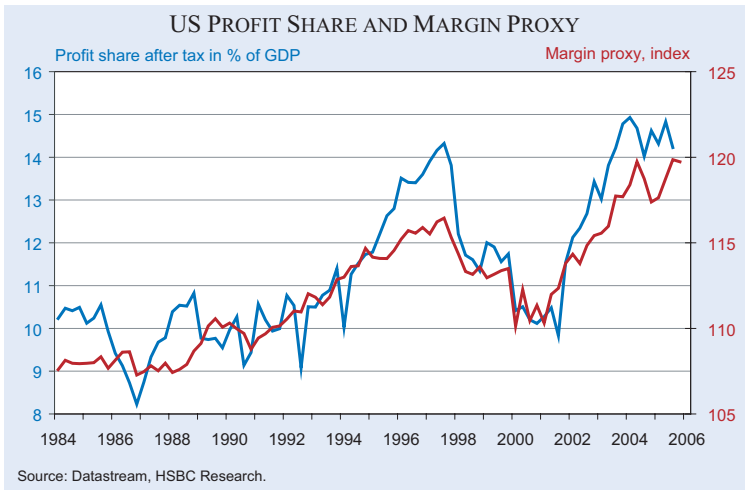


ices, and using M&A to help position themselves accordingly.

National governments – and central banks – can help shape merger and acquisition activity more directly, and not always in a way that is consistent with principles of positive economics. The EU has (in)famously spent more than a decade trying to formulate a common code for assessing mergers and takeovers in pursuit of its nominal commitment to a single market for capital, only to be frustrated by national governments seeking to protect local interests.

Topical illustrations here would include lists of “strategic” interests to be ring-fenced from foreign ownership, and the fostering of “national champions”. Varying effects have been felt in the European aerospace, banking, pharmaceutical, utility and even food processing industries as domestic M&A has been preferred over cross-border deals. Further

Figure 6



afield, it is all but impossible for foreign companies to buy control of Chinese companies, for example.

China also serves to illustrate a more positive effect that “strategic” national concerns can have on M&A activity. China’s wish to secure long-term oil supplies, for example, led to CNOOC bidding (unsuccessfully) for a US oil company in 2005. More generally, the director of China’s “National Commission for Brands Promotion” has argued for the creation of international-

ly-visible brands by China (Financial Times, 30th August 2005). IBM’s personal computer division was bought by Lenovo, and Haier made an aborted bid for Maytag.

The boundaries of the modern firm are thus shifting along several axes. A more committed approach to profitability is encouraging increased horizontal and vertical integration as peers, suppliers and customers are absorbed. Further horizontal and vertical integration is also being driven, however mistakenly, by the belief that organic growth and profits are more difficult to come by. Foreign direct investment is a fertile source of integration globally.

A third dimension in which M&A is reshaping the firm is the extent to which activities are driven by the interaction of market forces with government – to extend the analogy, we might think of this dimension as market “depth”. Some European mergers in particular are being negotiated on the margin of government. It is easy to imagine a combined entity opting for a deeper involvement with a national government in the hope of being sheltered from overseas takeover.

Lastly, and with some artistic licence perhaps, we might suggest that a growing awareness of the longevity of some corporate liabilities is helping reshape companies in a fourth dimension, that of time. In countries where defined-benefit pension schemes exist, significant pen-

Economic nationalism has given preference to domestic over cross-border M&A deals

sion deficits are beginning to shape deal-making. The practical relevance of such deficits to long-term corporate cashflow may be overstated by current accounting frameworks, but there is no doubt that corporate financiers are paying attention to them when advising would-be bidders.

Business confidence

Assuming a rationale for merger exists, one of the factors affecting timing will be the general state of business confidence. Few chief executives will attempt a significant acquisition if they believe that business is about to take a material turn for the worse.

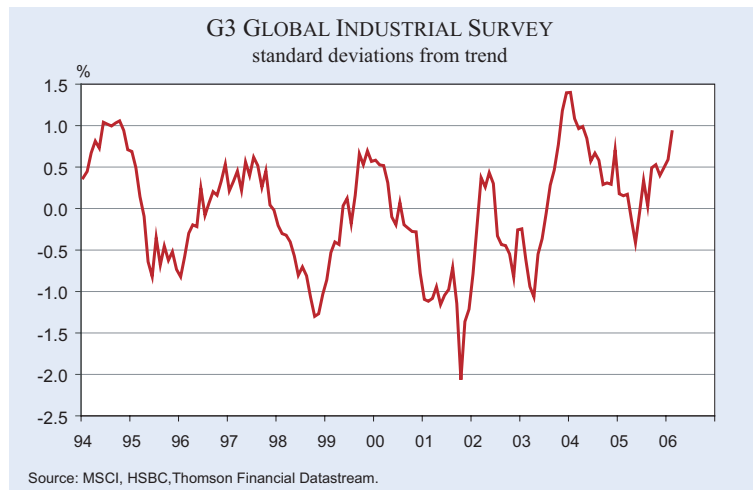
The widely-followed surveys of industrial confidence, such as Ifo's own survey, or the US ISM index, trace out reasonably cyclical paths over time. However, not all sectors are adequately represented in such surveys, and the frequency and amplitude of the cycles revealed by them differs from the M&A cycle.

Econometric analysis might yet reveal a statistically significant long-term correlation between such surveys and some measure of M&A activity, with other factors accounting for the divergence of the two cycles. Meanwhile, we note that survey levels are currently relatively buoyant (see chart). In February 2006, the Ifo survey's headline index hit its highest level since October 1991.

The availability of finance

Internal fund generation is currently strong. Global net income has almost tripled from its 2002 low, and cashflow has been further augmented by the relatively slow start to the capital spending cycle (a hangover from the excesses of 1999/2000, no doubt). Balance sheets have been rebuilt, and are arguably under-leveraged: transatlantic net debt/EBITDA ratios have fallen by more than a quarter since 2001, and we estimate that there is around \$1.5 trillion of gross cash on the non-financial transatlantic balance sheet (yielding a negligible real return).

Figure 7



In practice, the usual source of financing for deals is external. At present, the banking system itself is more than adequately capitalised (with many banks returning excess capital to shareholders) and credit spreads are historically low. Rising interest rates at the Federal Reserve and the ECB may start to affect credit quality and the willingness of banks to lend at some stage, but for the time being, external funding is both plentiful and cheap. M&A is one of the factors cited as responsible for a recent acceleration in Euro area bank lending.

Equity issuance associated with M&A has as yet been relatively modest, but this is not surprising given corporate balance sheets and the level of real borrowing costs: the use of stock as an acquisition vehicle tends to come closer to the peak of an M&A cycle, and is usually a signal that valuations are becoming stretched (see below).

In a somewhat ironic development, one specialist participant in the M&A cycle is enjoying particularly easy access to funds at present. Defined benefit savings schemes have recently been encouraged, by accounting and regulatory changes, to reduce their holdings of equities, and to "immunise" their long-term liabilities by switching into a mixture of bonds and "alternative asset classes" – the latter including holdings in private equity groups. In some countries this has coincided with policies aimed at fostering the growth of the venture capital industry independently, with the net result that the private equity sector has experienced strong inflows.

With the general level of bond yields partially damped by those liability-driven purchases, some

External financing of
M&A has come to
include private equity

private equity groups have been able to leverage their inflows cheaply to purchase quoted targets – in some cases, no doubt, the very same assets spurned by the traditional long-only, defined-benefit buyers. A side-effect of regulators' understandable wish to protect defined-benefit savers has thus been a marginal shift towards private equity sponsored M&A at the expense of traditional portfolio investment.

Favourable valuations

For firms considering stock-financed deals, average valuations are arguably less important than their distribution: companies enjoying relatively-high price/earnings multiples can acquire cheaper firms without diluting their earnings. After 4 years of converging valuations, PE ratios have in the last year started to diverge once more, albeit from subdued levels.

As noted, however, for the time being most deals are not being financed by the issuance of equity, and the valuations that matter most might instead be those that compare target values with the cost of borrowing or the opportunity cost of using cash. Such valuations currently are well below the average levels of the last twenty years in most regions, partly reflecting the unusually low levels of real interest rates. Even now, some three years into the stock market rally, there are many European companies whose net credit costs are below the dividend yield paid on their stock.

The case against M&A: not proven

“It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.” – Mark Twain

An investment maxim that arguably needs debunking – along with the idea that organic growth is dead, or that low inflation means low profitability – is the notion that M&A is necessarily destructive, and a contributor to low shareholder returns.

It is one thing to believe that companies should be in some sense “non-tradeable”. This is the stuff of normative, not objective, analysis, and part of the political debate. But it is a different matter to suggest that, within the accepted context of a liberal market framework, mergers and acquisitions are generally bad for the owners of companies.

Even if it could be shown conclusively that M&A results in a net incremental loss of value to shareholders, it might be a loss that owners would tolerate when set alongside the perceived costs of the counter-factual situation in which merger and acquisition activity is absent. “Undisturbed” values of companies might be lower if there were no market for corporate control: liquidity would be reduced, and corporate governance looser.

The friction and volatility introduced by M&A might thus be an unavoidable component of the liberal economic model. The existence of a market for corporate control should be permitted, like any other trade in a free market framework, unless market failure becomes evident. The harshness of such a model is often overstated: there is room within it for government to provide an adequate safety net for workers who lose their jobs through restructuring, and indeed to tax any excessive profits that might arise from it.

Empirically, of course, it is extremely difficult to isolate the effects of M&A on shareholder value. There are many variables to control for, and unless a strong version of the efficient market hypothesis holds, the period of analysis can be open-ended. Focusing on the short-term impact on shareholder returns of a bid, for example, may exclude the longer-term synergies that might be extracted from the combined group.

Longer-term analyses are themselves confounded by the increased room for macroeconomic and sector-specific variables to affect company values independently of the deals under consideration. More detailed “clinical” studies that focus in depth on individual deals are perhaps most satisfying, but their results are difficult to generalise.

And this implicitly assumes that merger activity proceeds in a series of discrete, non-overlapping transactions that permit each deal to be analysed clearly. But many large deals are perhaps never really concluded, and effectively remain work in progress. To further complicate matters, much M&A activity is prosecuted by “serial acquirers”, large firms for whom the ongoing, unceasing acquisition and exchange of corporate assets is part of normal business life. Such activity can last for decades, and the web of agglomerated franchises and their values can be impossible to disentangle.

These complications have not prevented economists from attempting to measure the incremental value of

The effects of M&A on shareholder value are not easily determined

deals. Perhaps most recently and comprehensively, Robert F Bruner (2002, 2004, 2005) has identified and summarised the results of more than 130 “scientific” research papers published in academic journals and based on M&A data mostly from the last 30 to 40 years.

Bruner’s conclusions from his authoritative reading of the literature will surprise many. He notes huge dispersion among the various results, and in “Deals from Hell” carefully documents ten spectacular failures. He concludes, however, that generally, and in contrast to the received wisdom cited above:

“The fashionable view seems to be that M&A is a loser’s game. Yet an objective study of more than 130 studies supports the conclusion that M&A does pay. These studies suggest that the shareholders of the selling firms earn large returns from M&A, that the shareholders of the buyers and sellers combined earn significant positive returns and that the shareholders of buyers generally earn about the required rate of return on investment”. – Bruner, 2005, p13

Bruner notes that “serial acquirers” seem to be more successful than companies that are more sporadically active; that cash and debt-financed acquisitions seem to add most value; and that strategic fit, or the degree of ‘relatedness’, is important. Two of these at least are in my view general characteristics of the current upturn in M&A activity, and as noted above are reasons for thinking that the acquisition cycle is not yet excessively frothy (or “irrationally exuberant”, if you prefer).

If anything, the academic literature’s focus is, despite its extent, in most cases a rather narrow one. Most studies focus on short-term event windows: deals are often appraised on the basis of stock price movements over periods that in most cases are counted in days, and in many instances end with the announcement of a bid.

More tellingly, perhaps, the published studies (and the discussion above) generally exclude a potentially important consideration, namely, the possibility of third-party, or industry-wide effects. Merger activity may affect the strategic position not just of the immediate players

but of the wider industry (perhaps even of the corporate sector at large).

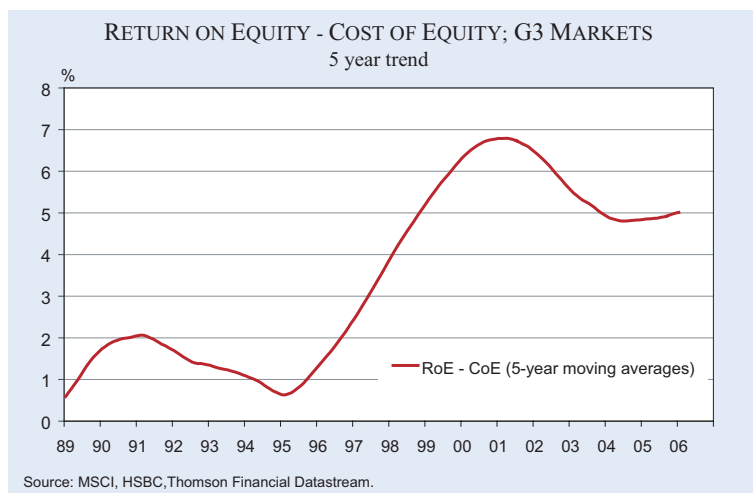
A reduction in competition, of course, can be good for companies but bad for their customers and suppliers. Antitrust authorities rightly keep a close eye on M&A, and track closely the changes in market power that might follow a merger.

In practice, the commercial world is not characterised by clear-cut textbook extremes of perfect competition and full-blooded monopoly. The vast bulk of products are differentiated either by nature or by physical location – transport costs make the global market in such near-commodities as steel and cement much more fragmented than one might imagine, for example – and the reality is that most business is transacted under conditions of varying degrees of imperfect competition. (Just as much international trade is best viewed as part of a global supply chain, rather than the “head to head” competition that grabs headlines.)

When the US Department of Justice calculates its Herfindahl indices showing the changes in concentration that would follow a mooted merger, prospective increases in concentration are not outlawed automatically but are compared to specified threshold levels. National European regulators, and the EU Commission, operate a still more judgemental approach. There is as yet little sign that competition in aggregate has fallen too far for regulatory comfort (some possible exceptions might include consumer software, aerospace and national utilities). For companies and their owners this likely leaves room for further consolidation, enhanced bargaining power and higher profitability.

M&A activity may not only affect the players but the wider industry

Figure 8



Have the successive waves of merger and acquisition activity in the 1980s and 1990s contributed to the improved trend over this period, on both sides of the Atlantic, in real corporate profitability? This trend has coincided with a steady reduction in the likely long-term cost of capital to companies, with the result that the gap between the return on equity and its cost has risen markedly, pointing to a possible increase in the ability of companies to deliver “super-normal” returns, for a while at least.

Factors other than consolidation have likely played a role in raising the return on capital, of course. Company managements are arguably more focused on delivering higher returns to shareholders than was the case a quarter-century back, particularly in Europe. Labour agreements are more decentralised; the business cycle is smoother, thanks partly to the decline in inflation and improved monetary credibility; and the opening-up of global markets has allowed companies to diversify their cost bases and address new customers.

It is, moreover, difficult to show that concentration has increased over time, though again the appropriate comparison in this context might be with a counter-factual scenario in which M&A had been prohibited (that is, in which concentration was lower than it actually was).

The idea that concentration might trend higher over a prolonged period sits uneasily with the notional cut-and-thrust of capitalism. Many of the technology and telecom companies around which the bubble of the late 1990s inflated didn't exist five years earlier; many of them don't exist now. But some industries and franchises do last for many decades, and the two big merger waves of the last quarter century do not appear to have been fully unwound through subsequent disbursements (though there have of course been spectacular failures). One possibility, perhaps, is that a core of businesses – including resources, consumer products, utilities, banking (though the sector remains very fragmented) and insurance – have steadily become more concentrated over time, while capitalism's “creative destruction” has been located at the margins, as new technologies are tried and tested (in some cases indeed to the limit). The rising returns shown in the chart suggests that this topic merits further study.

The conjecture that M&A has contributed to improved profitability, low inflation notwithstanding, is

thus a plausible one, and cannot immediately be refuted. And it is largely ignored by the mergers literature – possibly because to attempt to account for these indirect effects would make an already difficult task all but impossible.

Perhaps the most sensible conclusion, then, is to accept that M&A is part of the fabric of the market economy, and of likely value to shareholders for that reason – though we can no more easily quantify its worth than we can that of markets in general.

Room for further consolidation

In a report published in September, we took a look at the relative concentration of quoted sectors to gauge the room for future consolidation. We concluded that the most fragmented sectors in most regions include real estate, engineering, support services, building materials, and banks. The most concentrated include mining, tobacco, personal care and oil. Japanese engineers and retailers appear particularly fragmented; European and US tobacco are especially concentrated.

More detailed screens can be constructed at the stock level in an attempt to identify potential targets.

The usefulness of such exercises and stock screens will always be limited, however, by the unavoidably subjective elements in the M&A process. Note, for example, that hostile bids are still very rare in Japan, and not that common in Germany; and that events in the European electricity sector are demonstrating that an industry can be relatively concentrated and still provide corporate financiers with a lot of work. One recurrent theme in the literature is that successful deals are often those where the “fit” is good. High-water marks in previous M&A cycles were such exotic, and unfocused, proposals as: the proposed acquisition of a major UK bank by an advertising agency; and the actual acquisition of a US entertainment group by a European sewage company.

Conclusion

The revival in M&A seems to be propelled by several objective drivers, including low borrowing costs, high profitability and cashflow, and undemanding valuations. The evidence for the view that M&A

Past M&A activity is only one factor among many in raising the return on capital

destroys value is much less robust than is generally assumed.

Of course, human nature is extrapolative, and while M&A activity and balance sheets look sound now, the exuberance may not look quite so rational in a couple of years' time. Will the cycle again end unhappily? Perhaps. The late Peter Cook might have been thinking of the financial markets when he remarked "*I have learned from my mistakes, and I am sure that I could repeat them exactly*". But the question then would be whether the global economy would be better off without a market for corporate control. If one subscribes to a liberal model the answer is surely "no".

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