Exploring the development and the nature of merger waves: Evidence from US and UK Capital Markets.

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Abstract

A series of merger waves has been witnessed to in many countries. This paper is intended to enlighten many aspects of merger waves diachronically. The analysis of the relationship between merger waves and the condition of the economy in the preceding periods is subject to several past studies. The most possible reasons for their development among them are examined. Furthermore, the merger waves of the US and UK capital markets, with a large economic impact worldwide, are described in details and differences in the type of deals, the methods of payment, and the behaviour of the involved companies, are depicted over time with their special characteristics.

Key words: mergers, acquisitions, merger waves

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I. Introduction

The strategy literature commonly argues that mergers and acquisitions (M&As) are one of the mechanisms by which firms gain access to new resources and, via resource redeployment, increase revenues and reduce cost. This major proposition for the M&As activity is mainly imposed by intense competition, evolving technology, changing regulations in the financial markets, and many other factors. Notwithstanding, the process of internationalisation and the expansion of the European Union has fostered the whole activity in recent years, which evolve an international perspective of M&As (Zarotiadis & Pazarskis, 2003).

The M&As activity over time present trends, upwards or downwards, creating some specific merger waves. The analysis of the relationship between merger waves and the condition of the economy in the preceding periods is subject to several past studies. The main problem with these studies is that none of them explain properly a merger wave outside of the examined marketplace or timeframe period, over which they were applied. Along with this proposition, there is the belief that merger waves are merely considered the simple result of a combination of economic and legal conditions that make activity of this sort appealing to companies at certain times in the past.

A series of merger waves has been witnessed in many countries with open market economies. The most representative and influential country merger waves with a large economic sense worldwide were US and UK merger waves (Weston et al., 1996). Each one of these wave has had different motives, including regulatory and economic factors, while the nature of the waves also changed with differences in the type of deals, the methods of payment, and the behaviour of the involved companies, depicting over time to some extent specific and various modes in the context of behavioural corporate finance.

In order to examine the complex phenomenon of M&As diachronically, this study proceeds to an historical and behind various argumentations analysis of M&As activities, and attempts to investigate the development and the nature of M&As. The structure of this paper is as follows: section II analyses the type of M&As separately and their classification, section III refers at the related literature that attempts to connect M&As activity to economic factors; section IV provides
an analysis of merger waves in the United States of America (US); section V presents a similar analysis of merger waves for the United Kingdom (UK); last, section VI concludes.

II. Type & classification of M&As

The term of “merger” is perceived, in general, as the action of unity from two or more companies. In this study, the terms “merger” and “mergers and acquisitions (M&As)” are used in many cases at the text, providing similar meanings for the terms “merger” and “acquisition”, while in others, there is a clear distinction among them and always exists a provision of the exact meaning. To make clear, the perception of each term, they are analysed separately below (Agorastos & Pazarskis, 2003):

The type of M&As activity, or how a company can make an M&A and under which exact way can an M&A activity be formed, is possible in three ways:

- merger by absorption, where the acquiring firm retains its name and its identity, and it acquires all of the assets and liabilities of the acquired company; after the merger the acquired firm ceases to exist as a separate business entity,

- merger by consolidation, where an entirely new firm is created; both the acquiring firm and the acquired firm terminate their previous legal existence and become part of the new firm, and

- merger by acquisition, where one firm purchase another firm’s voting stock for cash, shares of stock, or other securities; there are two types, acquisition of stock and acquisition of assets.

Furthermore, according to the correlation of the activities of merged companies, there is a classical distinction for M&As activities of four types:

- horizontal merger, where a company takes over another from the same industry and at the same stage of the production process,

- vertical merger, where the target is in the same industry as the acquirer, but operating at a different stage of the production chain, either nearer the source of materials (backward integration) or nearer to the final customer (forward integration),

- congeneric merger, where a company takes over another from the same industry, but not at the same production process, and
- conglomerate merger, where the acquiring firm and the acquired firm are apparently unrelated to each other (Gaughan, 1996, Weston et al., 1996).

Last, according to the process and the nature of the negotiations, as well as the agreement of companies’ management, if it is pro- or contra-oriented to the M&A action, M&As activities are distinguished as:

- friendly or amicable M&As, where the acquirer and the acquired company achieve a common agreement on this specific action, there is a common consensus, and no official reaction on the completion of the process,

- hostile M&As or takeovers, where the target company express in public its disagreement to the M&A action, and attempt to defend itself through some precise actions from the eventual acquirer company (Sudarsanam, 1995).

III. Reasons for creation of merger waves

Despite the fact that there are many researches for the motives of M&As, the empirical research on the issue of why M&As occur in waves has been limited and with a little success. As the economic theory attempts to connect M&As activity to economic factors, there were many possible explanations. Trautwein (1990) surveyed several different theories of M&As and argued that no one approach could conclude for a single explanation of the merger motivation. Most of these explanations were used to provide evidence on some of M&As over the last century, but their argumentation appear to be more relevant in the exact merger wave or the examined marketplace, over which they were applied, with no other valid result. Nevertheless, it is true that these events had changed indisputably the behaviour and the performance of companies with their impact, in a lower or a higher degree.

In this context is classified the economic disturbance theory (Gort, 1969), which suggests that changing economic conditions had different result on opinions of company’ interested parties for their company value. More specifically, Gort (1969) argues that mergers are more likely to occur in upswings, than in downturns, of the stock market prices, because

“when security prices are low relative to their mean value over a period of years, managers and long-term investors will tend to consider the shares of their firm undervalued. The stockholders of
firms that are potential acquirers, on the other hand, can be expected to resist acquisition prices that are far above those at which the individual investor can purchase securities in the open market on his personal account. Consequently, valuation discrepancies of the type needed for acquisitions to occur will be far more frequent in periods of high than in periods of low security prices” (Gort, 1969, p. 628)

Thus, the economic disturbance theory assumes that stockholders and managers base their current valuations of their company's stock on the recent past, but non-holders do not (Mueller, 1977), and these differences of opinion, result increased levels of M&As activity.

Several finance text-books present the rising of the stock market as a positive sign of a country’s economy. In parallel, this rise of the stock market facilitates companies’ plans on M&As (by raising funds through the issue of new shares, etc.). If these two elements are paired, the result is increased levels of merger and acquisition activity (Steiner, 1975).

Another important factor that determines the level of M&As activity is the managerial theory, which is consistent with a cyclical merger pattern. In an upswing in the stock market, corporate profits and cash flows are rising. If there is no opportunity for growth via internal expansion, what is remaining, as alternatives, are higher dividend payments to be paid or growth through external expansion (M&As). For this reason, it is not surprising that many companies performed M&As during periods of prosperity (Salter & Weinlold, 1978).

Mitchell and Mulherin (1996) in a contemporary study examined why mergers occur firstly, in waves; and secondly, within a wave, mergers strongly cluster by industry. They argued that there are considerable differences between levels of M&As activity in different industries, and these conditions are the result of shocks to the industry from changes in the economic and regulatory conditions. The authors found that the shocks were proxied by abnormal sales growth, were significantly associated with M&As activity, and deregulation was cited as the most pronounced shock for industry consolidation. Also, they claimed that industries tend to be restructured and consolidated in concentrated periods of time, which are hard to be predicted.

More recent studies on executives’ rewards and their M&As decisions confirm that M&As actions are partially influenced by their impact on
management compensation. Datta et al. (2001) had found lower bid premiums and a more aligned strategy with shareholder wealth, as executives’ compensation was heavily weighted by stock options granted.

As it is referred above, the formation of merger waves is due to some special reasons. The most important were referred above. Thus, it is clear that merger waves are merely considered the simple result of a combination of economic and legal conditions that make activity of this sort appealing to companies at certain times.

IV. History of M&As in the US

The history of merger waves in the US has been characterized by four major waves or periods of high levels of M&As activity, followed by periods of relatively low activity. Each of these has been distinctly different from the others, presenting peculiarities, especially, in the type of deals, the methods of payment, and the behaviour of the involved companies (Tarasofsky & Corvari, 1991).

The first US merger wave began at the end of the nineteenth century, at 1895, as companies were trying to position themselves after the Depression of 1883. The introduction of the Sherman Antitrust Act (1890) and the combination of a rising stock market have fostered the whole activity. Its activity peak was between 1898 and 1902, and lasted until 1905. The first merger wave was imposed by firms as they demanded the development of large national markets and the extended production capacity, through acquired firms of the same industry (McCann & Gilkey, 1988). As the Sherman Act made it possible for companies to form near monopolies without any regulatory interference, acquisitions with stock-for-stock exchange made it feasible. This first wave was mainly characterized as the horizontal merger movement at the US, and was associated with the completion of national transportation systems, making them the first broad common market in the world. During this merger wave, almost 1800 firms were disappeared and approximately 71 companies formed virtual industry monopolies. Undoubtedly, the first merger wave was led to a massive transformation of the industrial landscape in the US (Sudarsanam, 2003).

The second US merger wave started ten years after the end of first one, at 1915, and ended with the beginning of the Great Depression, at 1929, where the
country’s economic collapse led to chaos in the US stock market and a disastrous end of M&As activities overnight (McCann & Gilkey, 1988). The motives to start the firm interests in this wave were due to the fact that the regulatory framework was changed again. All began as the US courts made it clear that they no longer approved industry monopolies by no means and start to take apart forcibly companies that had a monopolistic character. The first “victim” of this tactic was at 1911 the break-up of Standard Oil, established and owned by John D. Rockefeller, which acquired multiple subsidiaries throughout the US, and drove many of its competitors out of business. The US Supreme Court accused Standard Oil of discriminatory practices, abuse of power and excessive control of its market, and forced it to sell thirty-three of its most important subsidiaries, with a forbiddance at the new owners of these subsidiaries to create a new trust. The final expression of this anti-monopoly policy was a new merger legislation expressed by the Clayton Act, in 1914, which actively, and in paradox, encouraged companies to form oligopolies instead of monopolies. So, as once again companies tried to positioning themselves and reserved a privilege position in the changed marketplace, the second US merger wave had already begun (McCann & Gilkey, 1988). The rising of stock market and stock-for-stock exchange, as a way of financing M&As, facilitated companies’ plans to succeed easily for vertical integration, and extended profit margins through economies of scale. Obviously, in this merger wave, the term “merging for monopoly” has been replaced by the “merging for oligopoly”, as remarked Stigler (1950).

As the level of M&As activities decreased notably in the post-war era, throughout the 1940s and 1950s, a new legalization, the Celler-Kefauver Act (1950) that was introduced to extend the Clayton Act, give new incentives for special market concentration (Scherer, 1979). As a result the rise of conglomerate mergers, the only feasible way, has become the new reality in the 1950s, and the third US merger wave had started. This merger wave began at the end of the 1950s, and lasted until the middle of the 1970s. The oil crisis of 1973, that resulted the sharp increase in inflation, along with the world-wide economic crisis, have signalised the end of this third merger wave, as the US economy has entered in a new economic downturn at the middle of the 1970s, with its stock market. The major characteristic of this merger wave, as referred above, was the conglomerate-oriented mergers, as the anti-trust laws had made it very difficult to
implement horizontal or vertical integration strategies for expansion. 80% of the mergers that took place involved two interested companies from different industries (Rumelt, 1974), and, by 1973, fifteen of the top 200 US manufacturing companies’ previous strategy fall in this category (Baskin & Miranti, 1997). The majority of merger deals usually were friendly mergers (Shleifer & Vishny, 1991). Until 1965, as Internal Revenue Service (IRS) rules allowing non-taxable stock swaps, the financing of M&As with stock-for-stock exchange was the most popular one. After 1965, these tax advantages had became less important in financial planning of aggressive conglomerates that were trying to create large companies in banking, insurance, oil and steel, and, cash payment became the norm of conglomerate acquisitions in this period. Finally, the studies of Harry Markowitz, John Lintner and William F. Sharpe on portfolio theory, that efficient portfolios equated risk and returns, promoted notably the conglomerate formation.

The fourth US merger wave began by the late of the 1970s. This merger wave exceeded all of the proceeding waves in the size of the deals, as a new generation of financial entrepreneurs promoted an entirely new idea, the Leveraged-Buy-Out (LBO) partnerships, and the highest degree of hostility, as large companies became targets of unwelcome acquisition bids. Almost half of all major US companies during this merger wave had faced the possibility of a hostile acquisition in the 1980s (Mitchell & Mulherin, 1996). At its first stage of the merger wave, the acquisition of small companies was observed, while two categories of firms were the targets: owner-managed firms, whose owners were approaching retirement and wished to liquidate their entities; and subsidiaries spun-off from larger firms, that want to sell them for their disappointing performance (Baskin & Miranti, 1997). At the second stage of this merger wave, after 1984, that of mega-mergers or of merger-mania, much larger companies were the targets. One of them was the well known RJR Nabisco and Co. which was acquired from Kohlberg Kravis Roberts and Co. partnership (KKR) for $24,7 billion in 1989. The merger motives were mainly due to the governmental deregulation in certain industries. Many researchers support that the US government relaxed some of the restrictions on takeover activity that the earlier law enforcement had put in place (Shleifer & Vishny, 1991). But behind this, the real motive is that many conglomerates failed entirely, and companies want to concentrate on areas in which they were most profitable and effective.
Furthermore, the changing market conditions, with increases in the costs of inputs (mainly, in oil) and the rapid developments in technology, had fostered the whole activities. Finally, ineffective corporate management drove usually a stock company undervaluation, thus making it an appealing target for acquisition. After the completion of the M&As process, the ineffective managers were removed and the overall company performance was improved (Scherer, 1988). The popularity of debt financed transactions was increased during this fourth merger wave, and the use of junk bonds make it possible, even for very large companies to be takeover targets.

The end of this fourth US merger wave is not universally accepted. It is considered from some researchers that this merger wave lasted until the end of the millennium, while others are claiming that it is still continuing. Despite this debate, it is clear that in the period that followed (from 2000 till now) the rationalism in M&As activities prevails. The LBO, the hostile takeovers, and the debt-financed transactions of the 1980s no longer exist in this period (Andrade et al., 2001). The most possible explanation for these changes is the improvement of corporate governance, where it became more difficult for managers to enter into highly risky deals.

V. History of M&As in the UK

The history of merger waves in the UK reveals a less glamorous and shorter history than US merger history. There is no clear consensus of the exact time of merger waves diachronically among researchers. In general, there are observed four major waves or periods of relatively high levels of M&As activity, followed by periods of relatively low activity.

The first UK merger wave began in the 1920s, and lasted until the end of the inter-war period. As the structure of British industry was changing, the emergence of larger companies was a new reality in the business world. One of the solutions was the external development through M&As, or the so-called “defensive mergers” (Weston et al., 1996). Among their main aims were the mass production, the increase of productivity, and an overall increase in share prices at the London Stock Exchange. This merger wave drove to market concentration in many manufacturing industries, and a notable example was the creation of
Imperial Chemical Industries (ICI), in 1926, formed out of four major chemical companies. Furthermore, the companies’ negotiations and transactions were almost always unknown to public, and were regulated between the directors of the companies, while neither institutional nor private shareholders had much influence on corporate decisions. The end of this wave placed at the beginning of the Second World War.

The second UK merger wave began in the middle of the 1950s, as a new generation of financial entrepreneurs, or more precisely corporate predators, want to take advantage from inefficient management at many UK companies. The first of these predators, Charles Clore with its bid for Sears in 1953, saw that some companies were undervalued at the stock market much lower than the real price of their assets, and offered to the shareholders of the company a higher price for their investment. The success of the bid has been described by Littlewood (1988) as “a catalyst for change in both the complacent attitude of company directors towards their shareholders, and in the passive and undemanding attitude of shareholders towards their investment”. As the hostile take-over was a new phenomenon in the UK, the authorities was very suspicious. The Bank of England discouraged banks and other financial institutions from lending to predators, in the early 1950s. But the hostile takeover of British Aluminium, a “blue-chip” company, from Tube Investments, a British engineering company, and its American partner, Reynolds Metals, in 1958, changed City attitudes to takeovers overnight. Among the top 200 manufacturing companies in 1964, 39 were involved in M&As activities within the next five years (Hughes, 1993). Last, this UK merger wave was mainly characterised by conglomerates or congeneric mergers, and ended at 1968, when the City Takeover Code was published (1968), and the Takeover Panel, was created to police it. (Samuels et al., 1999).

The third UK merger wave started at the early 1970s, and for a decade, included a number of glamorous hostile bids from a new generation of predators, in Charles Clore’s footsteps, such as Jim Slater and James Goldsmith. These “asset strippers” (as they regarded from the employees of the affected companies, and characterised with no interest in the long-term health of the companies they bought) had financed their M&As by issuing new shares in their own companies. Furthermore, the popularity of horizontal deals still remained active, despite the fact that conglomerate deals grew correspondingly (Sudarsanam, 2003). For the
above referred reasons, the legal framework changed in 1973 with the Fair Trading Act, that formalized the procedures for regulating M&As activity in the UK and created the Office of Fair Trading (OFT), which examines each deal and decides whether it should be referred to the Mergers and Monopolies Commission (now know as the Competition Commission). The most important event in this wave was the corporate acquisitions of US firms (in the United States) from UK firms. Many UK firms recognised the strong possibility that, in the long run, the US economy would be globally the most stable and developed one (Cooke, 1999).

The fourth UK merger wave began in the 1980s, as was existed the confidence that with market deregulation and the privatisation of state-owned companies, the national economy could achieve an overall improvement. So, the Thatcher government’s adopted as its central priority, in order to provide market efficiency and to reduce the role of the state in business, the abolition of exchange controls and privatisation. The outcome from the abolition of exchange controls (the well-known as Big Bang) was a dramatic restructuring of the financial services industry, with the M&As actions to involved many interested parties (brokers, jobbers, banks, other financial institutions), UK or not. But, if the abolition of exchange controls forced to severe changes, the same did privatisation. The programme included the sale of part of shares of British Petroleum, the privatisation of British Aerospace, British Rail, British Telecommunications, and other public utilities (gas, electricity, water). In this wave, very large companies, virtually invulnerable to takeovers in the past, also US firms included, were targets (Ross et al., 1999). The size of deals, the increased hostility, and the use of leverage during this merger wave depicted something completely different within this wave. Even the major crash of the stock market on the Black Monday in 1987 was not enough to stop this merger wave. Finally, the creation of the Cadbury Committee (1991) with its findings (the Cadbury Report, 1992) and a major concern about the low confidence in financial reporting and the ability of auditors to provide the correct company results, signalised a new direction in M&As. The Cadbury Report increased the level of monitoring to which Boards of Directors were subjected and the degree of deal’s transparency. As a result the M&As activities that followed were friendly and horizontal mergers, as companies were also seeking to get bigger and reach an international perspective with global economies of scale (see, Glaxo’s hostile
bid for Wellcome in 1995, and five years later, the merger between GlaxoWellcome and SmithklineBeecham).

VI. Summary and conclusions

The M&As activity over time present trends, upwards or downwards, creating some specific merger wave. A series of merger waves has been witnessed to in many countries. This paper is intended to enlighten many aspects of merger waves diachronically in a two-fold analysis. First, by the analysis of the relationship between merger waves and the condition of the economy in the preceding periods that is subject to several past studies. The most possible reasons for their development among them are examined. Their conclusion is that formation of merger waves is due to some special reasons, and it is clear that merger waves are merely considered the simple result of a combination of economic and legal conditions that make activity of this sort appealing to managers and companies at certain times in the past. Second, the merger waves of the US and UK capital markets, with a large economic impact worldwide, are described in details and differences in the type of deals, the methods of payment, and the behaviour of the involved companies, are depicting over time their special characteristics. Their analysis confirms solemnly the above referred conclusion.

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