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MOTIVES BEHIND MERGERS & ACQUISITIONS: THEORY & CRITICAL REVIEW OF LITERATURE

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ABSTRACT

In this age of cut – throat competition, every company wants to grow and be ahead of its competitors. There are two ways to achieve growth- first the Greenfield expansions resulting in Organic growth in one's own unit, and second the Brownfield expansions or M&As resulting in Inorganic growth. In a hurry to expand and beat the competitors profitably, the companies are restructuring themselves through M&As.

Mergers and Acquisitions (M&As) are the inorganic growth strategies which have become important in today's corporate world due to increase in competition and complexity. This paper is an attempt to discuss major studies undertaken to identify the motives behind mergers and acquisitions. Broadly, literature review has been done on empirical studies in journals, published papers and other useful internet material to explain different aspects such as domestic and cross- border M&As, their causes, trends etc.

KEY WORDS: *Mergers, Acquisitions, Synergy, Motives, Corporate Restructuring, shareholders.*

1.1 INTRODUCTION

"**Corporate Restructuring** refers to the changes in ownership, business mix, assets mix and alliances with a view to increase the shareholder value. It includes a wide array of activities such as mergers, acquisitions, joint ventures, spin-offs, leveraged buyouts, demergers, buyback of shares, capital reorganization, sale of business units and assets, etc." Out of these, mergers and acquisition is most common route taken by corporations for the inorganic growth all over the world. In fact the last two decades have been known as the M&A waves.

Every day, we find newspapers filled with news about M&A deals. Various parties that are interested in this field include owners of business firms who are searching for potential partners to implement mergers in future, investment bankers who are responsible for managing the mergers, lawyers who provide advisory services to the parties involved, regulatory authorities that are concerned about the operations & safety of capital market and increasing corporate dominance in the economy and, academicians who want to understand these areas better.

Mergers and Acquisitions take place when two or more companies are brought under the same effective control and are managed by the same group. It can be done in two ways: (i) acquisition of one business unit by another or, (ii) creation of a new company by complete consolidation of two or more units.

We have tried to review and summarize the major studies carried out in the field of Mergers and Acquisitions in India and abroad. This extensive review will be helpful in enhancing the present level of understanding in the area of mergers and

acquisitions, understanding the reasons behind success or failure of merger deals and formulating the problem for further research in this field.

1.2 OBJECTIVES OF THE STUDY

The major objectives of reviewing the literature are as follows:

- To have an overview of M&A activities in India and abroad.
- To examine the literature on the Motives behind Mergers and Acquisitions.

1.3 LITERATURE REVIEW

Researchers have conducted a number of studies to answer the basic question: Why do mergers and acquisitions take place? But there is no conclusive explanation available in the literature for why do mergers and acquisitions happen. This section discusses major studies undertaken to identify the motives behind mergers and acquisitions.

Trautwein (1990) has divided the causes of merger activities into seven groups: efficiency, monopoly, empire building, raider, valuation, process, and disturbance theory. **Efficiency theory** states that mergers are carried out to achieve synergy, thereby benefiting the shareholders of acquiring firm. **Monopoly theory** states that mergers are executed to increase market power, thereby transferring wealth from the customers to the acquirer. According to the **Empire building theory**, managers go for M&As to achieve their own personal goals rather than, maximizing the wealth of shareholders. **Raider theory** (including greenmail), involves benefiting the shareholders of acquiring firm at the cost of shareholders of target firm. **Valuation theory** states that managers go for mergers, when they have better information about the value of the target, than the stock market, thereby generating gains to their firm. **Process theory** holds that mergers are executed on the basis of outcomes of various processes; these may be need for expertise, uncertainty, political pressures, lack of planning etc. Lastly, **Disturbance theory** states that M&As are caused by economic disturbances such as oil crisis etc.

Berkovitch and Narayanan (1993) have identified three main reasons as to why firms go for takeovers- synergy, hubris and agency. They have tested three hypotheses related to these motives using a sample of 330 tender offers of US firms during the period 1963 1988. They have used market model and have computed Cumulative Abnormal Returns (CAR) of the target and acquirer upon announcement of a takeover attempt. The target gain has been computed by multiplying the target's CAR by the market value of the target firm's equity as of the end of six trading days prior to the first announcement for the target, minus the value of the target shares held by the acquirer. The acquirer gain is computed by multiplying the acquirer's CAR by the market value of the acquiring firm as of the end of six trading days prior to the first announcement made by the acquiring firm. Total gain has been defined as the sum of target and acquirer gains.

The authors have used correlation among target, acquirer, and total gains and have shown that the synergy hypothesis implies positive correlation between target and total gains, the agency hypothesis implies a negative correlation, and the hubris hypothesis implies zero correlation. They found that the synergy is the dominant motive, followed by hubris in takeovers with positive total gains. Moreover, agency is the primary motive in takeovers with negative total gains. So, agency motive is responsible for reducing the value of the acquisitions. The synergy hypothesis states that two firms merge to take advantage of economic gains that result from sharing of resources. The agency hypothesis suggests that managers undertake acquisitions to achieve their own personal goals rather than maximizing the wealth of firm's shareholders. Hubris hypothesis says that managers of acquiring firms make errors in evaluating the targets and this leads to acquisitions and mergers where there are no synergic gains and hence overpayment made to the target company.

Solvin and Sushka (1998) have investigated the motives of parent subsidiary mergers by using a sample of 105 US publicly traded firms during 1970 1993. They have used market model method to study the stock price reactions, along with statistical tools such as least squares regression, z test and sign test. They have concluded that parent subsidiary mergers help in corporate restructuring and reallocating the resources to higher valued uses. According to the authors, "the elimination of publicly traded minority shareholdings in a subsidiary helps in improving corporate flexibility and increases value by allowing the combined entity to make investments and conduct restructuring activities that might not otherwise be undertaken".

Goold and Campbell (1998) have indicated that "shared know how, pooled negotiating power,coordinated strategies, vertical integration, combined business creation and, shared tangible resources"–are sources of synergy for merged companies in UK. The authors, however, have suggested that even ifa synergy prize is found to be very large, the corporate executives should not rush for it because it may destroy firm's value, rather than creating it. This is possible, because the managers are subject to four types of biases namely, **synergy bias** (mangers tend to overestimate the benefits and underestimate the costs of synergy), **parenting bias** (believing that synergy can be achieved only by compelling the business units to cooperate), **skills bias** (assuming that all know-how needed to realize synergy will be available within the organization) and, **upside bias** (managers focus only on the potential benefits of synergy and overlook the negatives). So, the managers should take care of all these biases and ultimately, select the corporate interventions that help in achieving truly valuable synergy.

Seth, Song and Pettit (2000) studied 100 acquisitions of US firms by foreign firms during 1981 1990 to identify the causes for cross border acquisitions. They have used event study methodology to estimate abnormal returns to the acquirer and target firms. The total gains have been defined as the difference between the value of the combined firm given the acquisition announcement and the sum of the value of the individual firms if the announcement had not been made. The results indicate that synergy is the dominant motive in takeovers with positive total gains. The authors have also suggested governance of hubris hypothesis for few of the companies studied by them. In the takeovers with negative total gains, agency or managerialism hypothesis holds true. An important contribution of this study is the finding that higher the competition in the market for corporate- control (i.e., multiple bidders), higher the total gains and the gains to the target firm. According to the authors, this is due to the fact that, when multiple firms bid for the same target, it gives a stronger signal about the potential increase in the value of the target firm along with these bidders, compared to a situation when there is only a single bid.

Mueller and Sirrower (2003): Using a sample of 168 mergers between large US companies during the period 1978 1990, the authors have tested four hypotheses: the **synergy** hypothesis, the **hubris** hypothesis, the **market for corporate control** hypothesis, and the **managerial discretion** (agency) hypothesis to find out the motives of merger based on gains to the shareholders of acquiring firms. The market for corporate-control hypothesis states that acquiring firm can benefit from the merger by changing the policies of the target firm, which reduce its share price, or by replacing its executives with the deserving and competent ones, thereby increasing its market value from its present level to its (higher) potential value. The gains to acquirer shareholders were measured using ordinary least squares (OLS) market model and market-adjusted model. The authors found significant support for the managerial discretion hypothesis and hubris hypothesis and non significant for the market for-corporate control hypothesis as a motive for merger. This paper rejects synergy as a motive. However, synergy has been considered as a primary motive in a number of studies.

Ghosh (2004) took a sample of more than 2,200 U.S. acquisitions completed during the period 1985-1999 and found that firms go for mergers and acquisitions for achieving greater market share. In order to determine the increase in the shareholders' wealth arising due to the increase in market share, he used the market model to calculate the abnormal returns to acquiring and target firms and hence the cumulative abnormal returns for merged firms. The analysis reveals that the increase in the market share, which is higher in case of related acquisitions, leads to greater market power and efficiency for the firm. This ultimately, benefits the equity shareholders due to direct positive correlation observed between an increase in market share and cumulative abnormal returns. Moreover, the operating performance of firm also improves due to increase in productivity and better asset management.

Mukherjee, Kiymaz and Baker (2004) took a sample of 75 US firms during 1990 2001 to identify motives for mergers and acquisitions as well as divestitures. They used a well-designed questionnaire focusing mostly on close ended questions addressed

to firms' CFOs. The respondents were to answer on a five point equal-interval scale; accordingly one-sample t-test was used to check whether level of agreement or disagreement differed significantly from zero. The results of survey show that main reason to go for mergers and acquisitions is to achieve operating synergies while the primary motive for divestitures is to increase focus. The authors found that firms generally go for horizontal mergers, (i.e. combining with former competitors or with those whose products fit together), and believe that diversification through acquisitions, helps in decreasing losses during downturns in economy.

Kumar and Rajib (2007) studied a sample of 227 acquirer and 215 target companies during the period 1993 2004. They identified the features of capital structure as a main motive for the merger for both acquirer and target companies in India using statistical tools such as Mann Whitney U test and Kolgomorov Smirnov test and logit regression. They have pointed out that the companies with tighter liquidity positions are more likely to become a target and larger the size of the firm, lesser is the probability of it becoming a target. The authors suggest that the large firms which have unused debt capacity, can acquire other firms by using this financial slack, thereby creating value for themselves.

Narayan Kar and Soni (2007): This study helps to identify the motives and trends in M&A activities of various sectors of Indian industry post liberalization, using the method of least squares and financial data for 15 companies pertaining to period 1990-91 to 2000-01. The results reveal that Indian companies normally go for horizontal and vertical mergers as they like to expand in related areas to achieve benefits of synergy and "their main motives behind M&As are to achieve better quality of human resources, strong brand presence and global identity and leadership, apart from growth and expansion".

Ramakrishnan (2008) used a sample of 87 Indian companies undertaking mergers and acquisitions during the period 1996 2002 to investigate the motives and long term performance of merged companies. For this, he used long-term pre- and post-merger financial data of firms along with statistical tools such as paired samples t- test and cross sectional linear regression model. The study shows that achieving operating synergy is the primary motive behind the mergers in India. The firms have been able to achieve synergistic gains because of increase in efficiency and better utilization of assets, arising due to the shift of Indian firms, from uncompetitive, fragmented structure pre- merger, to more consolidated, competitive, and operationally viable business units post-merger.

Rani et.al (2012): Using a sample of 1072 target companies and 687 acquirer companies, the authors conducted a survey to study the motives and trend of merger activities of Indian companies during the period 2003-08. The responses provided by the company executives in the questionnaire revealed that the companies merge with each other to achieving synergy. The operating economies provide synergistic gains to the companies. Another finding of this study is that the subsidiaries merged with the parent companies during the study period, for consolidation and coping with changing regulatory environment. The authors have suggested that "managers of companies can adopt the strategy of merging large number of unlisted subsidiaries". This will help the companies in reducing the compliance cost and strengthening their corporate governance mechanisms. However, this is a need to undertake further study on the Parent subsidiary mergers and synergy motive especially in the Indian context.

Tripathi and Lamba (2014) undertook a study to determine the motivations of Indian firms to go for cross border acquisitions and to study the impact of merger motives on post-merger performance. The sample data consisted of 69 cross border deals by Indian companies during 1998-2009 and statistical tools such as factor analysis, likert scale, Independent Samples t-test and Binary logistic regression were used for the analysis. The analysis shows that there are five motives of cross border M & As by Indian companies -Value creation; Efficiency Improvement; Market Leadership; Marketing & Strategic motives and Synergistic gains motives.

The study shows that motives also depend on the development status of the country of acquired company. The acquirers prefer the target companies in developed economies for improving their market value and those in developing countries for deploying

excess cash flows, saving taxes & material costs. The age and industry of acquiring company is also related to motives. The younger companies go for cross border M&As to gain strategic resources, integrate with the suppliers as well as customers, reduce competition in the market and increase market share. The acquirer companies in the service sector aim at decreasing selling costs, reducing competition and integrating vertically with the target and the suppliers. The results also indicate that having value creation as the motive significantly improves the post-merger operating profits.

1.4 CONCLUSION

The researchers have conducted in depth theoretical and empirical studies in the field of Mergers and Acquisitions to identify the reasons of such business combinations. While a plethora of literature is available on M&As in the international context, few studies have been done in developing economies like India particularly in the financial sector.

The literature review indicates that main motivation for mergers is to achieve operating synergies. "Synergy is the ability of a corporate combination to be more valuable than the individual companies that were combined. Exiting literature identifies operating, financial and managerial as three main forms of synergies". Moreover, unlisted wholly owned subsidiaries merge with their parent companies to achieve consolidation and to cope up with changing regulatory environment. Thus, M&As help the firms to gain access to new resources and increase revenues and reduce costs by putting resources to best uses.

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