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TITLE PAGE

MERGERS AND ACQUISITIONS – DO THEY
CREATE SHAREHOLDER VALUE?

OVERVIEW OF THE DISSERTATION

The topic of mergers and acquisitions, and their ability to create shareholder value, is one that continues to raise a fair amount of debate. Many studies have been carried out, both locally and abroad.

They have attempted to analyse the wealth effects of mergers and acquisitions on both the shareholders of the acquiring and acquired firms. In some instances the findings have been fairly consistent across companies on the various stock exchanges, while other have produced controversial results.

Generally the findings regarding the acquired firms have been consistent, across most studies, but the results regarding the acquiring firms has been less straightforward.

This paper discusses the various types of mergers and acquisitions that a company may undertake, as well as the possible rationale for undertaking such investments.

Some of the more recent and well-known studies that have been undertaken are then discussed, and an attempt is made to find a common thread amongst all the various studies.

Further factors which research has found to have an impact on the success or failure of mergers and acquisitions are then discussed, with the purpose of trying to identify the key reasons for merger failure, and hence the failure to create shareholder value for the acquiring firm. In other words, what are the traits or key factors that lead to successful mergers and acquisitions, ones that do not destroy shareholder value?

Finally, the area of divestitures is discussed, because it is often believed that they are a key admission of the failure of past merger activity. Trends in merger and divestiture activity are also examined.

Finally, a conclusion is drawn from the various studies and readings that have been done. The basis of this paper is primarily a secondary literature review.

Two case studies are then undertaken; one which focus's on acquisitions by an IT Company which fail to create shareholder value, and the second examines an unrelated acquisition and subsequent divestiture by a listed company in the transport sector.

A significant limitation that was encountered in doing research on the topic was the lack of availability of recent studies undertaken. The majority of the work done on this subject was researched during the 1960's to 1980's. With the only significant South African study being conducted by Affleck-Graves *et al* in 1988. Although recent articles and commentary on the subject have been written in the late 1990's, I was unable to find any recent studies.

The majority of research undertaken has also been done in the American and European markets, with as mentioned, only one or two studies being conducted on the JSE.

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INTRODUCTION:

The topic of mergers and acquisitions is one of those areas of finance, which attracts interest from many sectors. Mergers and acquisitions (M & A's) are not a phenomenon of the twentieth century. Indeed, amalgamations between business entities are as old as business itself.

Historically, takeovers and mergers have come in waves that have rolled in when equity markets were buoyant. It is thus not surprising that the past five years have produced a new wave of merger mania.

Merger mania is dangerous. Volumes of research across international markets have demonstrated that waves of M & A's can destroy shareholder value.

One of the most popular myths associated with mergers and acquisitions, is that they create shareholder value. Recent research illustrates that South African mergers between 1990 and 1998 destroyed shareholder value. The deals produced an average return of -20% in the post merger year. The results are better than those for the period 1985 to 1990, yet this is little consolidation. (Business Day, Aug 01 2000)

Recent research by KPMG International found that 83% of corporate mergers and acquisitions fail to enhance shareholder value because of poor planning or execution, or both. The risk seems to lie in the overestimation of potential cost cuts and synergy gains, as well as underestimating the problems of integration. (Business Day, March 13, 2000)

This trend is not unique, and other studies across international markets present a similar picture: mergers and acquisitions in the 1990's continue to destroy value.

In value theory the firm is viewed as an economic unit whose objective consists of the maximization of profits or, more generally, the maximization of the present value of the firm. In the current context this means that a merger or series of acquisitions, to be considered successful, must increase the present value of the owners interest in the firm. This is the basic concept of merger success.

Accordingly, we can say that a given merger is successful if, other things equal, it increases the total current wealth of the owners of the acquiring firm. Therefore a merger may be considered to be successful if the investment performance of the acquiring firm exceeds the average investment performance of firms in the same industry as the acquiring firm. (Hogarty, 1973)

Creating value from a merger is both an art and a science. Empirical evidence suggests that six factors are critical to achieving success in M & A's:

- Smart Corporate Strategy;
- Effective Communication with all involved throughout the process;
- Comprehensive pre-merger planning and due diligence investigations;
- Similar corporate cultures, or the formation of a new culture;
- A focus on the people aspects of the deal;
- Real determination from management and abundant resources during the post merger integration phase.

South African transactions that adhered to these factors over a ten-year period to 1995 outperformed the market and the sector by an average of no less than 21% in the post merger year. (Business Day, August 01, 2000)

This paper examines the different types of mergers and acquisitions that occur, as well as the possible motivations behind them. The major question that will then be addressed is: Who gains from mergers and acquisitions, and do they create value for the shareholder?

Throughout this paper the word merger will be used to mean the combination of two business entities under common ownership.

Many people, for various reasons, differentiate between the terms merger, acquisition and takeover. However most commentators use the three terms interchangeably. It is sometimes very difficult to decide if a particular unification of two companies is more like a merger, in the sense of two roughly equal-sized firms coming together on equal terms, or whether the act of union is closer to what some people would say is an acquisition or takeover – a purchase of one firm by another with the associated implication of financial and managerial domination.

In reality it is often impossible to classify the relationships within the combined entity as a merger or a takeover. Hence this paper will use these three terms interchangeably.

STRATEGIC DEFINITIONS OF MERGERS:

Mergers may be classified into three broad categories: Horizontal, Vertical and Conglomerate.

1. Horizontal Mergers:

In a horizontal merger two companies, which are engaged in similar lines of activity, are combined, i.e.: the acquiring company operates in the same market as the target company. An example of a South African horizontal merger was the amalgamation of Shoprite and Checkers.

2. Vertical Mergers:

Vertical mergers occur when firms from different stages in the production cycle amalgamate. In other words a firm either expands forward to the customer, or expands backwards to the raw material supplier stage. A South African example would be Eskom taking over a coal mine.

3. Conglomerate Mergers:

A conglomerate merger is the combining of two firms, which operate in unrelated business areas. In such mergers companies diversify away from their main line of business into unrelated business areas. Some conglomerate mergers are motivated by risk reduction through diversification, some by the opportunity for cost reduction and improved efficiency. A South African example would be the combination of the South African Breweries and OK Bazaars.

During the 1970 and 80's there was a move towards conglomerate mergers. More recently however, there has been a shift by companies to get back to their basics, and divest from all operations that do not support their core business. (Correia *et al* 1993)

~~X~~ REASONS FOR MERGERS

Firms decide to merge for a variety of reasons. Some of the main reasons that have been identified are the following:

- **Synergy:**

A merger should result in synergistic benefits. Synergy is sometimes described as the $2 + 2 = 5$ effect, i.e.: the whole is greater than the sum of its parts. A merger should take place only if the value of the combined entity is greater than the value of the separate entities added together. This may be expressed as follows:

$$V_{xy} > V_x + V_y$$

where:

V_{xy} = value of the combined firm

V_x = value of firm X

V_y = value of firm Y

Lev (1983) further classifies synergistic motives into short-term financial and long-term financial reasons. Perhaps the most notorious among short-term financial strategies, was the use of acquisitions to boost EPS by acquiring companies with lower P/E ratios. The assumption underlying this strategy is

that the market mechanically applies the buying firms P/E ratio to the artificially increased EPS, thus increasing stock price.

A second short term financial consideration is improved liquidity. Companies often acquire other firms with excess cash or stable earnings in order to improve their own liquidity. These motives however, seem to run against the grain of the efficient markets theory.

Turning to longer-term financial synergy, another way in which mergers are thought to increase the combined value of two firms is to increase debt capacity. Presumably, the larger size of the combined entity provides lenders with greater protection, thus allowing the combined firm to have a greater debt to capital ratio. (Lev, 1983)

- **Operating Economies:**

A merger may result in economies in production or distribution, such as lower unit costs through higher production. This is often cited as the reason for horizontal mergers. As output increases, the burden of fixed costs per unit falls, increasing margins and profitability in general.

- **Managerial Skills:**

A company may find itself in a weak economic and financial position. The failure of management to manage assets efficiently would be reflected in relatively depressed stock prices. (Depressed relative to the stock prices of comparative firms run by efficient management). However, with proper management, the firm could experience an improvement in its financial

position. A firm with strong management resources may decide to take over a firm currently earning low returns in order to introduce improved management and reap the benefits of the expected increased returns. It is often found that firms earning low returns become the subject of takeover attempts.

Conversely, from a different perspective, a large firm may decide that it needs the management skills found in a smaller firm.

- **Market Power:**

One of the most important forces driving mergers is the attempt to increase market power. This is the ability to exercise some control over the price of the product. It can be achieved through a monopoly, oligopoly or dominant producer positions. If a firm has a large share of a market it often has some degree of control over price. Market power is a motivator in both vertical as well as horizontal mergers. Even conglomerate mergers can enhance market power.

- **Entry into New Markets:**

If a firm has chosen to enter a particular market but lacks the right know-how, the quickest way of establishing itself may be through the purchase of an existing player in that product or geographical market. Also where a company finds itself in a declining industry or market, it may acquire new technologies to improve its growth prospects.

- **Diversification:**

Diversification is often cited as a reason for mergers. A company in a particular business field may decide to enter into an unrelated business area. It

therefore obtains the benefits of diversification in that there is not a perfect correlation between the returns of the two sectors, the company will reduce the volatility of its returns, and so reduce the investors required rate of return.

(Correia *et al* 1993)

The problem with this reasoning is, that, short of preventing bankruptcy or acute financial distress, paying large premiums to diversify out of a firms basic industry should not benefit stockholders. They achieve diversification much more efficiently simply by diversifying their own portfolios. Consequently they are not likely to pay a premium to hold the shares of a diversified company. (Lev, 1983)

- **Tax Considerations:**

There are often tax benefits associated with acquisitions. One reason for undertaking a merger may be to obtain the benefit of the tax-assessed loss of the target company.

- **Managerial Motives:**

This reason often raises controversy, as it is one of the few reasons, which does not site shareholder wealth maximization as its objective. According to such explanations, management sometimes deviates from the classical economic objective of maximization of stockholders wealth. Instead it pursues its own private goals. Some of the reasons advanced as managerial motives for mergers are the following: empire building; status; power and remuneration.

All the above merger motives discussed will be readdressed in the main argument, when analysing if mergers and acquisitions create shareholder value. As the type of merger, as well as the motivation for the merger do tend to have a significant bearing on the market perception of the merger, and hence the subsequent creation of value for the shareholder.

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THE BASIS OF PREVIOUS STUDIES UNDERTAKEN:

THE METHODOLOGY

Mergers and acquisitions have long played an important role in the growth of firms, and recent years have seen increasing levels of merger activity in developed countries. Numerous theories, as discussed above have emerged as possible explanations for this increased merger activity. They all have one unifying thread however, namely that to be successful, mergers and acquisitions must increase the present value of the owners interest in the firm (Affleck-Graves, Flach & Jacobson, 1988: 147)

Assessment of the effects of mergers and acquisitions on the share prices of companies engaged in merger activity has been a source of considerable controversy among financial researchers for many years.

In order to assess the markets response to mergers and acquisitions, stock prices are expected to provide a fairly reliable means of evaluating corporate performance. Early studies of the effects of mergers and acquisitions tended to focus on financial statement data, but since the seventies the shift has been almost completely in favour stock market data.

The aim of this type of research is to isolate the so-called “abnormal returns” – that part of a company’s stock price change, which can be attributed to the markets learning of an impending merger. The first step then is to establish the firms “normal” or “expected” rate of return. This process begins by determining the historical

relationship between an examined stocks rate of return and the return on the market as a whole.

Using the “market model” to calculate the “beta” of the firm, the beta is then multiplied by the realized rate of return on the market during the examination period to obtain an “expected” return. The “abnormal” return on the stock is then determined by subtracting the expected rate of return from the actual or realized rate or return over the relevant period. The abnormal rate of return is interpreted as the markets response to the announcement of a merger.

This technique is a reasonable one, but there are two important assumptions, which underlie its use. The crucial one is market efficiency. Reliance on this method of assessing value added (or lost) through acquisitions is based on strong beliefs in market efficiency. It is based on a belief that information is very quickly, if not instantaneously, impounded in stock price changes. Stock price changes are thought to reflect in an unbiased way changes in the underlying value of the company. They represent the markets immediate assessment of the long-term profitability of the investment. Only given this assumption can you deduce the long-term consequences of events like mergers from observed changes in stock prices.

The second assumption underlying this line of research is that the capital asset pricing model (CAPM) provides a good measure of expected corporate returns to stockholders. The basic purpose of employing the CAPM is to adjust expected returns for the level of risk. A key assumption of the CAPM is the constancy of the risk measure “beta” that is, beta is estimated statistically over a period running from for example five years prior to the acquisition and up to the acquisition, and the

relationship is assumed to hold over the examination period. If beta is either not constant, or for any number of other reasons fails to measure stockholders perceptions of risk, then you do not get a reliable measure of abnormal returns.

It is therefore difficult to say whether the use of stock market data is unambiguously a good or bad method of gauging the success of corporate acquisitions, but it is probably the only reasonable technique that we have available if we want to use market information. (Lev, 1983)

THE EVIDENCE

Most of the previous studies undertaken have been done in either Europe or the United States. In South Africa, little quantitative research has emerged attempting to examine merger activity on the JSE. Few studies have emerged which examine the effects of merger activity on the share price of both the acquiring and the target company.

Of the studies conducted throughout the world, the evidence on the effects of acquisitions on target firm stocks appears to be quite consistent across different studies. The studies on acquiring firms however seem to provide conflicting evidence of the effects of mergers.

EFFECT ON TARGET FIRMS:

Studies such as those of Halpern (1973), Mandelker (1974), Langetieg (1978) and Dodd (1980) all showed that shareholders of acquired companies enjoy significant positive abnormal gains, on or before the announcement of the merger bid. Dodd (1980) and Asquith (1983) concluded that even when bids have been rejected, net shareholder gains are still positive. (Affleck-Graves, Flach & Jacobson 1988)

In a South African study of share price performance of companies on the Johannesburg Stock Exchange (JSE), Affleck-Grave, Flach and Jacobson (1988) consider the returns accruing to the shareholders of acquiring and target firms. The objective is to assess whether firstly, mergers and acquisitions are associated with any abnormal positive or negative shareholder returns and if so, how these returns are

shared between the shareholders of the acquiring and acquired companies. Secondly whether the JSE is efficient with respect to merger announcements.

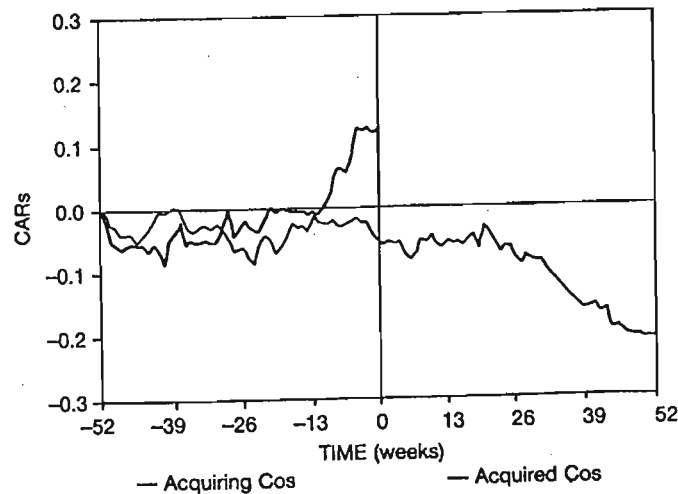
The researchers used three models to manipulate the data, namely the market model (previously discussed), the Industry model and the 0-1 Model. As results from the three models were virtually identical, I will highlight only their findings from the more well known market model.

In their study, Affleck-Graves *et al* (1988) examined a sample of 25 mergers. Eight of the mergers included in the sample involved the acquiring company buying out the minority interest of its subsidiary, and the balance of seventeen were “pure” mergers. The researchers decided to examine these two sets of mergers independently to check for the possibility of differing performance between the two groups. Hence they repeated the entire procedure for each of these subsets.

The results of the study by Affleck-Graves *et al* using the market model were the following:

Figure 1 shows the plotted CARs for the market model using all 25 mergers. The CARs for the acquiring companies remain relatively stable until approximately 20 weeks following the merger after which there appears to be a steady downward drift. This indicates that shareholders of the acquiring company's earn negative abnormal returns in the year following the merger announcements.

Figure 1: Market Model - 25 Mergers



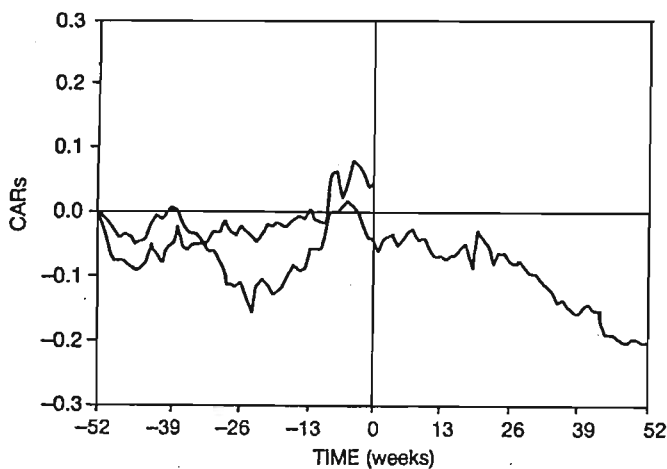
Of particular interest are the periods immediately preceding and immediately following the merger announcement. From the CAR plot for the acquiring companies one can find no evidence of any positive abnormal returns accruing to these shareholders. Indeed, if anything, there is evidence of small negative abnormal returns to the shareholders of these companies around the announcement date. However, the negative abnormal returns around the announcement date are not large and therefore it is concluded that merger announcements, on average, have no effect on the share prices of the acquiring firms. This in turn implies that such merger announcements have no information content for the market. This could be as a result of the market already anticipating that the acquiring companies were likely to be involved in merger activity and this would already be impounded in the price of the shares. An announcement of the particular merger would merely confirm what the market had already anticipated and hence the announcement *per se*, would have no informational value to the market. Alternatively, the market might not anticipate the merger, but on

the announcement it may assume that it was a zero net present value decision to the acquiring company, thereby leaving the price of the shares unchanged.

With respect to the acquiring companies, Figure 1 indicates that the CARs have a random pattern similar to that of the acquiring companies until approximately 13 weeks prior to the announcement. Thereafter, these shareholders earn highly significant positive returns with the CAR plot attaining a maximum value in the week of the announcement. This indicates that the shareholders of the acquired companies earn fairly substantial abnormal returns around the time of the merger announcement. In addition, the results presented in Figure 1 indicate that the information regarding the merger was already available to the market approximately 13 weeks prior to the announcement.

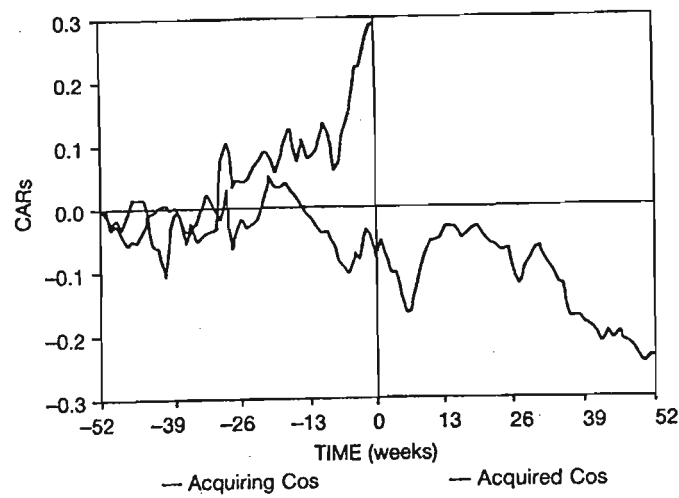
The plotted CARs for the 17 “pure” mergers are displayed in Figure 2. The trend for the acquiring companies is similar to that displayed in Figure 1. The acquired companies also display a similar trend to that shown in Figure 1 with the CAR plot indicating positive abnormal gains for at least 13 weeks prior to the merger announcement.

Figure 2: Market Model - 17 Mergers.



The results for the eight “buyout” mergers are displayed in Figure 3, and are not markedly different to those presented in Figures 1 and 2. The acquired companies in this group clearly achieved substantial positive abnormal returns in the eight weeks prior to the announcement although it is possible that the upward drift commenced some time before this.

Figure 3: Market Model - 8 Mergers



In the case of the acquiring companies, it is possible to see a downward drift in the CAR plot both in the weeks preceding the announcement and immediately thereafter.

The researchers were therefore able to conclude from this study: In the context of the JSE, the empirical evidence indicates that shareholders of acquired companies earn abnormal returns for approximately 10 weeks prior to the announcement of the merger. On the other hand, there is no evidence of superior returns accruing to the shareholders of the acquiring companies either prior or subsequent to the merger announcement. If anything, the abnormal returns are slightly negative for this group of shareholders around the time of the announcement.

Finally, the results indicate that this group of shareholders earn negative abnormal returns during the year following the announcement. (Affleck-Graves, Flach & Jacobson 1988)

The significant features to emerge out of this study and their results were consistent with previous findings by other researchers. The results from the JSE were also consistent with those from previous studies on the NYSE.

In addition, the results presented in the study indicate that the gains to the acquired companies appear to have been experienced from approximately ten weeks prior to the announcements, whereas other studies Mandelker (1974) and Langetieg (1978) observed that gains from seven and six months respectively. In contrast Dodd (1980) using daily data, observed most of the gains on the JSE accruing on the day before the announcement. (Affleck-Graves, Flach & Jacobson 1988).

Affleck-Graves *et al* (1988) go on further to point out, that although one may be tempted to conclude that insider trading or information leakages are the cause, it is important to stress that this is in no way proved by the results presented. Other rational explanations such as accurate appraisal by investment analysts and anticipation by the market cannot be ruled out.

In a study undertaken by Limmack, (1991) during the period 1977 to 1986 evidence regarding the effects on target companies were consistent with previous studies. Limmack, found that significantly positive abnormal returns are obtained by target companies over a period beginning two to three months prior to the formal announcement of the bid. The results were consistent with those obtained by Franks *et*

al (1977) who suggested that the stock market is beginning to anticipate mergers on average at least three months prior to the announcement date.

Limmack further did a comparison of results for targets in completed and abandoned bids. The results revealed no significant difference in the overall pattern of returns, except that the completed bids were anticipated earlier than the abandoned bids.

Furthermore researchers had uniformly found that over a long-term period prior to the announcement of mergers, target firms stockholders had earned negative abnormal returns; that is the stock price performance of acquired firms was on average below the average risk adjusted performance of the market as a whole. This finding was therefore consistent with one of the major motives for mergers previously mentioned, namely the role of acquisitions in weeding out inefficient managers. Findings therefore suggest that there is evidence that acquired firms were relatively inefficient, as least as far as the market perceived them.

These findings thus suggest that merger and acquisition activity may serve as a valuable mechanism for replacing inefficient managers, reallocating the economy's resources to more efficient uses or users. (Lev, 1983)

The suggestion is then, that the benefits accruing to the target stockholders is as a result of the markets perception of significant improvements in the efficiency of operations, which will ultimately raise the value of the acquired firm.

Another striking result of the studies conducted by Dodd (1980) was that unsuccessful merger proposals and tender offers were associated with permanent positive revaluations of target shares.

Dodd (1980) found that for 53 unsuccessful tender offers examined in his study, the average excess return over the 121 days around the transaction was 15.6 percent. It therefore appeared that the attempted transfer of control revealed information that resulted on average, in a significant increase in the market value of the company's shares.

Over two thirds of these firms, were subsequently acquired within five years and revaluation could reflect the markets anticipation of these acquisitions. Alternatively the revaluation could reflect expectations of improved managerial performance following the attempted takeover.

Of the 108 cancelled merger proposals that Dodd (1980) studied, these too were all associated with a positive overall revaluation. The gains to target stockholders were smaller than those in tender offers but were nevertheless significant.

From the results of Dodd's (1980) findings, we can conclude that there is a permanent revaluation associated with an average takeover bid rejected by the target management. The higher price reflects the fact that an unsuccessful acquisition attempt is often followed at a later date by a different, but successful bid.

EFFECT ON BIDDING FIRMS:

When we move to the stock markets reaction to acquiring firms, the situation is much less clear. The studies are not consistent, and the evidence much more difficult to interpret. The studies are consistent in the sense that most indicate that the abnormal returns to buying companies stockholders are very small – though some find negative and other find positive average gains. (Lev, 1983)

Asquith (1983) and Schipper & Thompson (1983) found that positive gains are made by acquiring firms which engage in announced merger programmes and that these gains are capitalized at the announcement of such programmes. In studies of individual mergers however, such as those of Halpern (1973) and Mandelker (1974), there is no evidence of positive gains being made by shareholders of acquiring firms. Dodd (1980) in fact found evidence of small losses whether the merger bid was successful or not. (Affleck-Grave, Flach & Jacobson 1988)

Barnes (1984) extended this view and found significant negative gains in the longer run. It appears as if investors expectations of synergistic benefits resulting from the merger were overly optimistic, in other words higher expectations at the time of the merger were unjustified.

Jensen and Ruback (1983) made the following comments:

“Several studies show indications of systematic reductions in the stock prices of bidding firms in the year following the event. These post outcome negative abnormal returns are unsettling because they are inconsistent with the market efficiency and

suggest that changes in stock prices during takeovers over-estimate the future efficiency gains from mergers.”

Barnes (1984) examined two conflicting hypothesis in his paper. The first hypothesis concerns efficient capital markets and the instantaneous rise in share prices on merger news. The second concerns the benefits eventually accruing to the firm as a result of a merger, arising from such things as increased efficiency and enlarged markets.

Concerning the second hypothesis, most of the evidence suggests that merger gains are not realised. While there were slight share price gains around the time of the merger, there were substantial and significant price decreases in the longer term after the merger. Overall, share prices took around six months to adjust to a lower level, which was maintained for the remainder of the analysis period. The sample group of mergers was broken down into various groups and types of mergers, but the results were largely unaltered.

Concerning the first hypothesis, Barnes (1984) concluded the following: The efficient market hypothesis suggests that, in the first place, merger news was interpreted as “good news” but, as a result of later information and the way in which the merger turned out, expectations were substantially revised downwards. Barnes points out that one is tempted to interpret the reversal of such expectations and valuations solely in terms of the inefficiency of the markets and incorrect investor interpretations. However, at the merger announcement, not all the information was available. Some information may even have been misleading and the eventual outcome and success of the merger may well have been substantially different from that anticipated by those involved. (Barnes, 1984)

Affleck-Grave *et al* in their South African study of mergers and acquisitions on the JSE, found that shareholders of the acquiring companies do not benefit by the merger activity in the short term. The results of this study indicate that the benefit to acquiring shareholders is unlikely to be positive and moreover, that, on average, the actual announcement of the merger has little impact on the share price of the acquiring company.

Limmack (1991) found that in the period surrounding the bid (i.e.: bid month to outcome month), it appears that target company shareholders do not lose. If the post outcome period is included in the analysis of returns and wealth changes to bidder companies, then Limmack (1991) found that substantial losses were experienced, on average. Limmack (1991) concluded that it appeared that both the bidder companies and the markets overestimated the likely benefits to be obtained from acquisitions.

The results obtained indicated that the market adjusts the price of shares of large bidders in the period immediately surrounding the bid but that the market adjustment for smaller bidders is less immediate with wealth losses obtained over a period of up to two years following the outcome of the bid.

The results further suggested that the gains made by target company shareholders were at the expense of bidder companies. One implication of this result however is that, investors holding well-diversified portfolios will suffer no wealth decrease as a result of acquisition adjustment. (Limmack, 1991)

Lev (1983) offers an alternative explanation for the evidence that acquiring shareholders do not experience gains. He suggests that most of the gains from mergers

to buyers are already reflected in stock prices well before announcements were made. Stated differently, the market had anticipated the event, and thus there was little or no response to the actual announcement. Another explanation is the market for corporate control is so competitive that there is practically no gain to the acquiring firm. Buying companies expect simply to earn a normal or average rate of return on their investment in the acquired firm. They paid the “right price”, the acquisition represents a zero NPV investment and there is no value added (or lost) for stockholders.

Others however would interpret the results as indicating a rejection of the value-maximization hypothesis. Corporate managers conducting mergers often pursue their own interests without regard for their stockholders. Which means that the results of no gains to stockholders of acquiring firms could be due simply to some bad decisions by managers. (Lev, 1983)

THE CHARACTERISTICS OF MERGERS, AND THEIR EFFECT ON THE SHARE PRICE:

An obvious question that flows from the above is whether the level of any excess return experienced by the target and acquiring firms can be related to the characteristics of the merger.

Research by van den Honert, Barr, Affleck-Graves & Smale (1988) focused on four easily identifiable features of merger activity, which describe the relationship between the target and acquiring firms and the mechanics of the merger and aim to quantify the wealth effect of these four features for shareholders of the target and acquiring firms.

The features that the researchers considered were the following:

- The relationship between acquiring and target firms;
- Their relative sizes;
- The amount of prior control of the acquirer in the target;
- The medium of exchange

In their study, however, each of the four characteristics was considered in isolation for the acquiring and target firms.

Each of these four features is discussed in order to determine why they are important for merger activity.

CHARACTERISTICS THAT DESCRIBE MERGER ACTIVITY:

- **RELATED AND UNRELATED MERGERS:**

Brews (1987) cites the nature of the business of the target firm relative to that of the acquiring firm as perhaps the most important characteristic in the profile of a prospective target firm. It may seem that by acquiring an unrelated asset, a firm is diversifying which should lead to a reduction in risk. Brews and others have, however found that firms that branch out into unrelated fields are likely to be less successful in the long run since they do not know the business of the prospective target firm.

The study aims to determine the extent to which wealth gains accrue to shareholders of acquiring and target firms, which engage in mergers with firms in related industries on the one hand, and to shareholders of acquiring and target firms, which engage in mergers with firms in unrelated industries on the other.

A merger was classified 'related' if the target firm was in a related industry to the acquiring firm and the acquiring firm was operating in a specific industry, i.e.: was not of a conglomerate nature.

- **PRIOR CONTROL OF THE TARGET FIRM BY THE ACQUIRING FIRM:**

For the purposes of their study, van den Honert *et al* (1988) divided mergers into two groups, those where the acquiring firm had effective control of the target, and those where the acquirer did not have control.

- **RELATIVE SIZE OF THE TARGET FIRM TO THE ACQUIRING FIRM:**

Brews (1987) investigated the size of the target firm as a merger criterion.

Whether size of the target firm was measured relative to the size of the acquiring firm ('size' of the firm could be before tax profit, turnover, market capitalization or any other measure) or in absolute terms, the conclusions were clear. Firms should be wary of acquiring firms very much smaller than themselves. The management time and effort required negotiating and implementing such a transaction, and indeed correct matters should this go awry, is usually exorbitant. (Brews 1997)

A merger was classified as 'large' if the market capitalization of the target firms was more than 25% of the market capitalization of the acquiring firm at the announcement date.

- **THE MEDIUM OF EXCHANGE:**

Firms with a surplus of cash and a shortage of good investment opportunities often turn to mergers as a way of redeploying capital. In fact, failure to do so may induce a predator firm to attempt a takeover and redeploy the capital for them. Brews (1987) found that certain South African companies used surplus cash for merger activity since they felt they were in a strong position. Thus the fourth attribute investigated was the difference in wealth accruing to shareholders of both acquiring and target firms where the merger was financed with cash only (cash-rich acquirers) or by shares only.

The study by van den Honert & Barr (1988) examined a set of 45 companies on the Johannesburg Stock Exchange (JSE) over the period 1975 – 1985. They were selected by applying certain pre-determined criteria.

The sample was then further bisected in four different ways, according to the criteria outlined above.

THE RESULTS:

- **RELATED VS UNRELATED MERGERS**

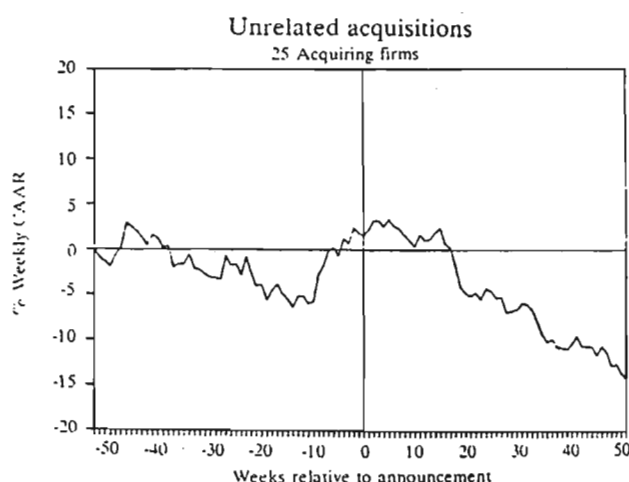
Unrelated Acquisitions – Acquiring Firms: (*Figure 4*)

The cumulative average abnormal return (CAAR) exhibits a downward trend in the year prior to the merger. This indicates worsening investor confidence and expectations on the future cash flows of the firm. Some 12 weeks prior to the merger announcement, however, the CAAR shows a strong upward trend, which reaches a peak of 3% within four weeks of the merger announcement. Investor's expectations are subsequently revised and the net CAAR a year after the announcement is some -14%.

A justification for the acquisition of an unrelated asset that is often cited is that of diversification and hence risk reduction. If this is the motive of acquiring firms included in this sample then there is no evidence that the market values increased with diversification. After all, as previously mentioned, it is easier and more effective for the shareholder to rather hold a diversified portfolio.

Furthermore, the downward trend in the CAAR could also reflect the anticipated and often overlooked problems in post-merger firms associated with the integration of two unrelated entities into an efficient whole.

Figure 4: Unrelated Acquisition – Acquiring Firms



Related Acquisitions – Acquiring Firms

As a comparison, the CAAR plot of the sample of acquiring firms in the related acquisitions is shown below (*fig.5*). The feature of the plot is that the CAAR for the acquiring firms fluctuates in a fairly narrow band throughout the period and there are no major increases or decreases in the CAAR. Thus there is evidence that investors in acquiring firms that pursue related acquisitions anticipate this behaviour and expect the benefits almost a year before the actual merger.

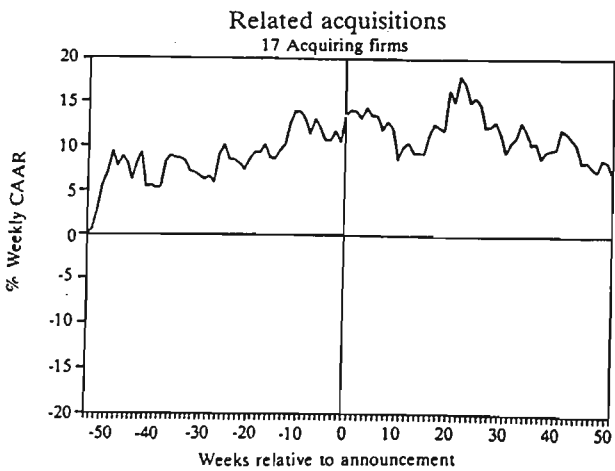
There is some downward revision some 5 – 10 weeks subsequent to the announcement. From weeks 10 to 20 there are significantly positive average

abnormal returns, leading to a sharp rise in the CAAR plot. This is the period during which the target firm is de-listed, and indicates that the de-listing has some informational content. A year after the merger, the net CAAR is 7% compared to the -14% of the unrelated sample.

According to the above, it appears as if the pursuance of a related acquisition policy increases value, whilst an unrelated acquisition policy decreases value.

Many of the mergers in the related acquisitions sample resulted in a concentration effect in those particular industries. For example C.G Smith and Illovo Sugar. The positive CAAR exhibited by the sample could be a reflection of the markets perception of the benefits accruing from market concentration and the characteristics of monopoly power associated with it.

Figure 5: Related Acquisitions – Acquiring firms



Related & Unrelated Acquisitions – Target Firms:

The plots below (*fig.6 & 7*) show the samples for the related and unrelated target firms. Both samples exhibit a strong announcement effect although the CAAR after the announcement reaches 30% for unrelated acquisitions compared to only 10% for related acquisitions. Furthermore, in the case of the unrelated acquisitions the CAAR starts moving upwards some 15 weeks before the announcement whilst most of the movement occurs from only one week before the announcement for the related acquisitions.

The CAAR for the target firm is a reflection of the markets perception of what premium the acquiring firm is willing to pay in order to complete the merger. Thus management of firms pursuing an unrelated acquisition strategy appear to be willing to pay more for the target than those following a related acquisition strategy. This is reflected in the CAAR performance of the acquiring firm subsequent to the announcement where CAAR's of the acquiring firm subsequent to the announcement where CAAR's of acquiring firms involved in unrelated acquisitions drop away after the announcement. (*See figure 4*)

The CAAR plot for related acquisition target firms is negative over the 10 months prior to the merger and a positive CAAR does not develop until the announcement. This might indicate poor management in the target firms. The lower premium paid by the acquiring firms could be a result of poor management in the target firms or it could be a more accurate assessment of the value of the merger by the acquiring firm, compared to the valuation of

target firms by the management of the acquiring firms in the unrelated merger sample.

Figure 6: Related Acquisitions – Target Firms

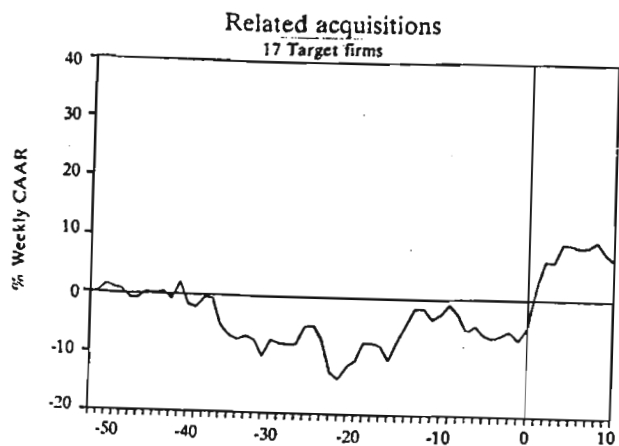
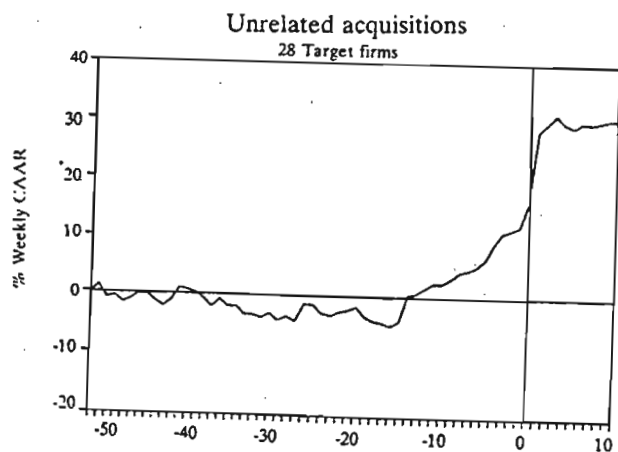


Figure 7: Unrelated Acquisitions - Target Firms



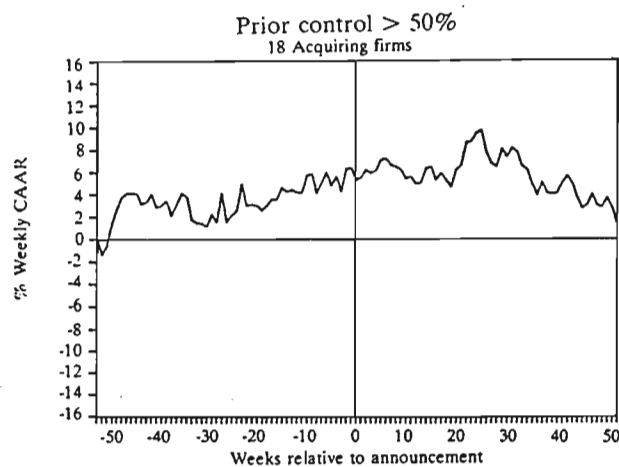
For both related and unrelated mergers the gains to acquiring firms are minimal, indicating that investors perceive no economic gains to be had from the investment. Post announcement performance in fact shows that on average the net effect over the period considered are negative.

• **PRIOR CONTROL OF THE TARGET FIRM BY THE ACQUIRING FIRM:**

Acquiring firms with prior control greater than 50%:

The CAAR plot (fig. 8) for the sample of 18 acquiring firms that had effective control of the target at the time of the announcement is shown below. The average prior holding for this sample was 63.5%.

Figure 8: Prior Control > 50% Acquiring Firms



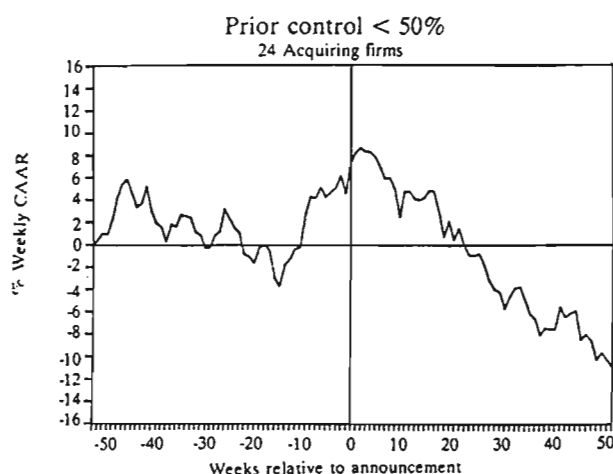
The plot exhibits similar characteristics to the CAAR of the related acquisitions sample. The overall CAAR fluctuates in a narrow band throughout the period with a net positive effect of 2% one year after the announcement. The fact that the acquiring firms are already deeply involved in

the target firm would suggest that they know the business and perceive there to be benefits from the purchase of the minority interest. The profitability however is not sustained, and the CAAR plot exhibits a downward trend towards the end of the year after the merger announcement.

Acquiring firms with prior control of less than 50%:

The CAAR plot (*fig.9*) for the acquiring firms that had less than 50% prior control at the time of the announcement is also shown below.

Figure 9: Prior Control < 50% Acquiring Firms



There is a strong upward effect some 15 weeks prior to the announcement reaching a peak of some 8.5% soon after the announcement, but all these gains are subsequently lost as investors revise their expectations when the true consequences of the merger become evident.

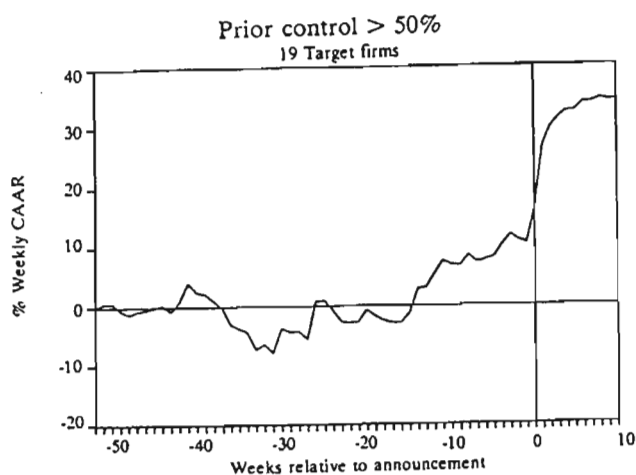
In fact the CAAR of the acquiring firms was in a distinct downward trend before the upsurge and indications are that an acquisition strategy was being

followed in order to boost sagging performance. However the benefits from the merger do not appear to be achieved and there is a net reduction of shareholder wealth over the period studied.

Target firms with prior control greater than 50%:

The CAAR plot (*fig.10*) for the target firms in which prior control was more than 50% is shown below.

Figure 10: Prior Control > 50% Target Firms



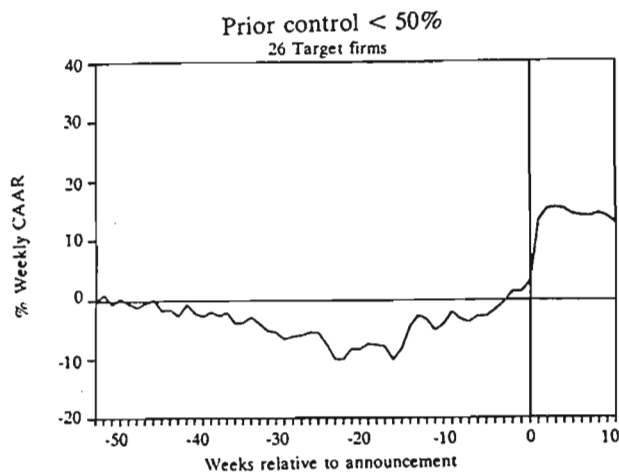
The minority shareholders begin to anticipate the impending buyout some three to four months before the actual announcement. However the announcement still has strong informational content.

Target firms with prior control less than 50%:

For the sample of target firms where prior control was less than 50%, the announcement effect is very pronounced and positive returns are not experienced until the actual announcement week. Furthermore the target firms

appear to have been performing poorly prior to the merger, a sensible reason for the takeover bid by the acquiring firm.

Figure 11: Prior Control < 50% Target Firms



- **THE EFFECT OF RELATIVE SIZE OF THE TARGET FIRM TO THE ACQUIRING FIRM:**

Size of the acquiring firm:

An acquisition was defined as 'large' if the ratio of the market capitalization of the target firm to that of the acquiring firm on the announcement date was greater than 25%.

Figure 12: Large Acquisitions – Acquiring Firms

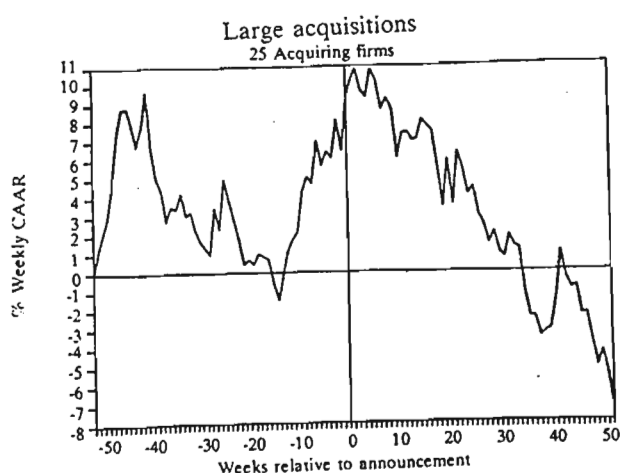
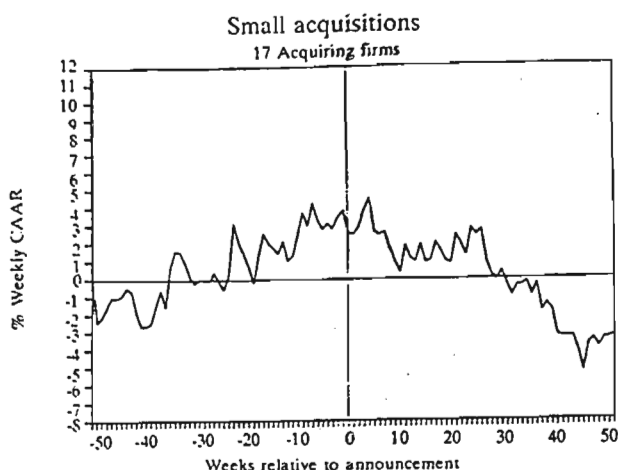


Figure 13: Small Acquisitions – Acquiring Firms



Both plots show an upward trend starting some three months before the announcement, indicating that investors are anticipating potential merger benefits. The peak in each case is reached approximately three to four weeks after the announcement, at a level of nearly 11% for large acquisitions and 4% for small acquisitions.

Thus the level of expected benefits is proportional to the stake involved. Indications of revised investor expectations about the benefits of the merger lead to a sharp downward trend in the CAAR from some four weeks after the announcement, with the net effect one year after the announcement being negative in both cases. Thus the size of the acquisition has no consistent effect on the wealth-creating possibilities by merger, i.e.: small acquisitions are equally likely to be unsuccessful as large ones.

Size of the target firm:

The CAAR plots for relatively small and large target firms are presented in the two plots below.

Both plots exhibit a zero or negative CAAR before the announcement possibly indicating poor management in target firms. The announcement effect is much more pronounced for large acquisitions than for small acquisitions where an upward trend begins some four months before the actual announcement. The magnitude of the announcement effect is however much larger in the case of small acquisitions where it rises to 38% soon after the announcement. In the case of large acquisitions it is only 13%.

Figure 14: Small Acquisitions – Target Firm

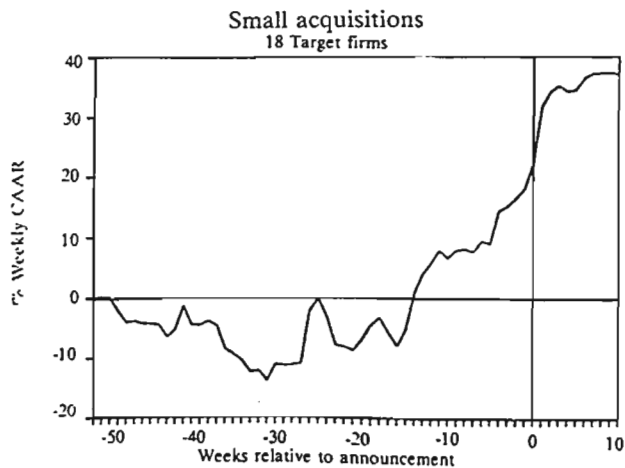
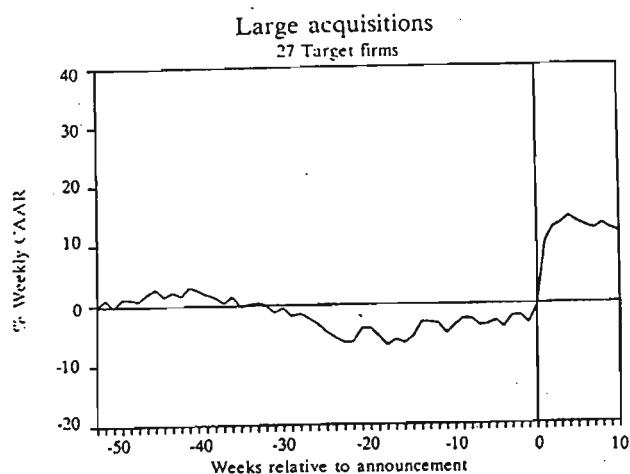


Figure 15: Large Acquisitions – Target Firm



One justification for merger from the point of view of the target firm is a source of cheap capital from the acquiring firm. When the target is small relative to the acquiring firm this effect will be most marked (in percentage terms) and the CAAR plots for relatively small target firms exhibit this, rising significantly more just after the merger announcement than do the relatively large target firms.

- **THE ROLE OF THE MEDIUM OF EXCHANGE:**

Cash and Share exchanges – Acquiring firms:

Those firms that used only cash or only shares as a medium of exchange for the financing of the merger were isolated. The CAAR plots for the acquiring firms involved in share exchange and cash exchange mergers are shown in the two plots below.

Figure 16: Share Exchange Acquisitions – Acquiring Firm

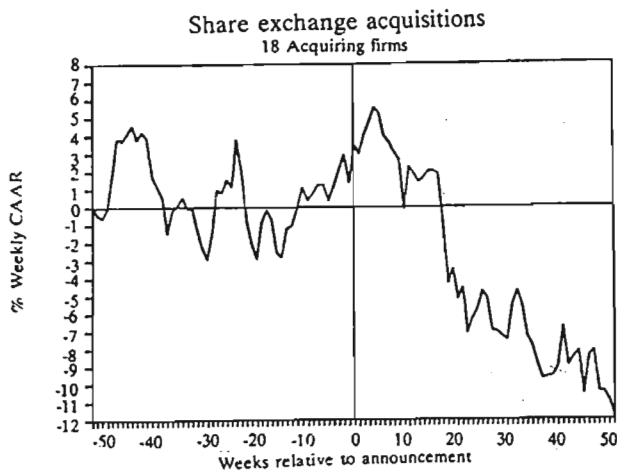
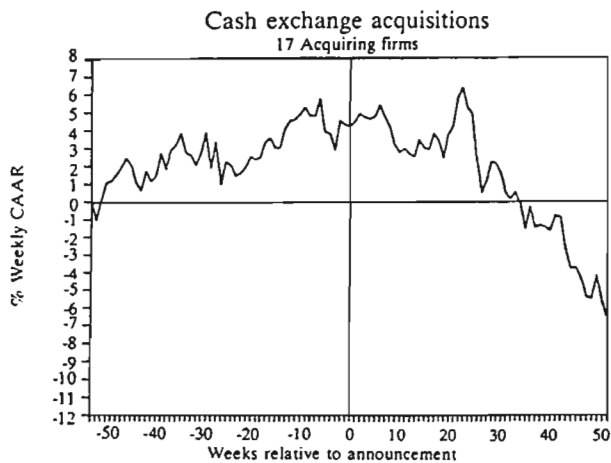


Figure 17: Cash Exchange Acquisitions – Acquiring Firm



The sample of firms using only shares as a medium of exchange, exhibit random behaviour up until the anticipation of benefits from the merger some three months before the announcement. The sample of cash exchange firms, however, exhibits gently increasing CAAR's in the year before the merger, which fluctuate in a fairly narrow range. This could be due to the acquiring firm being successful and thus having excess sources of cash, which it needs

to invest. The positive CAAR's are either a reflection of the profitability performance of the acquiring firm or of the markets perceived benefits from acquisitions using the excess profits or cash.

Whatever the reasons for the positive CAAR's after the announcement, they are eroded rapidly and end up negative a year after the announcement. The decline is much quicker in the case of the share exchange sample. This could indicate worsened investor perception of the synergistic benefits possible from the merger, or the fact that the acquiring firm has given away equity and hence diluted shareholders holdings.

Cash and Share exchanges – Target Firms:

The CAAR plots for the target firms in the samples of share exchange and cash exchange acquisitions are presented in the two plots below.

Figure 18: Share Exchange Acquisitions – Target Firms

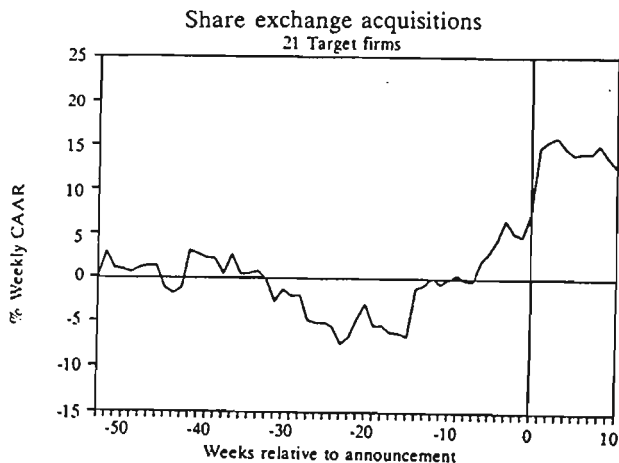
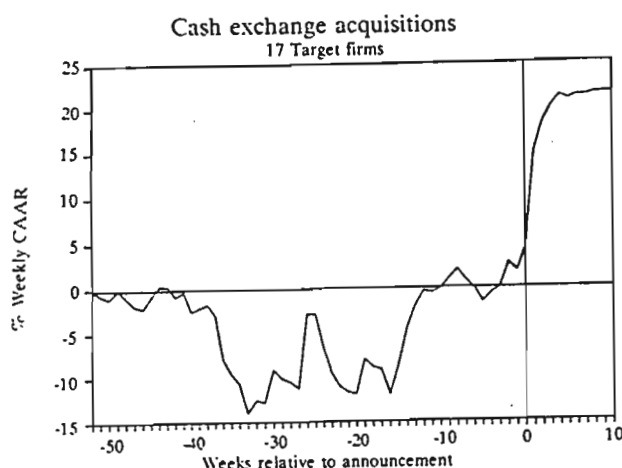


Figure 19: Cash Exchange Acquisitions – Target Firms



The overall characteristics of the two curves are similar for both samples. The CAAR plot for both samples exhibits a decline in the first half of the year prior to the merger announcement. The cumulated abnormal increase in returns after the announcement is 22% for cash exchange mergers and 16% for share exchange mergers. The shareholders from the target firm in the share exchange sample expect to benefit in the future from owning a small piece of a large and potentially profitable firm, and thus are prepared to accept a lower premium than they would if they were being paid in cash.

SUMMARY OF THE STUDY:

The following features emerge from the empirical results presented above. In related mergers the acquiring firms on average do not lose value from mergers, while targets show significant gains. In the case of unrelated mergers the acquirers lose, possibly due to the fact that they are unfamiliar with the business. In contrast, the target firms show massive gains. Similar results hold for the case where an acquiring firm holds

the prior control, i.e.: acquirers do not lose by merger if they held prior control. This may be due to the fact that acquirers who do hold prior control are involved in the target firm and hence are familiar with the business.

When the relative size is considered it was observed that the acquirers on average lost value by merger regardless of whether the target was small or large. However the target firms gained in both instances. An identical result held when the medium of exchange was the variable under consideration – acquiring firms decreased in value and targets gained.

A point that arises from this study is that the acquiring firms involved in merger activity do not tend to benefit in the short term from the merger while the target firms do experience abnormal positive returns around the announcement date.

(van den Honert *et al* 1988)

In a similar study conducted by Kitching (1967), the results of mergers and acquisitions were analysed, in an attempt to establish the underlying causes for variations in performance. While the previous study was based on stock market data, this study was based on discussions with top executives of 22 companies, and draws on their experience in acquiring and managing a total of 81 companies in the period 1960 – 1965.

The results of the study can be summarised as follows:

- **Type of Merger:**

Kitching (1967) found that there was a relatively high risk of failure in concentric acquisitions, and a relatively low risk in horizontal mergers.

The greatest proportion of acquisitions consists of the conglomerate type (*see Table 1*). This suggested a move to diversify and spread risk, but this strategy in itself is a risky one, as table 1 shows.

Kitching points out that although the type of merger is an important factor in the overall success or failure of the acquisition, it is by no means the determining factor; the primary cause must be sought elsewhere.

TABLE 1:

The types of acquisitions that have the highest incidence of failure (As reported by executives)

(Source: Kitching, HBR 1967, p91)

Acquisition Type	Percent of total	Percent of Failures
Vertical Integration	3%	0%
Horizontal	25%	11%
Concentric Marketing	13%	26%
Concentric Technology	14%	21%
Conglomerate	45%	42%

- **Size Mismatches:**

Several executives attributed acquisition failures to mismatches of size. A size mismatch is considered occurring when the acquired company's sales were less than 2% of the parent company sales volume before the merger. In 84% of

the failures studies, the acquired company's sales volumes were less than 2% of the parent company.

- **Synergy:**

Theoretically synergy in mergers should be greatest where production facilities are combined, because economies of scale are possible.

Combinations based on technology (process know-how and R&D transfer), marketing or organisation (personnel economies and productivity increases), and finance (additional and lower cost of capital) should be of diminishing value, in that order. According to top managers, however, the ease with which synergy is actually released occurs in the reverse order; that is, synergy is most easily accomplished where financial resources are pooled, and is most difficult to achieve where production facilities are combined.

Furthermore, top managers report that the monetary payoff is actually lowest, on average, where production and technological resources are put together, and highest where financial resources are combined. (Kitching, 1967)

Therefore, the findings in the study by Kitching, which examined merger and acquisition characteristics from the perception of top executives who are actually undertaking the integration, seem to largely concur with the finding in previous studies, like those of van den Honert *et al* (1988), which examined historical stock market data.

Both demonstrate the significance of mergers characteristics on the overall success of the merger. While the two studies examine the phenomenon from

different perspectives (van Den Honert et al examined 45 companies on the JSE, while Kitching sought the opinion of 22 top executives), the results clearly demonstrate that the characteristics of the merger do have a bearing on the mergers success or failure, and hence the resultant value created or destroyed for the shareholder.

SHAREHOLDER RETURNS AND EXECUTIVE REWARDS:

The rationale for corporate takeovers is traditionally couched in terms of maximising stockholder wealth and that firms will make acquisitions only if they believe it will enhance stock prices. While acquisition decisions are made by the senior executives and directors of the company, and not by stockholders themselves, it is argued that the market for managerial labour will discipline the executives into making acquisition decisions that are in the best interests of the stockholders.

An alternative motive for making acquisitions has been forwarded, and this rationale is not directly related to maximising stock market value. The motive notes that it is senior management who make acquisition decisions, and these managers will be influenced by their own self-interest. This rationale also argues that stockholder discipline of managers is weak enough so that managers can pursue, to some extent their own goals. Remuneration, power, prestige and safety of tenure are likely to be major desires of management, and maximizing firm size may be an objective that enables these goals to be attained. (Firth; Managerial and Decision Economics, 1991)

Chevalier (1988) argues that one rarely hears executives boast about the business empires they have single handedly diminished in scope and size. Even in the era of downsizing, many executives want to expand and diversify business operations – sometimes at the expense of the shareholder. (Chavalier, 1988)

Lev (1981) argues that diversification is a method by which managers can reduce their employment risk, and this may act as a prime motive in explaining some takeovers and especially conglomerate mergers. Perhaps the quickest way for a company to

increase its size or diversify into unrelated activities is to make major corporate acquisitions. It is thus contended that some managements pursue takeover and merger activity even if stockholders suffer reduced returns.

Firth (1991) further concludes that given the competitive market for takeovers in countries such as the United States and the United Kingdom, it should not be too surprising that acquiring firm management may pay too much for some acquisitions in their haste for maximising size or diversification.

This concurs with previous research done regarding the effect of acquisitions on stock market prices. In particular, the stock prices of acquiring firms fell when the takeover was announced and this loss was not recovered in the months afterwards. This evidence is consistent with the scenario of management maximising size even at the expense of their company's stock price. It is also consistent with previous finding by Roll's (1986), which argued that managements overpay for targets because they overestimate their ability to run them.

The potentially conflicting self-interests of management and stockholders can be reduced if the managers are themselves substantial investors in the company; that is, managers are motivated by their stockholder role.

Prior research in the United Kingdom (Firth, 1980) has intimated that the negative stock market reaction borne by the acquiring firm was mitigated somewhat for those companies where the senior management had a relatively large investment stake in their own concern. This is consistent with the view that management may scrutinize

the profitability of takeovers more earnestly when they have a substantial equity ownership stake at risk.

Similar findings were reported by Amihud *et al.* (1990) in their study on acquisitions in the period 1981-1983. They concluded that bidders who experience negative stock returns were characterised by having low managerial ownership. Additionally, the study by Lewellen *et al.* (1985) found that managers whose equity ownership in their firms was low relative to the value of their remuneration are associated with making acquisitions that produce negative returns for stockholders.

The traditional view that takeover decisions are motivated by concerns of maximizing stock prices and the counterview of acquisitions being motivated more by maximizing management utility may lead to differing outcomes. While maximizing stock price returns is likely, *ceteris paribus*, to lead to higher management remuneration (and possibly greater job security and prestige), other actions (such as increasing firm size) may have an even greater influence on executive compensation (job security and prestige), and these actions could reduce stock returns.

Firth (1991) points out that empirical evidence in the U.K has revealed that many takeovers result in negative abnormal returns for the acquiring firm, and this suggests that stockholder wealth maximization might not be an important motive in some of these acquisition decisions.

The results of studies undertaken by Firth (1991), which set out to prove that increasing managerial returns was a strong motivating factor in acquisitions, revealed the following:

The results showed that to make acquisitions that are well received by the stock market (i.e.: those with positive abnormal returns) leads to significant increases in managerial rewards. Even acquisitions that are met with negative abnormal returns appear to be rewarding to senior management. The acquisition process leads invariably to an increase in managerial remuneration, and this appears to be predicated on the increased size of the company.

Firth (1991) therefore concludes that the evidence is consistent with takeovers being motivated by managers wanting to maximize their own welfare. Shareholder wealth maximization appears, on the basis of the results of his finding to be a weaker motivation in many acquisitions. (Firth, 1991)

Chavalier (1988) although agreeing in principle with the argument that executives may undertake acquisitions, even if they are not in the best interests of the shareholders, she disagrees with the motives behind managements actions.

“Our findings do not support the argument that chief executive officers (CEO’s) have an incentive to pursue acquisitions in order to increase their own compensation, rather the results lend support to the argument that CEO’s have an incentive to pursue acquisitions to increase their prestige and standing in the business community.”
(Chavalier, 1988)

To answer the question of why managers undertake acquisitions, Chavalier examined two private benefits that could accrue to managers who undertake acquisitions, namely compensation and prestige.

Despite the prominence of the claim that acquisition activity is rewarded with increased compensation, there has been relatively little work done by researchers to compare compensation outcomes for executives who buy other firms, to those who do not. Furthermore, virtually no academic effort has been devoted to measuring the extent to which acquisitions affect an executive's prestige, perhaps due to the difficulty of measuring social prominence and power.

First Chavalier (1998) tested the hypothesis that managers can increase their salaries by undertaking acquisitions. To do this they compiled a comprehensive database, and studied the effect of firms' acquisitions on the subsequent careers of its CEO. They examined the pay changes surrounding the acquisitions of \$25 million or more.

Chevalier found no evidence that a CEO can increase their salary or bonus by undertaking an acquisition. In addition, the effect of acquisitions on compensation does not depend on whether the acquisition increased or decreased shareholder wealth, or on whether or not the acquisition involved diversification.

Next, Chavalier examined the hypothesis that managers can gain power, prestige and standing in the business community by purchasing other firms. In order to measure an increase in prestige, the authors focused on one plausible benchmark: the number of seats an executive holds on outside boards.

What Chevalier found was that CEO's who completed acquisitions were significantly more likely to gain outside directorship than those who did not complete acquisitions. The results lend support to the argument that CEO's have an incentive to pursue acquisitions to increase their prestige and standing in the business community.

Of the 215 managers in the directorship sample who did not make acquisitions, 27% gained one or more board seats, while 31% lost one or more board seats. On the other hand, of the 131 managers who did make acquisitions, 41% gained seats, while only 19% lost seats.

In addition, the researchers found that managers who undertake acquisitions are less likely to be replaced as CEO, therefore supporting the idea that managers undertake acquisitions in order to entrench themselves. (Chevalier, Capital Ideas, Fall 1988)

CORPORATE GROWTH THROUGH MERGERS AND ACQUISITIONS – IS IT A VIABLE STRATEGY?

The evidence already presented, although differing in the finer details seems to all point to the same conclusion, namely that mergers and acquisitions do not create sustainable value in the long term for the shareholders of acquiring companies.

Numerous studies have shown that corporate mergers are doomed to fail. A recent report by KPMG indicated that more than 50% of mergers destroyed shareholder value, and a further third made no difference. (Business Day, Mar 13 2000)

Despite all the negative findings regarding shareholder wealth creation through mergers, the trend of growth in merger and acquisitions activity continues to grow in South Africa, as in other countries around the world. (Business Day, April 10 2001)

Corporate growth through mergers and acquisitions is a strategy adopted by many South African companies to achieve their growth objectives. Research in both the United Kingdom and the United States, has found that most mergers and acquisitions do not meet expectations. Many fail, and are divested at considerable human and financial cost.

Brews (1987) conducted research on the viability of growth through mergers and acquisitions in the South African market. Through his research, Brews identified that growth through mergers and acquisitions can indeed be a viable and successful strategy, provided a clear acquisition strategy is followed. (Brews, 1987)

Rappaport (1979) said the following: “ Companies that merely react to opportunities to purchase are less successful in their acquisitions than those with an overall strategy which includes an acquisition programme...Successful companies formulate a set of acquisition criteria which are consistent with overall strategy, and then rigorously apply them.

Researchers have identified that there are certain key elements and criteria, which if firmly applied, can greatly enhance the likelihood of undertaking a successful merger.

Brews (1987) held interviews with 20 senior executives from a random sample of prominent South African companies. All had extensive experience in the field of mergers and acquisitions. They were asked to complete a questionnaire covering three sections, namely determining an acquisition strategy, screening and evaluating potential candidates and implementing and integrating an acquisition.

The major points to emerge were the following:

Nature of the Business/Industry:

Candidates indicated that this represented the most important characteristic of the acquisition profile. Most organizations specify that candidates should be in either the same business/industry or a related business/industry before being considered. The overall feeling was that companies should never acquire a business you don't know how to run, and if possible “stick to the knitting”.

Location of the Business:

Although respondents felt this was an important factor, it depended to a large degree on the geographical spread of the operations of the acquirer.

Management Policy:

A dominant consideration here was that they seek good management and retain them. Rockwell (1968) said the following: "The corporate asset in shortest supply these days is good, skilled, experienced loyal management. When you acquire a new company, the top leadership that comes along with the package is at least as important as the rest of the assets you buy."

Another consideration raised, was the compatibility of management. The management of any potential acquisition candidates should be compatible with their own management.

Return on Investment Policy:

Most of the candidates interviewed, indicated that a stated return on investment formed part of their acquisition profiles. Their return will obviously depend on the risk related to the particular acquisition under evaluation.

Minimum/maximum size of investment criteria:

Here again, the findings were conclusive. The message from the executives was that organisations should be wary of acquiring other organisations very much smaller than themselves. The management time and effort required to negotiate and implement such a transaction, and indeed to correct matters should the acquisition go awry, is usually exorbitant.

Rockwell (1968) listed Ten Commandments of successful merger/acquisition practice, these included:

- Pin Pointing the transaction objectives;
- Ensuring that the candidates management is competent;
- Involving the CEO of the target company in the acquisition programme;
- Clearly defining the business you are in;
- Understanding in depth, both you organisations and the acquisition candidates strengths, weaknesses and key performance factors;
- Making people your number one consideration

Levinson (1970) ascribed major reasons for failure to psychological reasons, including fear and anxiety on the part of employees of the acquired organisation, and condescending attitudes on the part of the acquirers management. To these reasons many can be added: inadequate evaluation, overhasty consummation, culture mismatch, insufficient implementation planning and inadequate resources to manage change. (Brews, 1987)

Brews (1987) therefore believes that if nothing else, his research demonstrates that growth through mergers and acquisitions can indeed be a viable strategy. The organisations surveyed confirmed that by and large their merger and acquisition programs have been successful. A possible explanation offered for this, is that most of the acquisitions undertaken by the organisations were either horizontal or vertical integration, two types of transactions, which are less risky and more likely of success.

Mergers and acquisitions, Brews concludes can be a viable strategy for growth, if they are undertaken through a systematic, structured and planned approach. Successful mergers do not just happen, they have to be skilfully managed and guided. An unprofessional or 'ad-hoc' approach to mergers and acquisitions is likely to result in disaster for all parties involved. (Brews, 1987)

THE RELATIONSHIP BETWEEN MERGERS AND DIVESTITURES:

Some observers have argued that the high rates of divestitures are incontrovertible evidence of the failure of past acquisition programs. Others have been more cautious, suggesting that the pattern of acquisitions and divestitures reflects evolving corporate strategies that attempt to match perceived competitive advantages and internal capabilities to accelerating changes in the external market environment.

The view that divestitures may be judged as conclusive evidence of the failure of acquisitions has been expressed most strongly by Michael Porter, as follows:

“The track record of corporate strategies has been dismal. I studied the diversification records of 33 large, prestigious U.S Companies over the 1950 – 1986 period and found that most of them had divested many more acquisitions than they had kept. The corporate strategies of most companies have dissipated instead of created shareholder value”. (M.Porter, 1987)

Porter’s conclusion is based on a compilation of data on 33 companies over the period 1950 to 1986. Each company entered on average 27 new fields and 80 new industries within those fields. About 70% of these entries into new fields and industries were accomplished by means of acquisition.

In order to test the success of these acquisitions into new areas, Porter calculated the ratios of divestitures to acquisitions for each company. On average these 33 companies ended up divesting 53% of acquisitions in new industries and 60% of acquisitions in new fields. When the acquisitions were in fields unrelated to the companies existing fields, the rate of divestiture was 74%.

In analysing the results of Porters study Weston (1988) (Divestitures: Mistakes or Learning) criticises Porters results. Weston purports that there is uncertainty about what divestiture ratios really tell us about past acquisition programmes. Many divestitures represent success rather than mistakes or failures. Some divestitures are planned at the time of acquisition because of poor fit or because they could contribute to financing. Therefore divestiture rates cannot be interpreted as unambiguous measures of failure. Weston concludes that Porters divestiture ratios, in short, do not allow us to distinguish reliably between those firms that performed well and those that did not.

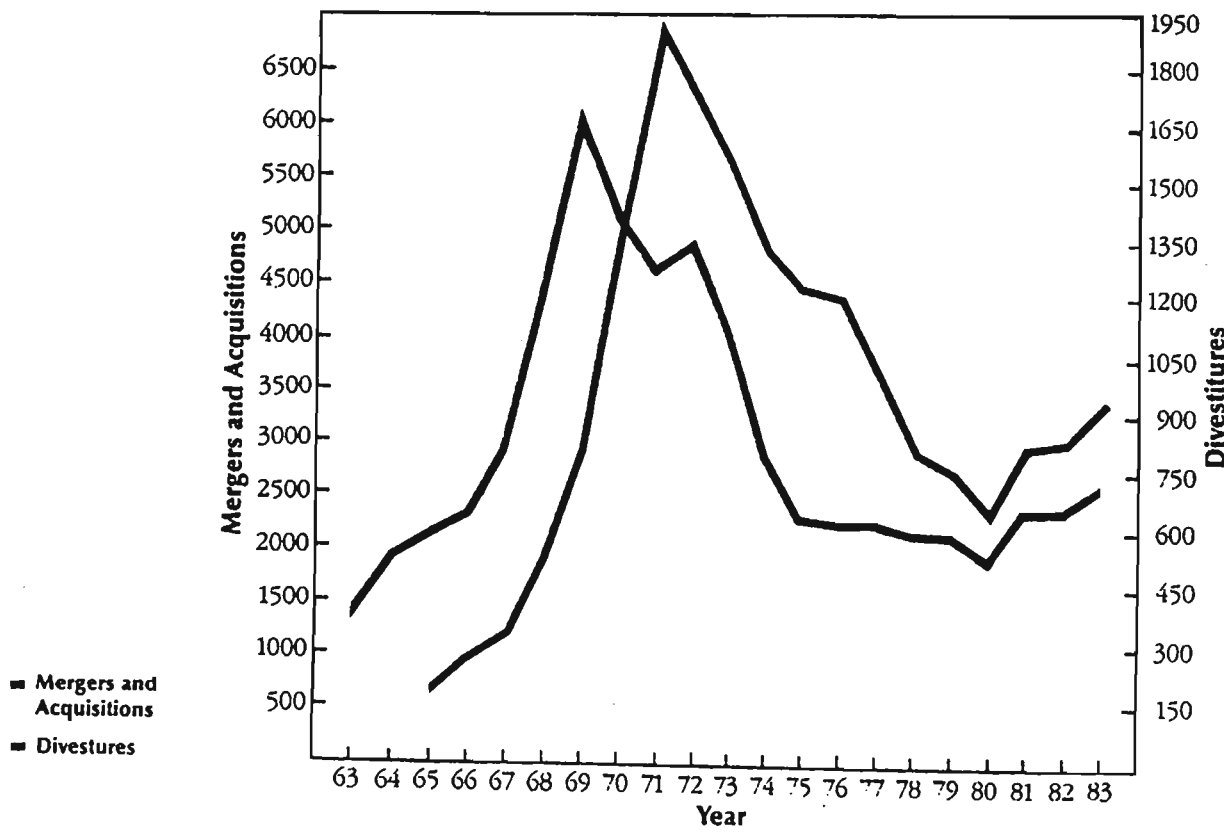
Studies of the market reaction to divestitures report significant positive gains to sellers and normal returns to buyers. These results could be interpreted as the markets positive response to the correction of previous errors in strategy. But stock market studies of takeover and mergers also consistently report net gains to shareholders.

Linn and Rozeff (1984) have suggested that divestitures represent corrections of prior acquisition mistakes. They found that divestiture “waves” follow one to two years after merger waves. These finding however should not necessarily be interpreted as challenging the value of merger activity. A firm may acquire another company with the intention of reorganising the acquired firm, and getting rid of those businesses that don’t complement the primary business lines. Also, changes in technology and product markets may cause combinations, which were once valuable to become inefficient. A sell-off may indicate that the divested resources now have higher values in other uses.

The point of the authors is that divestiture of previously acquired businesses may be consistent with many explanations besides the “admission of poor mistakes” hypothesis.

The table below shows a plot of mergers and acquisitions and divestitures for the period 1963 to 1983. The plot clearly shows the major merger wave in the United States of the late 1960’s, with a peak of over 6000 mergers in 1969. There is also a divestiture wave that peaks in 1971 at almost 2000 divestitures.

EXHIBIT 1:
The Numbers of Mergers and Divestitures 1963 – 1983



From their study; Linn and Rozeff (1984) established a ratio of divestitures to mergers of about one to three. This is clearly demonstrated by the graph below. (*Exhibit 1*)

The fact that the divestiture curve has roughly the same shape as the merger curve, but displaced by several years, is no statistical accident. The researchers found a strong statistical relationship between the annual rate of change in merger activity in any given year, and the annual rate of change in divestitures two years after.

In other words, if the rate of mergers jumps we expect that the rate of divestitures will rise sharply within one to two years thereafter. Conversely, if the merger rate declines we can predict that the divestiture rate will fall several years later.

CASE STUDY 1

TYPE: Related Acquisitions

COMPANY: Spicer Ltd

SECTOR: Industrial Information Technology

ACQUISITION: Various IT Companies

I have chosen Spicer Holdings, as the IT Sector in South Africa has had a particularly dismal record for merger and acquisition disasters. To name just a few, Bytes Technology Group (formerly Usko), CCH, Brainware, Advtech and Ixchange have all fallen from grace because of acquisitions that went awry.

Nature of the Business:

Spicer Holdings Limited is an information solutions company focusing on Information Security and Broadband communications integration services. The company consists of two international subsidiaries, MIS-Corporate Defence Solutions in England and InterIT-Konsult in Sweden, managed by Spicer Holdings Limited, listed on the JSE in South Africa.

Background:

When Sas Du Toit was appointed Chief Executive of Spicer in April 1998, he embarked on an aggressive acquisition programme. Initially the group made three local acquisitions (Zervos, Technicare and TCM) in deals totalling R356 million. They also made acquisitions off shore, with the purchase of the Swedish business Inter-IT Konsult acquired in August 2000 for R60 million.

The undoing of the group seemed to come with the acquisition of the UK based MIS Corporate Defence Solutions, of which it started to acquire in tranches from April 1999. It initially purchased a portion of the business for 1.5 million pounds, and then upped that in June to 2.5 million pounds. MIS had initially warranted a profit of R25 million, but instead of attaining these figures, it was doing very poorly, with little prospect of a turnaround.

In December 2000 Spicer and the unlisted IT Company IQ announced that merger discussions were underway. This would have resulted in a group with a market capitalisation of R1, 4 billion and positioned it in the top tier of South Africa's IT sector.

Spicer's share price climbed from 158c to 215c by the end of December; obviously the market anticipated this merger to produce very positive spin-offs. The deal was subject the completion of a due diligence exercise on Spicer's local and international operations.

In early 2001, Spicer issued a profit warning, which showed that certain of its operations were in trouble. The announcement followed the completion of the due diligence exercise by the IQ business Group prior to their proposed merger.

Their final investigation into Spicer's operations had shown gross irregularities at senior management levels within its UK operation MIS-CDS. The Companies MD was subsequently dismissed, and these findings were the subsequent deal breaker for

the proposed merger between Spicer and IQ. The termination of merger discussions had a very negative effect for Spicer.

Headline earnings per share plummeted from 3.2c to 0.4c for the six months to December 2000, and no dividend was declared. Spicer was punished by the markets following the completion of the due diligence exercise by the IQ Group, after the companies announced news of the merger the previous year.

Before the official announcement that the merger was off, the market already had wind of something, commentary by Alec Hogg was the following: “The IT firm Spicer is about to join the growing list of companies whose over-eager acquisition programmes have been their undoing. There is no official announcement yet, but this morning’s action in Spicer shares – down 17% to 44c on heavy volume in the first hour of trade – suggests the hoped for merger with South Africa’s leading unlisted technology company, the IQ business Group, is about to be cancelled” (Money Web, 21/02/2000).

By May 2000, the shares were trading at 9cents, from a high of R2.10 in January the same year.

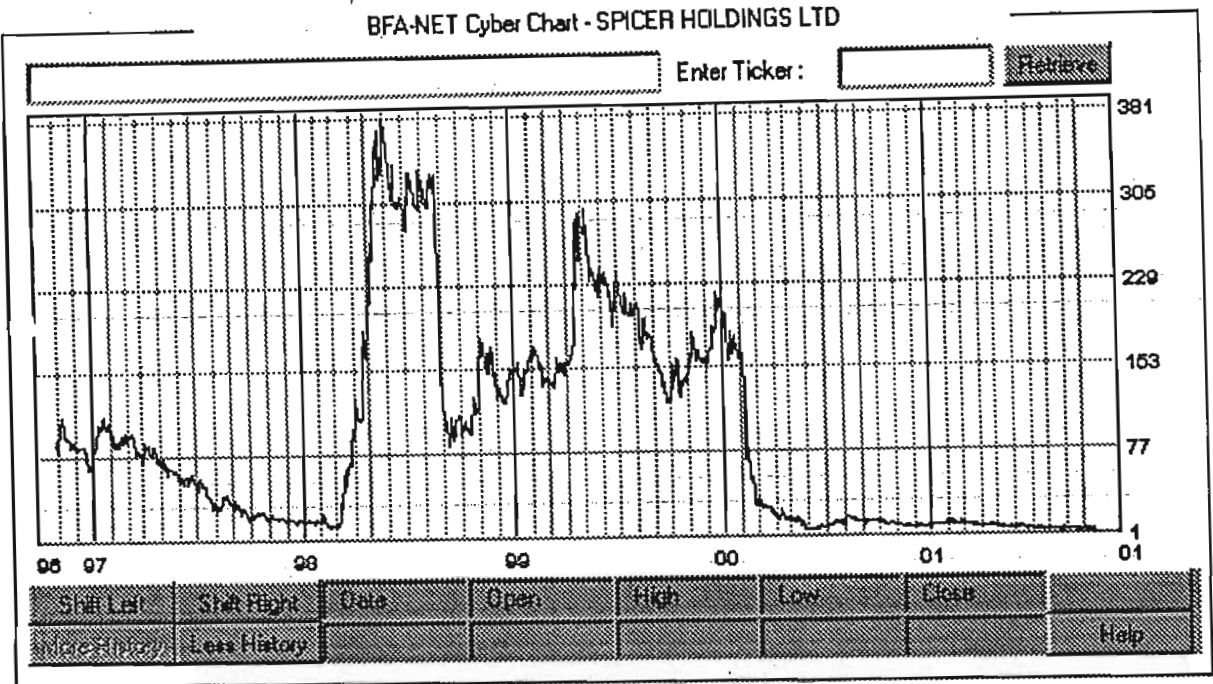
The graph below shows the share price movement over the period April 1998 to November 2001. One can clearly see the increase in share price towards the end of 1999, with the announcement of the proposed merger of Spicer and the IQ Group.

Following the cautionary announcement, and the subsequent cancellation of the proposed merger, one can see the marked decline in the share price from December

1999 to February 2000. The share price then declines further after the release of the Company's annual results in late February. For the remainder of 2000 and 2001, the share price has remained at these low levels. The current ruling price is around 3c, a share that was trading at above R2 less than two years previously.

SPICER HOLDINGS LIMITED

SHARE PRICE MOVEMENT FOR THE PERIOD 1997 TO 2001



SHARE STATISTICS

	JUN 00	JUN 99	DEC 97	DEC 96	SEP 95
EPS	-4.22	16.35	-13.52	-6.59	-.99
HEPS	-.10	10.30	-6.85	-3.4	-
DPS	-	-	-	0	3.00
Price Period End	8	227	18	74	125
Ret on SH Funds	-99.49	228.80	-63.43	-11.18	-2.50

Conclusion:

An analysis of the share statistics, confirms that the acquisition actions of the company have failed to create value for the holder of these shares. Over zealous actions by the company during periods when the IT sector was experiencing a boom, have ultimately resulted in the undoing of this company.

CASE STUDY 2

TYPE: Diversified acquisition in an unrelated industry, and subsequent divestiture

COMPANY: Super Group Trading (Pty) Ltd

SECTOR: Transport

ACQUISITION: BBR Security

I have chosen Super Group as an example to demonstrate an unrelated acquisition, and subsequent divestiture, particularly since market analysts were very critical of this acquisition.

Nature of the business:

In order to demonstrate the unrelated nature of this acquisition, it is necessary to examine the core competencies of Super Group.

Background:

Super Group owns the largest integrated cross-border transport operation in Sub-Saharan Africa, the largest truck rental operation in South Africa and one of the largest motor retailer groupings. Its portfolio includes short term and mechanical breakdown insurance, asset financing, banking and related financial services.

In April 1997 Super Group acquired BBR Security, a leading electronic security company, incorporating both monitoring and armed response. The initial acquisition, and subsequent smaller acquisitions in the security industry, saw Super Group invest roughly R200 million rand.

The initial market reaction to this acquisition was extremely negative, with analysts being particularly critical of the company, for venturing into an industry that it had no experience in.

Larry Lipshitz, the Group Chairman, tried to sell it to the market, on the basis that the acquisition of BBR would aid the Group in its transformation from an asset based enterprise, to one focused on technology, services, relevant logistics assets and intellectual capital, specifically in the high growth logistics industry.

Commentary at the time suggests that this argument was not entirely absorbed by the investment community.

The market furthermore, had concerns about the focus of the now diversified logistics company.

In November 2000, Super Group announced the sale of BBR Security to Chubb Security SA for R556 million. Chairman, Larry Lipshitz said in a press release that the BBR business no longer fitted into Super Groups overall strategy of transforming from an asset based enterprise to one focussed on technology and services.

The capital return that Super Group achieved on the sale of BBR Security was excellent, and it furthermore provided the Group with a huge cash resource.

The proceeds of this sale significantly reduced the gearing of the Group, while also restoring the confidence of analysts, with regards to Super Group being focussed on their core operations.

The table below shows the effects of the sale, had the transaction been implemented on 1 April 2000 for the unaudited six months ended 30 September 2000 on earnings per share, headline earnings per share and net asset value.

	Before the transaction (cents)	After the transaction (cents)	Percentage Change %
EPS	39.8	116.5 *	192.7
HEPS	39.8	44.7	12.3
NAV	351.9	420.4	19.5

**The significant increase in earnings per share is as a result of the exceptional profit arising from the transaction.*

(Business Day 16 November 2000)

Conclusion:

What initially appeared to the market as a poor investment decision, had actually now turned around to be something very positive. The security business was based on an exceptionally large annuity income, with high cash generation. Super Group had during the course of their ownership been able to recoup a fair portion of their initial investment, as well as use the large amount of cash generated to fund other investment projects.

The subsequent sale for almost three times the initial purchase price also went a long way to boosting the Groups liquidity.

This particular acquisition example is therefore a good demonstration of how an acquisition and subsequent divestiture may be purely for strategic reasons, and have nothing to do with a failed acquisition attempt.

CONCLUSION:

From a review of all the literature presented, it is evident that the topic of shareholder value creation through mergers and acquisitions is anything but clear-cut.

The issue of value creation varies greatly, depending on whether the subject is being approached from the perspective of the acquiring or target firm.

From the literature reviewed, it appears that there is a general consensus that value fails to accrue to the shareholders of bidding firms. The reasons offered for this are varied, but the primary ones appear to be that the market had already anticipated the event, and there is little or no response to the actual merger announcement.

A further theory offered, is that the synergy benefits to be gained from mergers are often over estimated, and subsequently fail to materialise.

Literature on the other hand is conclusive that value is created for the shareholders of target firms, although researchers do not all agree on the timing of such benefits.

The obvious question that then arises is why Companies continue to pursue the avenue of growth through mergers and acquisitions, when all the literature is very negative about the possibility of shareholder value creation. With some even going so far, as to state that mergers and acquisitions destroy shareholder value.

Ironically, recent business articles have cited a global trend showing an increase in worldwide mergers and acquisition activity.

Obviously then, not all mergers and acquisitions must be viewed in a negative light.

The characteristics of mergers appear to be an important factor in determining the eventual success of the merger. Perhaps this is one of the key factors that companies should consider when entering into mergers and acquisitions, as it appears from research done, to heavily influence the eventual success of the undertaking.

I believe then, that mergers and acquisitions can lead to shareholder value creation, provided a clear strategy is laid down and followed. These key elements relate to both the type of merger, as well as the characteristics of the target firm. If this set of acquisition criteria is rigorously applied, then there is every chance that an acquisition opportunity will be successful.

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