The Cities Service Takeover: A Case Study: Discussion
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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

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sufficient basis for public policy decision on mergers since there are many competing theories about what might lead to such value.

Richard Ruback's paper, in some sense, takes Paul Halpern's suggestion to the extreme. Halpern (1982) suggests that mergers are a theory of special cases. Ruback's paper is a paper about one and one case only. In discussing that paper there are three general areas on which I will focus. First, what should we expect to learn from a case study. Second, what methodological issues are raised in the paper. Third, what sort of interpretation can we make of the results of the paper.

A. What We Might or Might Not Learn

Given a sample size of one and given that the paper focuses on shareholder returns, we can't really expect to make generalizations about whether mergers are good or bad for owners, managers or the economy. What we can observe are the details of a specific merger. The value of this close analysis may be in making researchers careful about future sample selection. The complexity of an individual acquisition suggests that it may be wise to pick a roughly homogeneous set of mergers for study.

B. Methodology

Ruback uses standard residual analysis which presumes market efficiency. Leaving aside the larger issue of market efficiency, there are some specific areas in which the residual analysis might be extended. First, since the paper examines a few firms all in the same basic industry, it would be useful to have some control for an industry effect along the lines of Franks *et al.* (1977) or Langetieg (1978). Second, experimentation with some variants of the market model (e.g. an $\alpha = 0$, $\beta = 1$ specification, "Dimson" betas) would shed light on the robustness of the results. Of somewhat more importance would be an examination of possible effects of other events known to have occurred during this time period. For example, the Justice Department's merger guidelines were announced during the time period of analysis.

A more generic problem associated with this study and similar studies has to do with forming control returns for the second or third event in a sequence of related occurrences. For example, after a first merger bid, the expected returns from owning a stock depend in large part on the probability that an acquisition will occur and on the amount expected to be paid in the merger. These returns are unlikely to be related to any historical beta. In fact, subsequent to a first bid, returns to a target firm may be subject to what are practically entirely unsystematic forms of risk. This type of problem deserves additional research attention.

C. Interpretations

In interpreting this paper, it is very difficult to avoid the temptation to generalize. Caution is in order, however, since the results are based on events surrounding a single merger. The results in Table 3 show that that shareholders of Cities Service seem to have gained from the merger. Occidental shareholders seem to have received no substantial gains or losses as a result to the takeover.

However, there does appear to be a large loss to Gulf shareholders and, as Ruback points out, the returns to Mesa are difficult to interpret. However, given the high variability of returns for some of these entities (a cost of small sample size) the striking results in Table 3 are not always statistically significant. What is clear from the statistical results here and in other studies, however, is that the market anticipates mergers. The use of legal merger dates in event studies is clearly inappropriate. This suggests that we should follow Brown and Warner's (1980) counsel that much profitable time could be spent analyzing the financial press in constructing event studies.

In closing, I offer several suggestions and evaluations. First, I think the contribution of the paper is that it forces us to look at the specifics of a particular acquisition. It will thus be useful to future researchers seeking to form carefully selected samples. A further contribution could be made by integrating these data with those from other acquisitions in the energy industry to see if patterns emerge in that particular field. Finally I think that one must relate more fundamental characteristics of mergers to the valuation consequences of those mergers in capital markets. An important area for research will be to investigate whether merger-induced value changes are the results of real economies of scale or scope or, in contrast, turn out to be results of increased use of monopoly power. Or, even more heretically stated, such value results perhaps from buying undervalued assets in slightly inefficient capital markets. Mergers and acquisitions are not all the same; nevertheless, by careful sample design we should be able to make headway in unraveling the fundamental causes of merger induced changes in value.

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