Corporate Acquisitions: A Theory of Special Cases? A Review of Event Studies Applied to Acquisitions: Discussion
Author(s): J. Fred Weston
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DISCUSSION

J. FRED WESTON*: My emphasis will be on the "big picture" implications of Professor Halpern's broad survey. While the motives and effects of individual mergers may be complex, some generalizations may be drawn.

1. *Value Maximization vs. Managerialism*

The preponderance of the empirical evidence assembled by Professor Halpern supports the judgment that merger activity is rational value-maximizing behavior. On average the residuals, measured as rates of return or in absolute amounts, associated with the merger events are positive. Furthermore, the residuals do not decline significantly after the merger events. Thus the evidence does not support the managerialism theory of mergers which holds that managements merge primarily to increase the size of firms to augment their own compensation.

The empirical finding of value creation by mergers is reinforced by additional considerations. The Schipper-Thompson studies suggest that for firms engaged in merger programs, expectations may be capitalized into stock prices at the time of early merger activity. They also demonstrate that legislation adverse to merger activity had unfavorable effects on acquirers.

Another downward bias in the estimates of the value added by merger may arise in the application of the market model. Acquiring firms on average have experienced positive abnormal performance in earlier periods while acquired firms have experienced the opposite. Hence, the market model parameters may

*Graduate School of Management, University of California, Los Angeles.

result in understating the gains to the larger acquiring firms and overstating the gains to the smaller acquired firms.

2. *Monopoly vs. Efficiency*

The two major studies of this issue by Stillman and by Eckbo obtain somewhat conflicting empirical patterns. However, both interpret their results as supporting the efficiency theory. If efficiency is the basis for the positive residuals observed, what is their source? For horizontal mergers it is economies of scale. For vertical mergers it is economies of information management and avoidance of post-investment expropriation.

For conglomerate mergers which by definition combine supposedly unrelated activities, the rationale has been more difficult to formulate. There are three broad explanations. One relates to the Baumol theory of economies of scope which holds that by combining activities, costs of one or more of the outputs may be reduced. A second explanation relates to either excess capacity by the acquiring firm in managerial planning and control capabilities or financial economies of scale. A third explanation is improving the investment programs or operating strategies of acquired firms.

3. *Disciplining Management Performance*

This could encompass pure information effects, agency problems, inept management, and differential management efficiency. Professor Halpern argues that neither theory nor evidence supports pure information effects and I agree. The differential managerial competence explanation suggests the most general theory of mergers. It implies that one set of managers may enhance the value of assets under the control of a different set of managers.

4. *Financial Effects*

Professor Halpern points out that if bankruptcy costs are significant, the existence of a corporate income tax may confer benefits, because the merger may reduce expected bankruptcy costs and result in increased debt capacity. Also, mergers of failing or foundering companies take place to preserve organization values. Mergers as a substitute for bankruptcy are consistent with the existence of large indirect bankruptcy costs. More than pure diversification effects are involved if organization values are destroyed by bankruptcy, but can be preserved or enhanced by mergers. Tax effects can be significant in a number of important ways. Indeed a recent study by Dertouzos and Thorpe (1982) of mergers in the newspaper industry has concluded that tax effects were the primary explanatory factor.

5. *The Timing of Mergers*

Neither the theories nor empirical materials surveyed by Professor Halpern explain the apparent phenomenon that merger activity tends to come in waves. This suggests that something has been omitted. Residual analysis does not capture the strategic or long-range planning setting of merger activity. Other empirical studies are consistent with the proposition that firms with under-utilized managerial capabilities acquire firms in industries with relatively more favorable investment growth prospects.

The effects on the timing of merger activity of the levels of investment opportunities and of financial market conditions have been investigated by Chung (1981, 1982). In his results, the timing of annual merger activity is explained by the investment opportunity variables—the growth rate of GNP (positive) and the level of realized real interest rates (negative). The financial variables affecting the rate of merger activity are risk measured by the (Baa − Aaa) bond rate differential (positive) and financial stringency, the difference between the short rates and long rates (positive). As theory predicts, the financial variables are more significant for "pure" conglomerate mergers than for other types of mergers.

Another influence is Tobin's "*q*" measure, the ratio of market values to replacement costs. An efficient firm which seeks to add capacity or to expand into other industries will find it attractive to acquire firms with q-ratios low relative to their industries.

Thus merger activity is seen as a part of a broader resource allocation process. Even conglomerate acquisitions are concentrated in groups of industries which change in different economic environments. The high rate of divestitures (40–45% of all merger activity) is also consistent with this resource reallocation function.

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DISCUSSION

ROBERT S. HARRIS*: In recent months there has been no shortage of mergers in the U.S. We have seen numerous multibillion dollar takeovers and the issuance of new merger guidelines by antitrust authorities. In thinking about mergers, there are two large categories of issues. The first has to do with the owners and managers of the participating companies. Do shareholders of acquired firms benefit? Do shareholders of acquiring firms benefit? On net, is there value created by mergers? Or do many mergers simply carry out the whims of managers? The second large set of questions has to do with whether mergers improve the allocation of resources in the economy. Any value creation that might occur through merger could be as a result of real economic efficiency or as a result of the creation or exercise of monopoly power. Value creation to owners is not a

*University of North Carolina at Chapel Hill.