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Do Merger and Acquisition create value in short-term: A case of European companies ?

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ABSTRACT

M&A strategies have been favoured by many companies for several decades now, with the aim of developing. These operations can take different forms depending on the players involved. The most common form is the horizontal merger. The reasons why companies merge can be diverse, ranging from strategic, managerial, and financial motivations, most often to create synergies. The evolution of M&A in Europe has followed global trends, i.e. Europe has not deviated from the wave phenomena in M&A. Historically, Europe has always accounted for a high share of global M&A transactions. In 2020, European deals accounted for a third of all deals done worldwide during the year. While many thought that the Covid-19 pandemic would put an end to the seventh wave of M&A, the figures prove otherwise. Indeed, more than $1,770 billion in deals were signed worldwide between the beginning of January and the end of April 2021, according to data from Refinitiv. This is quite simply a record and represents a 124% increase in one year. This increase, driven by the US, tech giants, and SPACs, shows that the M&A environment is far from declining. This thesis aims to analyse literary reviews to observe whether these transactions create value in the short term, with a particular focus on European companies. Accounting, economic, and market indicators can all measure value creation, but market indicators, and more specifically abnormal returns, are the most widely used in the literature. The literature reviews will show contradictory results in the first instance. While many find short-term value creation for targets and sometimes for acquirers, some find zero or negative returns. We will see that the results depend very much on the type of mergers but also on the situation of the targets and acquirers.

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I. Introduction

The "Great Merger Wave" started around 1895, it was the first wave of mergers and acquisitions in history[1]. During this wave, historical companies like General Electric or Standard Oil developed using this method of external growth. The objective of this thesis is to observe whether M&A creates value in the short term. The case of European companies will be studied with a little more attention than other transactions in the world. The methodology used will be a study of several research papers, which will allow us to make a comparative analysis according to markets, types of transactions, payment methods, and types of companies. Our main hypotheses point to heterogeneity of results. Indeed, we believe that the results are likely to vary according to several factors.

Firstly, we will see in part II. what M&A is. Here we will analyse the four types of M&A: horizontal, vertical, conglomerate, and concentric. This will lead us to analyse the motivations of companies to engage in this type of operation. We will distinguish between strategic, managerial, and financial reasons. While the former can be offensive or defensive, managerial reasons can be seen in the conflicts of interest of managers with their shareholders or an excess of confidence. Financial reasons may concern taxes or lack of liquidity. Furthermore, all these strategies aim to seek synergies.

We will then review the different methods for measuring value creation. This study will conclude that abnormal returns are the most efficient method to calculate value creation and that is why it is so widely used in the literature.

A study of the waves of mergers and acquisitions will also allow us to better understand this phenomenon and to realise that their evolution resembles rather cyclical and irregular events, independent of the economic evolution of the countries in which the companies are involved. Very often these waves start in a period of economic recovery and end in periods of a major crisis. The figures on the European market will show us that the main market players are the UK, France, and Germany.

In part III. we will review the research papers we have selected. We will first see that many studies such as those of Servaes, or Mullherin and Boone show positive and significant abnormal returns for target companies or sometimes for both

[1] See Ralph L. Nelson "Merger Movements in American Industry, 1895-1956" Princeton University Press, 71-105, (1959)

targets and acquirers. However, we will see that not all studies are consistent in this area, as a significant number of studies show the presence of zero or negative abnormal returns for the acquiring company or the target, or both. However, this is not a random phenomenon, as the creation of value depends on certain specific criteria. Among these criteria we can mention the hostility or the friendliness of a transaction, indeed it will be proved for example that hostile transactions generate higher returns for targets than friendly transactions, while the opposite phenomenon is noticed for acquirers. The importance of other elements will be highlighted, such as cross-border transactions or the cash method of payment, which would generate higher returns than equity or mixed transactions. In this section, we will provide explanations for such differences in value creation due to these factors. A case review focusing specifically on Europe will be carried out to analyse whether the stated assumptions on value creation can be confirmed even in this market.

II. What is M&A

A. Types of M&A operations

In order to distinguish the different types of M&A, it is common to use the classification of the Federal Trade Commission in the United States[2]. This approach essentially aims to analyse the degree of professional proximity between the merged firms and to provide information on the position sought by the new management within the sector in question. According to this approach, we can distinguish four types of mergers.

1. Horizontal M&A

Horizontal mergers and acquisitions concern mergers and acquisitions between competing firms, i.e. firms with similar fields of activity. For example, if the target company sells similar products to the acquiring company, the combined sales result in a larger market share. If the other company makes products that complement your range, the acquiring company can now offer a wider range of

[2] See Federal Trade Commission and U.S. Department of Justice, *Guide to Antitrust Law, "Horizontal Merger Guidelines"* August 2010

products to its customers. This type of merger is the most common and accounts for more than half of all takeovers in the US and European markets. The objective of these transactions is often the specialisation and control of a significant part of the market.

Indeed, the main objective of a horizontal merger is to increase revenues by offering an additional product range to customers. It can also lead to geographical advantage, especially when the other company has operations in different areas from the acquiring company. Horizontal mergers can also help to reduce the threat of competition in the market. In addition, the bargaining power of the resulting company is higher. It is therefore, possible to negotiate lower prices with suppliers or to increase the final price because of the reduced number of competitors in the market.

An example of this is the historic merger of Air France and KLM. These two companies operate in the same sector and merged through an exchange offer[3] in 2004. This merger saw the birth of the Air France-KLM group, which at the time became the world's largest airline in terms of turnover[4].

2. Vertical Merger

Vertical mergers and acquisitions are mergers between firms located at different stages of the same industry. This type of merger can therefore take the form of a policy of integration upstream of the sector (purchase of suppliers). It can also take place downstream through the acquisition of distribution networks. Vertical mergers and acquisitions can therefore make it possible to control the entire economic chain, from raw materials to the finished product.

Thus, vertical mergers can help secure access to important supplies. They also help reduce overall firm costs by eliminating the costs of sourcing, negotiating deals, and paying market prices. In addition, vertical mergers can improve efficiency by synchronising production and supply between the two companies and ensuring that supplies are available when the company needs them. This type

[3] An exchange offer is a transaction similar to a takeover bid. A public exchange offer consists of a company announcing publicly that it wishes to acquire all or part of the shares of a target company in exchange for its own shares.

[4] Air France-KLM's turnover in 2005-2006 was about 21 billion euros, with a market share of about 27% in the European market. See Pierre-Henri Gourgeon "*Les secrets du redécollage d'Air France" 10-16* Le journal de l'école de Paris du management (2007)

of merger can also help in dealing with competitors. By making it difficult for competitors to obtain important supplies. This can weaken existing competitors and increase barriers to entry for new competitors.

Staying within our European market, we can cite the example of GDF[5], which is pursuing its policy of integrating the gas chain by buying up gas exploration and production companies, such as TCIN in August 2000. GDF has thus become, for the first time, an operator of offshore fields. The French group has acquired an additional production capacity of 800 million cubic metres of natural gas per year[6].

3. Concentric M&A

Concentric mergers and acquisitions concern the regrouping of firms in complementary businesses, intending to extend their range of products and services and their customer base. In this situation, we speak of concentric diversification, i.e. it is based on the pooling of technologies, know-how, costs, or customers between the merging companies.

Thus, the advantages of a concentric merger may initially be a larger market share as the acquirer diversifies. Diversification of the products and services offered, as the acquirer has access to the target's business sector through its products and services. New customers, as product diversification and increased market share often lead to new customers. In addition, the above could lead to improved profits and financial gain. We find that concentric mergers are closely related to horizontal mergers as they both aim at the same goal: a higher market capitalisation, however here the firms are rather complementary than competing[7].

We can illustrate this with one of the biggest concentric mergers in history, which is the merger between Heinz and Kraft, so we will deal here exceptionally with the US market. This 2015 merger was valued at around $50 billion. The deal created Kraft-Heinz, the third-largest food and beverage company in North

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[5] Gaz de France was a French energy group, specialising in the purchase, transport and distribution, and marketing of natural gas, created in 1946.

[6] This type of vertical merger therefore falls into the category of upstream integration policies. See Kaouther Bennani " *Fusions et acquisitions: les facteurs qui influencent la performance post-opération "* 7-10 (UQAM 2006)

[7] See Kison Patel "*Guide to Concentric Merger*" (Dealroom 2021)

America and the fifth-largest food and beverage company in the world[8]. At the time of the transaction, Kraft was a leading producer of mayonnaise, salad dressing, cottage cheese, natural cheese, and lunch meat. Heinz, on the other hand, was the world leader in meat sauces, pasta sauces, and frozen appetizers. Thus, the merger is concentric because the companies have a complementary business without being real competitors[9].

4. Conglomerate M&A

Conglomerate mergers and acquisitions concern the combination of firms whose businesses are unrelated to each other. This is known as conglomerate diversification. This type of merger may have several objectives and give rise to different acquisition policies. Thus, conglomerate diversification amounts to the acquisition of completely new strategic businesses (new products on an unfamiliar market). There is therefore no link between the value chains of the two companies brought together, which limits the synergies to purely financial considerations. These strategies are undoubtedly the riskiest, as they lead the company into unfamiliar territory. One of the reasons for resorting to conglomerate diversification is the acquirer's desire to balance its cash flows and better spread its risks. In particular, it is a matter of reducing the uncertainty linked, for example, to a downturn in the economy or the entry of a new competitor[10]. In addition to risk diversification, the merger also gives the company access to a new customer base, thereby expanding its customer base.

Conglomerate diversification reached its peak in the 1960s with the development, particularly in the United States, of companies such as ITT[11] or Westinghouse. However, since the 1980s, this practice has been in decline due to the difficulty of integrating businesses with no obvious links and above all due to the pressure of

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[8] Kraft-Heinz is a food industry behemoth with 2019 sales of $24.97 billion.

[9] See Rajesh Kumar "*Wealth Creation in the World's Largest Mergers and Acquisitions"* chap *"Merger of Kraft and Heinz Company: Integrated Case Studies"* 79-84 (2019)

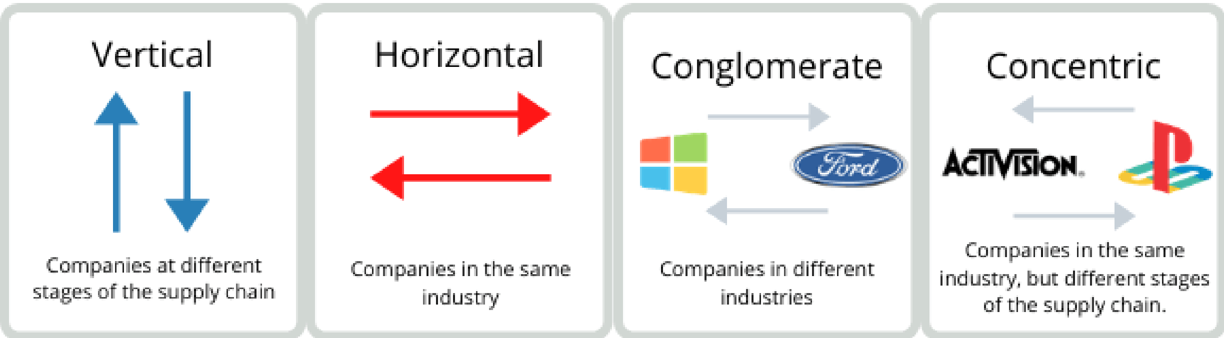
[10] See Olivier Meier, Guillaume Schier " Fusions acquisitions " 13-15 (Dunod 3rd ed)

[11] ITT is an American multinational company specialising in telephone communications. From 1962, the company implemented a major diversification policy. The first diversification operations were in the industrial field: automation, industrial pumps, air conditioning. In August 1964, for $40 million, ITT took control of Aetna Finances and thus gained a foothold in the insurance sector in the United States. Aetna merged with three other acquisitions in the same sector to form ITT Financial Services, which was to become the hub of the diversification.

shareholders who are looking above all for greater visibility and coherence in the grouped activities[12].

We can cite the case of Westinghouse mentioned above, the American company specialising in electricity has managed to enter different markets, in which it had no concrete activity at the beginning, through several mergers. For example, it entered the radio industry through the purchase of the international radiotelegraph company in 1920 or the television market after the purchase of the CBS television network in 1995.

Summary of the different types of mergers



See BoyceWire "Mergers and acquisitions definitions".

B. Motivations for M&A

Companies may have a wide variety of reasons for wanting to merge. We have decided to classify these reasons into four categories: strategic, managerial, financial, and the research for synergies. This list is not exhaustive, as other reasons may come into play, such as political reasons for example, but they remain relatively minimal compared to the reasons mentioned above.

1. Strategic reasons

1.1 Offensive strategic motives

We will focus here on transactions whose main objective is to improve the competitive position of the company by exploiting or enhancing the characteristics of the acquired company.

[12] See Damien J.Neven "*The analysis of conglomerate effects in EU merger control*" (2005)

Increase market dominance and influence

This is the desire to have sufficient economic power to strengthen the firm's power over other market players. This market power can be characterised by the capacity of the purchasing company, after the operation, to modify the conditions of the market to its advantage and to the detriment of the other players in the environment and in particular its main competitors. This motivation translates into strategies of confrontation with the main protagonists in the environment, using aggressive competitive policies or pressure against the other players in the sector, which is what is commonly called bargaining power.

For example, a firm may decide to reduce production quantities to increase its prices or impose practices on its competitors. Thus, this strategy is linked to the firm's ability to act in a discretionary manner in the competitive game.

Capturing specific resources

Sometimes a company must have new resources available fairly quickly, enabling it to remain competitive within the environment.

However, it may happen that the resources sought are not directly available on the market, as might be the case for patents, or that the company is not in a position to collaborate on a one-off basis to obtain these resources, due to the tacit nature of these collaborations. Thus the choice of merger becomes almost indispensable.

Among the resources sought by the acquiring companies, we can also mention the transfer of technology and the purchase of well-known brands. Thus, in this type of operation, the target company essentially has a role as a "resource provider" aiming to complete or improve the capabilities of the acquiring company.

For example, the Schneider Electric group[13], which was developing its activities in medium voltage and automation, was able to offer its customers complete systems for their electrical needs thanks to the acquisition of Lexel, a company specialising in low voltage.

[13] Schneider Electric is a French multinational energy company. The acquisition of the Danish group Lexel for 6 billion francs took place in 1999.

Access to new markets

One of the motivations may be the desire to position oneself in new and promising markets, with an objective of exploration, or to extend one's activities to new geographical areas, with an objective of internationalisation. The international development of firms is often a necessary step for companies when they are growing rapidly and facing fierce competitors who are increasingly globalised. In order to expand internationally, mergers seem to be one of the preferred ways for companies, given the increasing number of transnational acquisitions. This type of growth can therefore be an effective and rapid way of rapidly taking market share from competitors in strategic geographical areas for the development of the company.

For example, the acquisition of the Romanian cement manufacturer Holcim has given Lafarge a high share of the Romanian market that would have been difficult and time-consuming to achieve through organic growth [14].

Furthermore, external growth can also be an opportunity for cash-rich companies to invest in new, fast-growing business lines and thus gain an edge over current and future competitors.

Renewing yourself

Here we are talking about a strategy of innovation through a merger. It leads in a way to break with the rules of the game prevailing in the sector and to impose others by creating new capacities different from existing practices. This type of development may seem risky because there is no certainty about how the market will react to this attempt to impose new practices. However, this type of development is appropriate for companies in fast-moving sectors that require continuous adaptation or in mature activities threatened by substitute products.

For example, Northern Telecom acquired Bay Networks in 1998 to revitalise the company and make a profound cultural shift towards innovation and internet technology[15].

[14] Lafarge is a French distribution materials company. See Dominique *Barjot « Lafarge: L'ascension d'une multinationale à la française »* (Puf 2005)
The merger with the Holcim Group in 2015 saw the birth of the Lafarge-Holcim Group, which has become the world's leading producer of cement, concrete and aggregates, with sales of over €35 billion.

[15] Bay Networks was acquired by Northern Telecom in June 1998 for $9.1 billion, expanding Nortel's reach from its traditional carrier customer base into enterprise data networks. Reflecting this expanded product line and market, Nortel renamed itself Nortel Networks after the merger.

1.2 Defensive strategic motives

Changes in the environment and the actions of competitors may lead the company to react by making the necessary adjustments to maintain its position. In many cases, these manoeuvres lead to mergers and acquisitions.

Consolidate its positions in mature sectors

When sectors are mature (or in decline)[16], they often face a situation of overcapacity of the production apparatus and this can create risks of major price wars due to the need for companies to make a profit or cover their fixed costs as best as possible. Thus, mergers can be an interesting way to consolidate positions without creating a problem of overcapacity in the market. It can thus be a solution for the firm to continue to increase its market share despite a decrease in demand.

Adapting to technological change

It is often said that technology is constantly evolving, so companies are increasingly faced with constant technological changes that require them to maintain their technological potential to remain competitive. Indeed, the rapid evolution of technology allows the opportunity to create new products or processes and a strong need for investment in research and development. This forces existing companies to adapt, otherwise, their activities and their position within the sector are strongly threatened (risk of obsolescence of certain products, loss of competitive advantages, the emergence of new competitors). There are generally time and resource constraints that direct companies towards mergers, to renew the core competencies of the organisation, without disrupting the existing teams assigned to other strategic activities. It also helps to catch up with new or successful competitors, whose development risks marginalising companies that have failed to maintain their technological edge.

For example, the Kodak company disappeared mainly because of the strong technological evolution that it was unable to manage[17].

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[16] Reference is made here to the four life cycles of a sector or market: introduction, growth, maturity and decline. These four phases make it possible to define growth expectations for the company in relation to the evolution of its market share, its commercial policy and the structure of the sector.

[17] Kodak was an American company founded in 1881 and established itself in the 20th century as a giant in the field of photo film. However, the brand missed out on several technological

Preventing the actions of a troublesome competitor

M&A can be a defensive strategy to counter the threat of strong competitors. They can be part of a logic of protection or reaction to an attempted attack by one of its main rivals. Recourse to external growth is therefore approached here from the point of view of the balance of power between two or more competitors and can take place in a context of prevention or at the moment of aggression. The expected effect of this strategy may, depending on the situation, be direct or indirect, temporary or lasting.

One of the methods favoured in the past was counter-merger in order to create barriers for potential buyers. Indeed, a target company threatened by a hostile merger may acquire companies that could pose antitrust problems for potential buyers.

For example, in the 1970s, the department stores' chain Marshall Field & Co. acquired numerous other retail chains in an effort to create such antitrust barriers. Although the acquisitions were uniformly unprofitable, the acquired chains operated in the same geographic areas as the most likely potential bidders for Marshall Field, creating legislative barriers[18].

Acquiring critical mass

The size of the company, its competitive position, or its management are now important elements and are considered beyond the national framework. The direct consequence of this movement is the change in the perception of the importance of companies, which varies according to their level of internationalisation. The globalisation of markets is therefore forcing companies to grow through acquisitions in order to legitimately claim to be part of the competitive game that is now evolving at the world level. The aim is for the company to rapidly acquire a critical size in order to avoid being marginalised within the sector. M&A, therefore, appears to be a defensive response to concentration movements that condemn companies to choose between acquiring or being acquired.

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innovations such as the consumer camera and the super 8 camera. In addition, the strong competition from digital cameras knocked the company out of the market and it ended up filing for bankruptcy in 2012. In order to avoid this kind of situation, some companies prefer defensive mergers in order to adapt to new technologies.

[18] See Stephen Bainbridge *"Corporate Law"* Chap 12 *"Mergers and acquisitions"* 455-456 (4th ed 2015)

The threat of hostile takeovers is ever-present and particularly so for smaller companies. So we can compare this to a food chain, where companies seek to grow in order to move up the chain and minimise the risk of hostile takeovers.

Limiting entries into the area

A company wishing to avoid potential external threats may implement deterrent actions to reduce the attractiveness of potential entry into the sector. Generally, external threats are characterised as the entry of new competitors or the appearance of substitute products. Mergers can then appear as indispensable operations to face these threats by allowing the adoption of a reactive behaviour towards these new competitors. Indeed, as Michael Porter has shown, the barriers to entry can be strongly reinforced by the merger between the company and one of the players in the environment, such as a competitor, supplier, or distributor. Thus, this option allows the company to impose very costly entry standards that may make the entry policy too risky or insufficiently profitable[19].

2. Managerial reasons

Sometimes managers have their own reasons for merging. Studies have shown that the share price of large bidders falls on average when a bid is announced, especially when the target is listed. Two possible explanations are conflicts of interest with their shareholders and overconfidence[20].

Conflicts of interest

Leaders may prefer to run a larger company because of the extra remuneration and prestige it brings.

For example, Seyhun tested the hypothesis that merger initiatives by managers may be motivated by personal ambitions to gain control over more assets while seeking to secure their jobs. The author assumes that managers reduce the purchase of shares and/or increase their sales if they believe that the proposed merger may lower the value of their firm's shares due to the target's overpayment.

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[19] See Michael E. Porter "*From competitive advantage to Corporate strategy"* Harvard Business Review (1987)

[20] See Berk and DeMarzo *"Corporate finance"* chap 28 Mergers and Acquisitions 939-940 (Pearsons [3rd] ed 2013)

To test this hypothesis, Seyhun set up two samples of firms between 1975 and 1986: the first corresponds to the transactions of managers of firms not involved in the takeover (neutral) during the same period, and the second corresponds to the transactions of acquirers before the takeover. His findings show a certain optimism before the announcement of the latter, who decrease their sales and increase their purchases before the takeover[21].

Saint-Pierre expanded on Seyhun's research in 1991. Like Seyhun, he focused more on the target than the acquirer. He tested two hypotheses, the first of good managers who may refuse a takeover if they do not find it rewarding enough for their shareholders, and the second of selfish managers who put their interests before those of the shareholders and their opposition to the takeover should grow with their lack of management efficiency. He finds that the more the target's management compensation is correlated with its performance, the less these managers oppose takeovers and the more they act in the interest of their shareholders. Thus, if the opposition comes from selfish managers, then the motivation is personal, but if it comes from exemplary managers, then the motivation is economic[22].

Overconfidence of leaders

In a 1986 paper, Richard Roll articulated the "hubris hypothesis" to explain takeovers, according to which overconfident CEOs pursue mergers that are unlikely to create value because they truly believe that their management ability is great enough to succeed[23]. Thus, he argues, many M&As occur only because the managers of the acquiring firms overestimate their skills and overestimate the synergies expected from the deal, ignoring the "winner's curse[24]". As a result, these assumptions demonstrate the tendency of managers to overpay targets.

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[21] See H. Nejat Seyhun *"Do Bidder Managers Knowingly Pay Too Much for Target Firms?"* 1430-1466 Journal of Business (1990)

[22] See Mohammed Ibrahimi *"Fusions et acquisitions: de la pensée managériale et l'action stratégique à la création de valeur"* Chap 4 *"Motivations et performances des fusions acquisitions"* 87-88 (ISTE 2018)

[23] See Richard Roll "*The Hubris Hypothesis of Corporate takeovers*" The journal of Business vol 59, 197-216 (1986)

[24] It is a phenomenon that occurs in auctions with common values and incomplete information. It was first described in 1971 by Capen, Clapp and Campbell. The model states that if one puts coins in a transparent box and conducts an English auction, one finds that the average of the amounts bid matches the value of the coins but the amount bid by the winner is too high. This anomaly occurs in takeover bids to gain control of a company.

Using the Roll model, Hietala et al. analyse the 1994 acquisition of Paramount Pictures by Viacom and the bidding that preceded it. To estimate the fair value of the target, these researchers observed the evolution of the value of the shares at each announcement of a competing offer. If an increase in the share price of the first bidder is observed, the bid is considered insufficient, as the new bidder's offer reduces the chance of acceptance. Consequently, the evolution of the share value allows us to estimate the acquisition premium due to the optimism of the manager. In their study, Hietala et al. confirm the managerial hubris hypothesis because, on the one hand, Viacom overpaid for Paramount Pictures by almost $1.5 billion and, on the other hand, 2/3 of Viacom's stock was owned by its CEO[25].

3. Financial reasons

This section will analyse some of the financial reasons for certain M&A transactions. In particular regarding taxes, lack of liquidity, and debt capacity.

Tax savings

When a company makes a profit, it has to pay tax on that profit. However, when it makes a loss, it still has to pay taxes, without a refund. Thus, it might seem that a conglomerate has a tax advantage over a single company, simply because the losses of one division can be offset by another[26].

In addition, sometimes a company may have potential tax advantages but no profits to take advantage of them. It then has the opportunity to acquire a profitable business to earn by protecting its profits.

Finally, Hayn looked at tax optimisation and noted that tax savings depend on the type of settlement offered and the choice of target. For example, in the case of a cash settlement, the profits from the securities sold are exposed to tax in the same year, but in the case of a security settlement, the tax is deferred until the securities are sold. Indeed, if the target is taxed and the shares are paid for in cash, the offeror must therefore increase its premium by compensation equivalent to the tax loss. Therefore, his choice of the payment method or target will be influenced[27].

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[25] See Hietala, Kaplan and Robinson *"What Is the Price of Hubris? Using Takeover Battles to Infer Overpayments and Synergies"* Financial Management vol.32 5-31 (2003)

[26] See supra note 19

[27] See Carla Hayn *"Tax attributes as determinants of shareholder gains in corporate acquisitions"* Journal of Financial Economics vol.23 121-153 (1989)

Lack of liquidity

When a company has a substantial cash surplus and acquires a company with insufficient capital but promising projects, the target's management could now avoid refusing investments that could have been profitable due to the lack of financial resources.

However, it is also possible to interpret excess liquidity from the perspective of agency costs. Thus, Amit et al. studied the incentives of takeovers according to Jensen's hypothesis[28] implying that the acquirer's potential profit increases as a function of the target's agency costs, which are generated by abusive practices of its managers (necessarily hostile to takeovers) and as a function of the target's situation. Since managers are pushed to overinvest, agency costs increase thanks to excess cash. They, therefore, propose three types of targets: loss-making targets, high-profit targets, and other intermediate cases. According to them, only the second category generates a high profit for the acquirer in case of replacement of the target's managers, thus allowing a reduction in costs[29].

Debt capacity

The debt capacity of a company may increase if the cash flows of the acquiring company and the target are not properly correlated. Indeed, this could make the combined cash flow of both companies less volatile. Thus, greater debt capacity may result in better tax protection and thus reduce the post-merger WACC of the company. Thus, improved leverage increases value for all acquirers as they gradually reveal their growth opportunities to the market.

4. Synergies

Our previous analyses have already highlighted the three types of synergies: operational, managerial, and financial synergies. It is appropriate here to question the role of synergies in merger operations and also their economic justification, more particularly for cost and growth synergies which are types of operational synergies.

[28] See Michael C. Jensen *"Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers"* The American Economic Review Vol 76. 323-329 (1986)
[29] See Amit, Livnat, Zarowin *"A classification of mergers and acquisitions by motives: Analysis of market responses"* Contemporary Accounting Research vol 6. 143-158 (1989)

Cost synergy through volume effect

Cost synergies through volume effects are one of the most frequently cited reasons for a merger. They correspond to a decrease in the average unit cost of production associated with the number of products manufactured. These dimensional returns or economies of scale are increasing, when production increases in a greater proportion than the production factors (machines, equipment, techniques, labour). Firms will thus try to use their production capacity to the full, to spread fixed costs over large volumes[30].

For example, when Thomson bought Telefunken, it allowed them to significantly increase the scale of production in several consumer electronics products (closing factories and specialising plants with higher volume production). The achievement of economies of scale is therefore associated with the size effect created by the combination of similar companies[31].

Synergy of costs due to sharing of resources

Cost synergies can also be linked to the sharing of common non-specific resources (available in both companies). Particularly in the case of horizontal mergers, due to the proximity of the companies' activities, similar resources may be found within the two organisations and thus necessitate a policy of regrouping. This rationalisation policy may concern one or more activities and allow a reduction in costs through economies of scope. In this way, it is possible to eliminate certain duplications or to reinforce the coherence of the new organisation.

Some examples could be the regrouping of distribution networks and sales forces; the optimisation of production sites with, for example, the elimination of the least profitable sites; better distribution of personnel, and, in certain cases, the elimination of positions[32]. However, it is important to qualify all of this, as these costs are often accompanied by opportunity costs, so by way of compensation, rationalisation operations can be superficial.

[30] See supra note 9 and 31-34

[31] Id

[32] See Actoria *"Les synergies résultantes des opérations de fusions et acquisitions " (2020)*

Growth synergies

Growth synergies often arise from complementarities arising from specific resources available in one of the companies that can be used by the other firm. This type of synergy can take place at the level of both firms and lead to the cross-use of tangible and intangible resources. Thus, growth synergies aim to allow each of the firms direct access to a resource that is essential for its development[33].

For example, the purchase of Uniroyal by Michelin allowed the latter to benefit from the distribution network of the acquired company. This enabled it to sell its products without having to create or develop them[34]. Finally, we note that this approach consequently offers significant gains at different levels: saving time, making available competent salespeople, and existing networks.

In conclusion, although synergies play an important role in M&A transactions, we do not consider the search for synergies as an initial motive for the transaction. We do not consider the search for synergies to be an initial motive for the transaction. Indeed, synergies, and particularly the cost synergies that we mentioned earlier, often constitute the justification of the economic logic of the operation rather than an initial motive. Indeed, the managers of the initiating company very often need to justify to investors that the high premium paid at the time of the acquisition will be compensated by a drastic reduction in costs.

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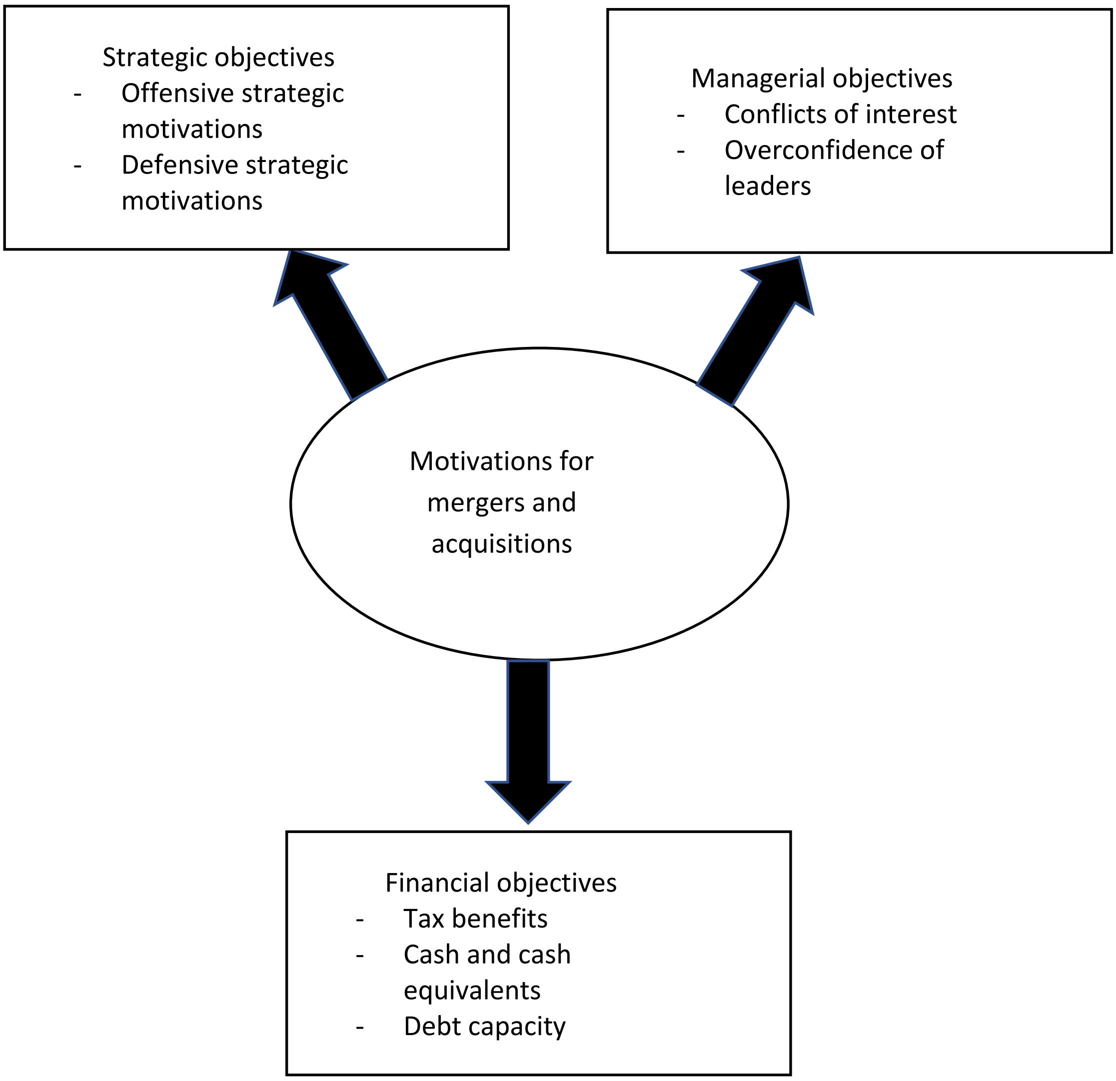
[33] See supra note 29

[34] The French group Michelin bought the American company Uniroyal in 1990 for 1.5 billion dollars. It was the third largest acquisition in the tyre industry. See New York Times September 23, 1989 Page 31



Summary of M&A motivations

C. Measuring value creation

1. Hypothesis of factors affecting value creation

One of the main objectives of M&A is value creation, which is reflected in the increased market value of the new company compared to the two separate entities. Several factors can affect the short and long-term financial performance of M&A operations and thus promote value creation.

The method of payment

In general, there are three alternatives for the financing method: payment in shares, payment in cash, or mixed financing. Travlos has shown that shareholders of acquiring companies lose money when the deal is paid for in shares (negative abnormal returns on the announcement), but they make positive returns when the deal is financed with cash[35]. This was confirmed by Rau and Vermaelen who showed that equity financing generates negative abnormal returns in the long run while cash financing has positive abnormal returns[36]. An explanation for this phenomenon was provided by Brown and Ryngaert, who showed in a study that when the exchange is done using shares, the taxation of capital gains is postponed to the moment of resale of the shares. When the transaction is paid for in cash, the target's shareholders will be taxed on their capital gains, which will strengthen their bargaining power and allow them to extract higher and higher premiums[37]. As the confirmation of Rau and Vermaelen focused on long-term profitability, this thesis will investigate whether this is also the case in the short term.

<u>The existence of multiple auctions</u>

When several potential buyers compete in auction processes, this leads to an increase in the premium they offer. Indeed, in theory, each bidder will increase the price to be paid to complete the acquisition within the amount of value creation it expects from the transaction. Thus, the target's shareholders may receive very large acquisition premiums on the value of their company. Bradley, Desai and Kim validate this reasoning and find abnormal profitability of targets when there are several competing bidders[38]. On the acquirer side, it is possible that acquirers may make zero gains when their expectations of synergies are uncertain, as we saw earlier with the "winner's curse".

<u>The behaviour of the target company's management</u>

M&A transactions can be friendly or hostile. Thus, if the board of the target company accepts the takeover offer, the transaction is considered friendly, but if it formally rejects the offer, the transaction is considered hostile. Whether the deal is friendly or hostile could have an impact on deal performance. Martin and

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[35] See Nickolaos G Travlos "*Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns"* Journal of Finance vol.42 943-63 (1987)

[36] See Rau and Vermaelen *"Glamour, value and the post-acquisition performance of acquiring firms"* Journal of Financial Economics vol.49, 223-253 (1998)

[37] See Brown and Ryngaert "*The Mode of Acquisition in Takeovers: Taxes and Asymmetric Information"* Journal of Finance vol.46, 653-669 (1991)

[38] See Bradley, Desay and Kim "*Synergistic gains from corporate acquisitions and their division between the stockholders of target and acquiring firms"* Journal of Financial Economics vol.21, 3-40 (1988)

McConnell explain that friendly mergers could create value through synergy effects and cooperation between the two companies' managers[39]. In contrast, in a hostile deal, the acquiring firm's management does not negotiate with the target's management, who in turn undertake defensive measures to obtain better terms for themselves and the firm they represent, thus increasing competition between the firms and pushing acquirers to pay higher control premiums.

Nevertheless, studies such as those by Franks, Harris, and Titman have shown that the attitude of managers does not seem to influence long-term financial performance[40]. In the context of our study, it might be interesting for us to compare hostile and friendly mergers in order to observe whether there are significant differences in the short term.

The growth or firm value approach

When an M&A transaction is carried out with the aim of rapid growth, the final outcome can be quite uncertain. Indeed, in this situation, the managers of the acquiring "growth-type" company [41]with a high market value to book value ratio often have over-optimistic forecasts and overestimate their capacity to generate synergies. Knowing that the larger the company, the larger the salaries and bonuses of the managers. Synergy effects may not live up to expectations. On the contrary, managers of a "value-type" acquiring company [42]with a low market value to book value ratio, tend to underestimate their ability to create value. In addition, growth companies pay more control premiums than value companies. Rau and Vermaelen find that value companies generally have higher returns than growth companies[43]. This factor, therefore, has an impact on value creation in M&A.

The sector of activity

The sector of activity is also a factor that can affect the performance of M&A. We have already analysed the differences between the types of deals (horizontal,

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[39] See Martin and McConnell "*Corporate Performance, Corporate Takeovers, and Management Turnover"* Journal of Finance vol.46, 671-87 (1991)

[40] Frank, Harris and Titman "*The postmerger share-price performance of acquiring firms"* Journal of Financial Economics vol.29, 81-96 (1991)

[41] These companies are characterised by above-market and above-industry growth. These companies offer significant potential for profit growth

[42] These companies are those that are undervalued by the market.

[43] See supra note 35

vertical...). Experts say that horizontal deals create more value than conglomerate mergers. Horizontal mergers or acquisitions are the most common form of M&A transactions and according to Meier and Schier, they account for more than half of the transactions in the US and European markets[44]. These transactions between two companies in the same industry allow for value creation due to all the advantages mentioned above. In contrast, conglomerate mergers are less likely to succeed. The latter are often unsuccessful, which can be explained, among other things, by the fact that the managers of the acquiring company have less knowledge of the target's sector of activity. Furthermore, conglomerate mergers do not seem to guarantee the expected synergies and increase costs. A McKinsey study states that after three to five years, 60% of merged companies fail to achieve returns above the cost of capital that was required to finance the acquisition[45]. Studies of companies that have opted for conglomerate mergers in the United States show that more than half of these have been sold or liquidated within ten years of the merger[46]. However, some studies, such as Kruse et al.'s, argue conversely that conglomerates outperform horizontal M&As in terms of long-term operating performance[47]. Thus, it would be interesting for us to compare the returns between horizontal and conglomerate mergers to observe whether there are significant differences or not.

Information asymmetry

Sometimes an acquirer may have an informational advantage over the rest of the market, so out of fear of dealing with better-informed investors, other uninformed investors may protect themselves by reducing the purchase price and increasing the selling price, leading to very high bid-ask spreads in secondary markets. According to Myers and Majluf, a comprehensive financial disclosure policy helps to reduce the level of information asymmetry between management and external investors and thus increases the value of the company[48]. Acquirers often try to gather as much information as possible about the strengths and weaknesses

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[44] See supra note 9

[45] See McKinsey "*Where mergers go wrong*" Article (2004)

[46] See Robert L. Conn "*The Failing Firm/Industry Doctrines in Conglomerate Mergers*" The Journal of Industrial Economics vol.24, 181-187 (1976)

[47] See Kruse et al. *"Long-term performance following mergers of Japanese companies: The effect of diversification and affiliation"* Pacific Basin Finance Journal vol.15, 154-172 (2007)

[48] See Myers and Majluf "*Corporate financing and investment decisions when firms have information that investors do not have*" Journal of Financial Economics vol.13, 187-221 (1984)

of the various competitors and the target and their respective motivations for winning the deal, which, if the information gathered is correct, will allow them to negotiate more advantageously. In case of information asymmetry, the lack of information on the target could affect the performance of the merger, as important elements may not be considered.

The size of the target

The importance of target size has also been studied for its impact on value creation. It can have two effects on performance. According to Switzer, acquiring a target that is relatively large in relation to the acquirer can lead to economies of scale and greater synergy, thus improving post-acquisition performance[49]. However, Clark and Ofek show in their study that the acquisition of a large target can lead to integration failure and management problems that may result in deteriorating performance in the long run[50]. We could study whether the previous hypothesis can be confirmed even in the short term on value creation.

In this section, we have studied different hypotheses of factors that can affect value creation, which will allow us to carry out comparative analyses between different studies to look for significant results on the short-term value creation of M&A transactions according to the type of transaction, the payment method, etc. The measurement of value creation is one of the main concerns of investors, but also the financial sector as a whole. To solve this problem, some indicators have been developed and used in recent years. There are three categories of value creation indicators: accounting, economic, and market indicators.

2. Accounting indicators

Traditionally, accounting measures were the most widely used.

ROE

Return on equity (ROE) is a measure of financial performance calculated by dividing net income by equity. It measures the profitability of a company by

[49] See Switzer *"Evidence on real gains in corporate acquisitions"* Journal of Economics and Business vol.48, 443-460 (1996)

[50] See Clark and Ofek "*Mergers as a Means of Restructuring Distressed Firms: An Empirical Investigation"* Journal of Financial and Quantitative Analysis vol.29, 541-565 (1994)

revealing how much profit a company generates with the money invested by shareholders.

$$ROE = \frac{Net\ income}{Book\ value\ of\ Equity}$$

ROCE

Return on capital employed (ROCE) is a ratio that can be used to assess the profitability and capital efficiency of a company. Thus, this ratio can help to understand the extent to which a company generates profits from its capital, as it is used.

$$ROCE = \frac{EBIT}{Capital\ Employed}$$

EBIT = Earnings before interest and tax

Capital employed = Total assets - Current liabilities

However, it should be noted that accounting measures only present historical data of the company and anticipate the future generally in the short term and only in a negative perspective.

Price-to-Book Ratio

Companies can also use the P/B ratio to compare a company's market capitalisation to its book value.

$$(P|B\ Ratio) = \frac{Market\ price\ per\ share}{Book\ value\ per\ share}$$

Price-to-Earnings ratio

The price/earnings ratio (P/E ratio) is a company's valuation ratio that measures the current price of its stock in relation to its earnings per share (EPS). [51]

$$(P|E\ Ratio) = \frac{Market\ value\ per\ share}{Earnings\ per\ share}$$

In this thesis, we will not find too many studies focusing on accounting indicators as other indicators seem to be more appropriate for our type of study.

3. Economic indicators

EVA (Economic Value Added) and NPV (Net Present Value) are the two main economic indicators. On the one hand, these indicators take into account the risk

[51] See Investopedia - Accountings measures (ROE, ROCE, P/B, P/E)

taken by the company. On the other hand, they do not allow the company's performance to be compared with that of other competitors.

EVA

Economic value added (EVA) is a measure of a company's financial performance based on the residual wealth calculated by deducting the cost of capital from its operating profit, adjusted for taxes on a cash basis.

$$EVA = NOPAT - (Invested\ Capital * WACC)$$

NOPAT = Net operating profit after tax

Invested Capital = Debt + capital leases +shareholder's equity

WACC = Weighted average cost of capital

NPV

Net present value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows over a given period. NPV is used in capital budgeting and investment planning to analyse the profitability of a planned investment or project. [52]

$$NPV = \sum_{t=1}^{n} \frac{Rt}{(1+i)^t}$$

Rt = Net cash inflow-outflow during a single period t

i = Discount rate or return that could be earned in alternative investments

t = Number of timer periods

Economic indicators can be very useful, but for the purposes of this study, we will focus on the last category of indicators, market indicators.

4. Market-based indicators

These indicators are very sensitive to the stock market, resulting in value destruction only because of a poor future expectation of performance. In all these cases, value creation is considered to occur when the final result is positive.

[52] Id (NPV, EVA)

MVA

Market Value Added (MVA) is a calculation that shows the difference between the market value of a company and the capital contributed by all investors, whether bondholders or shareholders.

$$MVA = (Market\ Capitalisation - Book\ value\ of\ Equity)$$

TSR

Total shareholder return (TSR) is a measure of financial performance, indicating the total amount an investor receives from an investment, and more specifically, from shares or units in shares.

$$TSR = \frac{(Current\ Price - Purchase\ Price) + Dividends}{Purchase\ Price}$$

Abnormal return

An abnormal return describes the abnormally high profits or losses generated by a given investment or portfolio over a given period. In other words, it is the excess return of a specific stock over a given benchmark[53].

$$AR_{it} = R_{it} - R_{mt}$$

ARit is the abnormal return for stock i at a specific time t

Rit is the return of stock i at time t

Rmt is the return of the given benchmark at time t

Thus Rmt is the shareholder's expected return and corresponds to the cost of equity, it can be calculated using the CAPM. It can be calculated using the CAPM,

$$R_{mt} = r_f + \beta * (r_m - r_f)$$

rf is the risk-free security

Beta is the risk measures that compare the return of the assets to the market

rm is the average return of the market

Since AR does not take into account fluctuations over a given period but only over a specific time, the cumulative abnormal return is often more widely used and is defined as the percentage sum of all abnormal returns from period 'a' to period 'b'.

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[53] Id (Abnormal Return)

$$CAR_i = \sum_{t=a}^{t=b} AR_{it}$$

The AR, in addition to being one of the most common in the literature, has the characteristics required for the thesis. Thus, it will be the indicator we mention most often in this thesis. If the abnormal return is positive, then value has been created, if it is negative, the return could not exceed the shareholders' expectations.

D. M&A in Europe

1. Merger Waves

Mergers and acquisitions do not have a clear trend. Indeed, their evolution looks more like cyclical and irregular events, independent of the economic evolution of the countries in which the companies are involved.

A merger wave is an intense period of M&A activity in a particular sector or industry that lasts for a varying period of time depending on the companies involved. We cannot really predict the start of a wave, however, their end could be linked in some cases to political and economic factors[54].

However, we can mention three factors that can trigger merger waves. Firstly, all waves occur during a period of economic recovery (after an economic downturn). Secondly, the waves coincide with the period of rapid credit expansion, which is the current situation where interest rates are low and the market is rising, so we can see that most of the waves ended with a collapse of the stock markets. Thirdly, M&A waves occur before an industrial or technological shock, such as technological and financial innovations, deregulation, improved air, and water quality, improved energy efficiency, etc. Mergers are also impacted when there are regulatory changes related to antitrust regulations or takeovers[55].

Thus, as we can see from the graph below, we can distinguish six waves of M&A, we can even consider seven if we count the period we are currently in.

[54] See Uddin and Boateng "*Explaining the trends in the UK cross-border mergers & acquisitions: An analysis of macro-economic factors"* International Business Review vol.20, 547-556 (2011)

[55] See Kreshnik Elshani "*The Impact of Finance Mergers and Acquisitions on Short-Term Performance of Acquiring Companies"* Jonkoping University 18-20

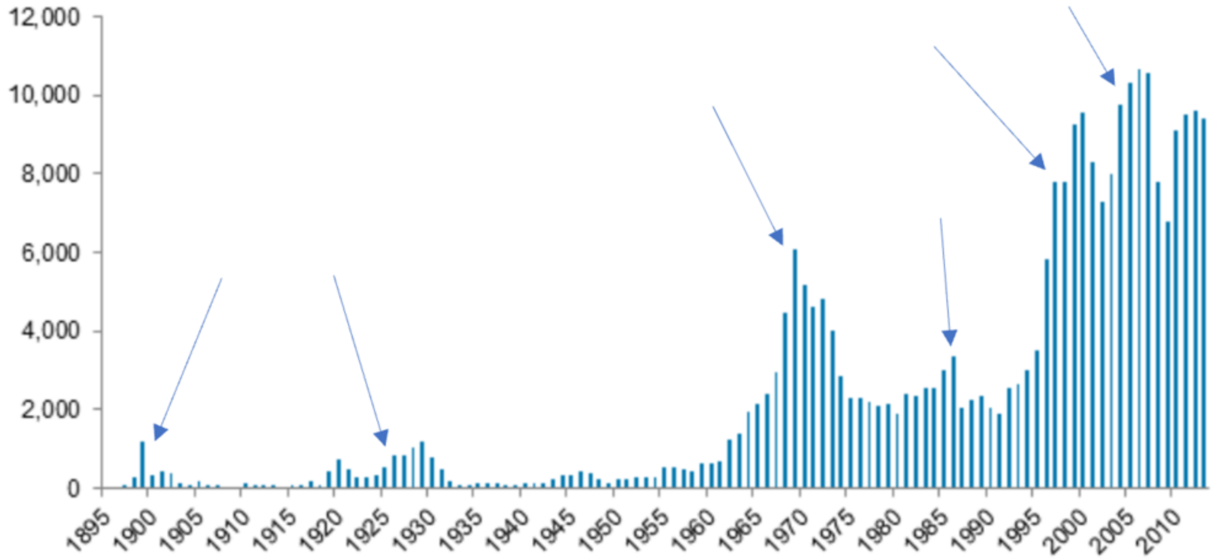

Figure 2 See Asset Management Study association : Market Basics : Merger waves (2019)

European M&A activity has the same characteristics as the global trend presented above. Therefore the wave analysis corresponds equally well to the European situation. Except for the very first waves for which we did not have enough relevant data on the European market.

<u>First wave 1895-1904</u>

The first wave is known as the "Great Merger Wave", most of the operations were horizontal or conglomerate mergers. This period saw the birth of major monopolies, especially in the mining, transport, and metal sectors[56]. Some examples of companies that evolved during this period through these operations are General Electric, Standard Oil, or Eastment Kodak. This wave came to an end with the stock market crash of 1905 and the Sherman Antitrust Act[57].

<u>Second wave 1919-1929</u>

The second wave began shortly after the First World War. This second wave of mergers took place in both the United States and Europe. Unlike the first wave, this one was characterised by vertical integration, forming oligopolies rather than

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[56] See CleverSM " Merger waves " Article (2016)

[57] The Sherman Anti-Trust Act of 2 July 1890 was the first attempt by the US government to limit anti-competitive behaviour by companies and thus marked the birth of modern competition law.

monopolies, with companies buying either their suppliers or their customers. Companies were primarily interested in securing the supply of raw materials[58]. One example is Ford, which flourished during this period. This wave ended with the Great Depression of 1929.

Third wave 1965-1969

Due to the great economic prosperity of this period, companies had acquired such wealth that they could afford to acquire other companies. During this period many mergers involving unrelated companies were formed, this was the rise of conglomerate mergers. The main motivation at this time was diversification. Indeed, the main arguments of firms were that diversification offered more stable profits and the creation of an internal capital market. Indeed, if one combines two or more activities that are not perfectly related, a shock in one of the sectors could be offset by positive flows from other sectors that would not be impacted by the shock[59]. The third wave came to an end due to the oil shock of the 1970s.

Fourth wave 1981-1989

This is a period that has seen an explosion of hostile takeovers. These hostile takeovers gave rise to the term "corporate raider"[60]. They were carried out in the form of leveraged buyouts and financed by junk bonds. As far as Europe is concerned, the presence of the Single Market has encouraged large companies to look for international M&A opportunities, intending to reach new markets but also to achieve sufficient size to be competitive[61].

Fifth wave 1991-2000

During this period, there has been a significant decrease in the rate of hostile takeovers. However, the size of mergers has soared. Most of the largest

The largest number of mergers and acquisitions in the history of M&A was carried out during this period. A bubble had formed around industrial, financial, and

[58] See supra note 55

[59] Id

[60] Raiders are traders specialised in hostile takeovers. Their actions are mostly speculative, choosing firms (usually conglomerates) that are undervalued on the stock market and vulnerable, i.e. without a possible white knight to stop the attack.

[61] See Betton, Eckbo, Thorburn "*Corporate Takeovers"* Handbook of Corporate Finance : Empirical Corporate Finance vol.2 chap 15, 291-430 (2008)

technology activities due to the internet boom. It was also during this period that European M&A activity reached that of the US. According to Thomson Financial Securities Data, 87,804 M&A deals were recorded in Europe during the period 1993-2001. This compares with only 9,958 during the fourth wave of European mergers (1981-1989)[62]. The wave ended with the bursting of the technology bubble.

Sixth wave 2003-2007

After the tech bubble burst, the major central banks drastically lowered interest rates, prompting companies to use high leverage to structure their capital and finance their acquisitions with debt. Thus, this wave of M&A represented the era of globalisation and international mergers. As we can imagine, the famous sub-prime crisis stopped this wave in 2007.

Seventh wave 2014-Actually

The seventh wave started around 2014 when the number and value of mergers and acquisitions continued to rise. One reason could be that risk aversion and the focus on organic growth by companies is fading. This wave can be characterised by a significant consolidation in the banking sector in Europe and other sectors such as the pharmaceutical industry. We are also seeing a new trend in this wave: the arrival of the BRICS. BRICS stands for Brazil, Russia, India, China, and South Africa, five of the world's emerging national economies. The entry of these countries into the M&A scene can be explained by the fact that they are either developing or newly industrialised countries, and they are also five of the most populous countries and it is not surprising that M&A activity in the coming years will be heavily concentrated in these countries or the continents to which they belong[63].

As we have seen with previous waves, they usually stopped because of a major economic/financial crisis. So we can ask ourselves whether the recent COVID crisis may have brought this wave to an end.

[62] See Martynova "*Mergers and Acquisitions in Europe*" SSRN Electronic Journal (2006)

[63] See CleverSM *"A historical Analysis of M&A waves"* Article (2019)

2. European M&A Data

Historically, Europe has always accounted for a high share of global M&A deals. In 2020, European deals accounted for one-third of all deals completed globally during the year. In 2020, M&A activity in Europe decreased in terms of volume and value compared to 2018 and 2019. Deals numbered 3,000 during the year and totalled $691.7 billion, which translated into €790.3 billion. The peak of European M&A activity was seen in 2007 when more than 18,900 deals took place. The largest M&A deal ever in Europe was the 1999 acquisition of Mannesmann AG by Vodafone AirTouch[64] .

Below we can see the breakdown of all M&A deals in terms of volume in Western Europe in 2019, broken down by target country. In 2019, the largest number of M&A deals targeted the UK with over 27% of all deals. Germany was the second most sought-after destination for Western European M&A deals, with 15.2%, after France with 14.4% [65]. Thus we might be likely to focus on these countries in this thesis.

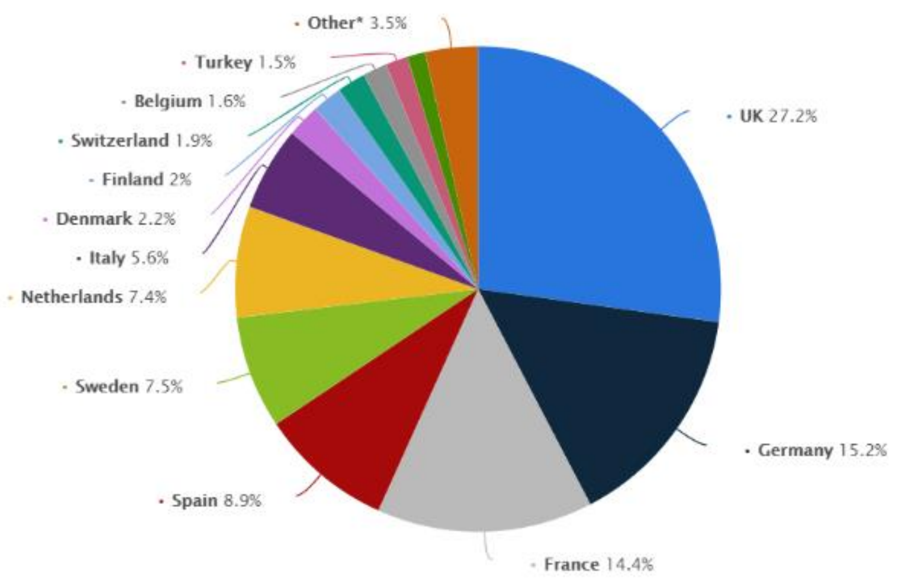

Figure 3 : Statista: M&A deal volume in Western Europe 2019, by target country

[64] See Statista "Value of Merger and Acquisition (M&A) deals in Europe from 2000 to 2020" (2021)

[65] Id "Share of merger and acquisition (M&A) deal volume in Western Europe in 2019, by target country"

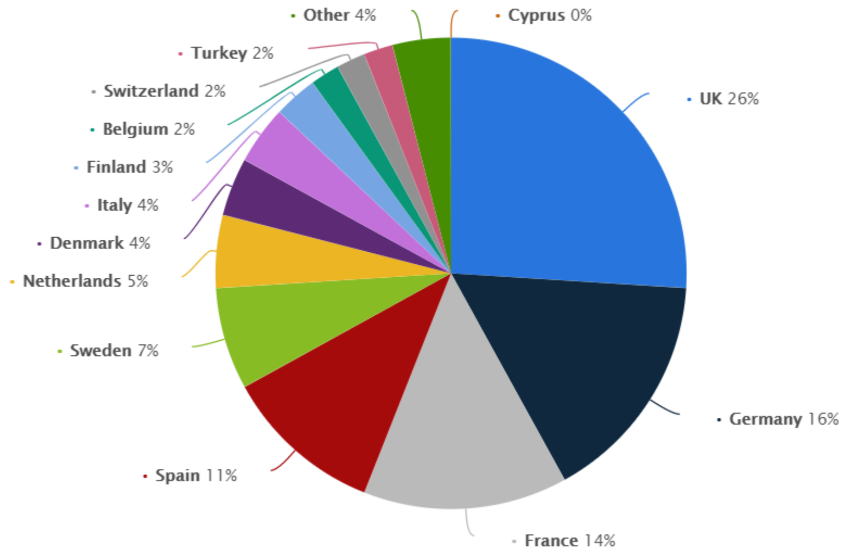

Figure 4 : Statista: M&A deal value in Western Europe 2019, by target country

We can observe a similar trend for the distribution of M&A deals in Europe in terms of value. We confirm that the three dominant countries for M&A in Europe are the UK, Germany, and France. The UK had the highest share of M&A deal value in 2019, with 26% of the total $1.1 trillion seen by Western European countries. Germany and France followed closely behind with 16% and 14% respectively[66].

III. Litterature Review on short-term M&A value creation

A. Positive abnormal returns?

A large number of studies have been carried out to analyse the effect of mergers and acquisitions on short-term value creation for companies. The majority of these studies focus on the measurement of abnormal returns, which we presented earlier, before and after the event. This paper will analyse the main studies carried out to understand the conclusions drawn from them. Secondly, we will carry out a cross-

[66] Id "*Share of merger and acquisition (M&A) deal value in Western Europe in 2019, by target country*"

sectional analysis to understand the different situations where value is created or not.

The first to use this method were Fama, Fisher, Jensen, and Roll in 1969[67]. Fama theorised that stock prices in the market reflect the information available, so the new stock price will be adjusted up or down according to the new information. This theory of Fama is essential, indeed it allows us to suppose that with the announcement of an M&A operation which would be regarded as new information, the price of the shares will be impacted.

Mandelker (1974)

Mandelker in his study used a sample of listed company mergers in the US between the years 1941 and 1962, he aimed to observe abnormal returns for the acquiring and acquired company. The results of the study were consistent with the hypothesis that the acquisition market is perfectly competitive and that merger information is efficiently incorporated into stock prices. Indeed, he was able to observe cumulative abnormal returns of 0.037% for the 40 months after and before the event for the acquiring company. Moreover, shareholders of the acquired companies obtain abnormal returns of about 14%, on average, in the seven months preceding the merger[68].

Dodd and Ruback (1977)

In this paper, Dodd and Ruback focus on takeover bids. Thus, they aim to study the impact of a takeover bid on the returns of the shareholders of the two firms. The results show that during the twelve months before the takeover bid, shareholders of the bidding firms earn significant positive abnormal returns of about 11.6% for the previous 12 months, but significantly reduced returns to 2.83% for the period after the announcement of the event, with even negative cumulative abnormal return of -1.32% [69]. We note that the results obtained seem to be consistent with the hubris hypothesis we saw earlier.

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[67] See Fama, Fisher, Jensen, Roll "*The adjustment of stock prices to New Information*" (1969)

[68] See Mandelker "*Risk and return: The case of merging firms*" Journal of Financial Economics vol.1, 304-335 (1974)

[69] See Dodd and Ruback *"Tender offers and stockholder returns: An empirical analysis"* vol.5, 351-373 (1977)

Jensen and Ruback (1983)

Jensen and Ruback review several empirical studies to draw conclusions. They argue that the evidence indicates that corporate takeovers generate positive gains, that shareholders of the target company benefit, and that shareholders of the bidding company do not lose. They argue that the market for corporate control should be seen as an arena in which management teams compete for the right to manage corporate resources[70]. Note that they argue that shareholders of target companies receive positive abnormal returns of about 20-30%.

Bradley, Desai and Kim (1988)

The authors of this study chose to deal with a sample of 921 companies listed on the NYSE and the American Stock Exchange between 1963 and 1984. As in the previous studies presented, they used the market model to measure abnormal returns for both companies. They showed that a successful takeover bid increases the combined value of the target and acquiring firms by an average of 7.4%. The period chosen was 20 days before the announcement date and ended 80 days after the event. The cumulative abnormal returns for the acquiring companies were positive (1.62%) but very low[71].

Frank and Harris (1989)

Frank and Harris analysed the effects of over 1,800 UK takeovers on shareholder wealth over the period 1955-1985. It shows that around the time of the merger announcement, targets gain 25-30% and bidders make no or modest gains (around 1%). These returns increased to 29.7% and 7.9% for target and bidding firms respectively when the period is taken 4 months before to 1 month after the date[72].

We have seen a significant number of studies showing positive abnormal returns in the short term after an M&A transaction. In addition to those mentioned above,

[70] See Jensen and Ruback *"The market for corporate control: The scientific evidence*" Journal of Financial Economic vol.11, 5-50 (1983)
[71] See Bradley, Desai and Kim "*Synergistic gains from corporate acquisitions and their division between the stockholders of target and acquiring firms"* Journal of Financial Economics vol.21 3-40 (1988)
[72] See Frank and Harris *"Shareholder wealth effects of corporate takeovers: The U.K. experience 1955-1985"* Journal of Financial Economics vol.23, 225-249 (1989)

we could have mentioned for example the studies of Jarrell and Poulsen[73], Servaes[74] , Kaplan and Weisbach[75] , or Mulherin and Boone[76] , who also reported average US target abnormal returns of 29%, 24%, 27%, and 21% respectively. However, we will see that not all studies are in agreement in this area, as an equally large number of studies demonstrate the presence of zero or even negative abnormal returns for the acquiring company or the target, or both.

B. Negative abnormal returns?

Firth (1980)

Firth analysed in his paper the impact of takeovers on shareholder returns using the same methods presented in the previous studies. The research showed that mergers and takeovers brought benefits to the shareholders of the acquired firms and to the managers of the acquiring firms, but that the shareholders of the acquiring firms suffered losses. Indeed, it found a return of -0.045 on average of the cumulative residuals for the month of the announcement[77].

According to Firth, the results show that merger operations are motivated more by reasons of maximising the utility of managers than by maximising the wealth of shareholders. We may note that a shortcoming of this study is the absence of statistically significant tests that would confirm that the results are not due to chance alone.

Lang et al (1989)

They took a sample of 87 targets and bidders of successful US takeovers from 1968 to 1986. For this sample, they found that shareholders of high q bidders earn significantly more than shareholders of low q bidders. In other words, there is a negative impact on the bidder's return when the bid is made by a firm with low

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[73] See Jarrell and Poulsen *"The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades"* Financial Management vol.2

[74] See Servaes "*Tobin's Q and the Gains from Takeovers"*, Journal of Finance vol.46, 409-419 (1991)

[75] See Kaplan and Weisbach *"The Success of Acquisitions: Evidence from Divestitures"* Journal of Finance vol.47, 107-38 (1992)

[76] Mulherin and Boone "*Comparing acquisitions and divestitures"* Journal of Corporate Finance vol.6, 117-139 (2000)

[77] See Firth "*Takeovers, Shareholder Returns, and the Theory of the Firm"* Quarterly Journal of Economics vol.94, 235-260 (1980)

Tobin's q. Typical bidders have persistently low q ratios before the announcement of the acquisition, while the q ratios of targets decline significantly over the five years before the takeover bid[78].

They argue that this demonstrates that takeovers of poorly managed targets by well-managed bidders have higher payoffs for the bidder, the target, and the total, which would not be the case otherwise.

Smith and Kim (1994)

This paper examines the extent to which takeovers mitigate the underinvestment problem and the free cash flow problem. They take a sample of 177 US targets and bidders from 1980 to 1986, with a five-day window before and after the transaction. They find negative returns for bidders from -0.23% to -1% to 0%[79] .

Holl and Kyriazis (1997)

In this paper, Holl and Kyriazis investigate the determinants of wealth creation and bid resistance, and the relationship between the two, for a sample of 178 successful UK takeover bids in a 0 to +2 month window. The results are interpreted in the context of the UK business environment.

They obtain negative abnormal returns of -1.25% for bidders two months after the bid announcement. In addition, they found that wealth creation and bid resistance are mutually dependent on each other[80]. According to them, these operations would have resulted from the absence of operational synergy although there would be managerial and financial synergies.

Walker (2000)

Walker studies the strategic objectives and stock price performance of acquiring companies. He conducts his analysis with a sample of 278 acquisitions, 230 mergers, 48 takeovers from the US from 1980 to 1996, with a 2-day window before and after the transaction. He finds that the market-adjusted abnormal returns are negative by -0.84%. He argues that the results support both the

[78] See Lang et al. *"Managerial performance, Tobin's Q, and the gains from successful tender offers"* Journal of Financial Economics vol.24, 137-154 (1989)

[79] See Smith and Kim "*The Combined Effects of Free Cash Flow and Financial Slack on Bidder and Target Stock Returns"* The journal of Business vol.67 281-310 (1994)

[80] See Holl and Kyrizias "*Wealth creation and bid resistance in u.k. takeover bids"* Strategic Management journal vol.18, 483-498 (1997)

information asymmetry hypothesis (acquiring firm shareholders earn higher returns from cash offers) and the strategic alignment hypothesis (acquiring firm shareholders earn higher returns from buyouts that expand the firm's operations geographically or increase its market share). Thus, shareholder losses are mainly limited to buyouts based on diversification strategies, where the acquiring firm claims potential overlap with its existing business. The latter companies tend to have more favourable growth opportunities before the takeover is announced[81].

Bruner (2002)

Based on 100 scientific studies conducted between 1971 and 2001. Bruner's analysis comments on the different research approaches and highlights the results for general activity. The majority of the research, he argues, that there is no significant effect on the share price of companies making offers around the day of a merger or acquisition announcement. However, he shows that target shareholders do get significant positive returns in the market. He argues that the wide dispersion of results around zero returns for buyers suggests that managers should approach M&A with caution[82].

Sudarsanam and Mahate (2003)

In this study, they analysed the effect of different types of purchasers, defined by their financial status and payment methods, on their short- and long-term performance in terms of abnormal returns, using a variety of benchmark models. For a sample of 519 UK acquirers over the period 1983 and 1995, with a one-day pre- and post-announcement window, they examine the abnormal return performance of acquirers as a function of their pre-offer financial status. They find that firms that overvalued their equity had lower returns. They also highlight, as in some previous studies, the importance of the payment method. Cash buyers generate higher returns than stock buyers, regardless of their prestige/value status[83].

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[81] See Walker *"Corporate Takeovers, Strategic Objectives, and Acquiring-Firm Shareholder Wealth"* Financial Management Vol.29, 53-66 (2000)
[82] See Bruner *"Does M&A Pay? A Survey of Evidence for the Decision-make"* University of Virginia (2002)
[83] See Sudarsanam and Mahate "*Glamour Acquirers, Method of Payment and Post-acquisition Performance: The UK Evidence"* Journal of Business Finance and Accounting vol.30, 299-342 (2003)

We have seen that the presence of positive abnormal returns is not systematic. Most of the time, abnormal returns are zero or even negative. However, this is not a random phenomenon, as whether or not value is created depends on certain specific criteria. We have already studied the factors affecting value creation. It is now a question of in which specific situations we are likely to obtain positive or negative abnormal returns.

C. Specific elements explaining the disparity between situations

Various elements can influence the value of the acquiring and target companies in a merger. The purpose of this paper is to examine these main elements.

Hostile or friendly

First, studies have shown that, in the majority of cases, hostile takeover bids and mergers generate higher returns for targets than friendly M&A announcements. However, the opposite is true for acquirers, whose returns on the day of the announcement are significantly lower in hostile bids than in friendly M&A. One explanation for this phenomenon is the presence of defensive strategies for target firms. Indeed, we know that when there is an initial announcement of defensive activity, the value of the target's stock decreases. This is usually a short-term deviation from fundamentals, caused by speculation, confusion, and high levels of information uncertainty. However, the trading and auction processes that result from the announcement of a defensive measure usually lead to increased bids and share prices, as we saw earlier in the context of multiple auctions. Furthermore, defensive actions produce a double benefit: initially positive effects on shareholder wealth ranging from 9 to 14%, and a significant reduction in the likelihood of successful bidding with the benefit of job security for incumbent managers who raise the defence. However, not all defences produce the same beneficial effects. Thus, it has been shown that most of the time benefits are brought about in the case of poison pills[84], they have been shown to systematically increase shareholder wealth[85].

Large equity stakes

Studies have shown that when the managers of the acquiring firm have large shareholdings, the share price of that firm will react more strongly. This suggests that when managers do not have large shareholdings, there are greater agency problems in the firm and this is reflected in the share price. Offeror shareholders may therefore believe that managers with low shareholdings prioritise growth strategies rather than focusing on maximising shareholder value. Indeed, Agrawal and Mandelker tested the relationship between a manager's holding of common stock and options and the characteristics of the investment decisions made by the firm, specifically changes in the variability of the firm's asset returns. They also studied the relationship between a manager's stock holdings and the firm's financing decisions, i.e. changes in the debt/equity ratio. They found that common stock and options held by corporate executives for which the variance of returns increases when an investment is announced is greater than for companies for which it decreases[86].

Method of payment

We have already seen that cash transactions seem to bring higher abnormal returns than those paid in shares. One of the hypotheses presented in the studies is that of the information asymmetry signal presented in particular by Majluf and Myers. According to them, the method of payment conveys information about the presumed value of the target company. We know that managers are supposed to act in the best interests of their shareholders. According to the signal theory, they

[84] "Poison pills take a wide variety of forms, but today most are based on the class of securities known as rights. Hence the official name of the pill, the "shareholder rights plan". A traditional right, such as a warrant, gives the holder the option to buy new shares in the issuing company. The modern poison pill adds three additional elements not found in traditional rights: a flip-in element, a flip-over element and a redemption clause. "See Stephen Bainbridge Corporate Law 4th Edition

[85] See Pearce *"Hostile takeover defenses that maximize shareholder wealth"* Business Horizons 47, 15-24 (2004)

[86] See Agrawal and Mandelker "*Managerial Incentives and Corporate Investment and Financing Decisions"* Journal of Finance vol.42, 823-837 (1987)

will therefore use cash as a payment method when they assume that the target company is undervalued because their objective is to preserve all gains for their current shareholders. Conversely, when managers believe that the target is overvalued, they will choose shares as a form of payment because, in this way, the buyer's current shareholders will share the risks and losses of the acquisition with the target company's shareholders[87]. Moreover, after the announcement, market participants usually interpret share offers as an unfavourable signal and cash offer as a favourable signal, which will influence market prices in a cautious direction.

Empirical studies have found strong evidence that the share price response of the target and the bidder is indeed sensitive to the means of payment in European takeover bids. Martynova and Renneboog indicate that all-cash offers, as well as offers combining cash, equity, and loans, are more sensitive to the means of payment. They find that all cash deals generate higher abnormal returns than equity deals. (12% for cash transactions and 7% for equity transactions)[88].

<u>Cross-boarder acquisition</u>

The impact of globalisation and the lowering of barriers to entry into international markets have increased the number of transactions[89]. Originally, cross-border mergers and acquisitions were most common in the US, but European companies are increasingly involved in cross-border transactions. This has been helped by deregulation and industry restructuring, which has made M&A cheaper and less risky. In addition, regulatory differences between countries can also offer interesting opportunities for the bidding company, such as avoiding customs duties or tax advantages.

Empirical studies clearly show that the effect of cross-border acquisitions is positive for the shareholders of the target company, but the effect on the share prices of the acquiring company is not significant. Danbolt conducted a study with a sample of 630 transactions in the UK between 1986 and 1991[90]. He found that target companies obtain clearly higher abnormal returns in cross-border deals than

[87] Supra note 47
[88] Supra note 61
[89] See Campa and Moschieri "*The European M&A industry: Trends, patterns and shortcomings" RePEc* (2008)
[90] See Danbolt "*Target Company Cross-border Effects in Acquisitions into the UK"* European Financial Management vol.10, 83-108 (2004)

in domestic deals. Campa and Hernando reach similar conclusions. They find that for target firms, the average cumulative abnormal return is 4% over a three-day event window and 9% for a longer-term event window around the day of the announcement[91]. However, as with Danbolt, empirical research on bidder abnormal returns shows insignificant results.

We have seen the main elements that can impact abnormal returns in M&A. These elements have been empirically proven in several studies, which reinforces the hypotheses put forward. We could also have mentioned other factors such as the size of the target or horizontal mergers, but these have already been discussed in part C. 1.

D. The case of European companies

Finally, in order to deepen our analysis of the European case made in part 1. D., we will here analyse some relevant papers dealing with M&A in Europe. The objective will be to observe the concordances with the elements we have located above and to realise whether the results may differ when we focus exclusively on the European market.

We will first analyse the study carried out by Miroslav Mateev in 2017[92]. This study was conducted with companies in the UK and continental Europe. A sample of 2823 European acquisitions made between 2002 and 2010 was selected. The aim was to analyse the stock returns of the acquiring companies. The author also performed cross-sectional analyses allowing us to confirm or refute the elements we have mentioned above. Thus, the first results show that the cumulative average abnormal returns (CAAR) for the two samples of European bidders (UK and Continental Europe) are positive. Overall, the results indicate that M&A announcements in Europe are viewed positively by shareholders of bidding companies.

Furthermore, concerning payment methods, CAARs were calculated over five different event windows for the UK sample, dividing them into three groups, those

[91] See Campa and Hernando "*Shareholder Value Creation in European M&As*" European Financial Management vol.10, 47-81 (2004)

[92] See Miroslav Mateev *"Is the M&A announcement effect different across Europe? More evidences from continental Europe and the UK"* Research in International Business and Finance vol.40, 190-216 (2017)

for share offers, cash offers, and mixed payments. The results show that, over a three-day event window, equity-paid trades achieve a cumulative average abnormal return of 2.52%, while the corresponding return for cash trades is only 0.57%. For blended payment trades, bidders' abnormal returns fall between those for equity and cash payments, amounting to 0.91%, over this same event window. Over a longer estimation period of eleven days, all-cash bids, as well as combined cash and equity bids, trigger significantly higher abnormal returns (0.89% and 1.94%, respectively) than all-equity bids (-0.03%). Thus, the author finds evidence that the bidder's stock price response is indeed sensitive to the means of payment as discussed above. However, we observe that in the short run the results obtained contradict those of Martynova and Renneboog who claimed that cash payments produce[93] . One explanation for this difference could be that the higher abnormal returns for equity offers could be due to a large number of acquisitions of unlisted targets using the bidder's own equity. Indeed, an analysis of the effect of payment on share returns between listed and unlisted targets showed that returns are higher for unlisted targets.

Furthermore, the comparison between the samples based on the sectoral relationship between the offeror and the target shows no significant evidence of superior performance when two firms come from the same industry. This result contradicts Martynova and Renneboog who found distinctions between mergers in related sectors[94].

The second study we will deal with is the one of Campa and Hernando, who analysed a sample of 262 European mergers between 1998 and 2000[95]. The method used is that of abnormal returns. The first results obtained are rather in line with the existing literature. Indeed, they find positive and significant abnormal returns for targets and little significance for acquirers. However, the interesting contribution of this study, compared to previous studies, is the distinction between state-regulated and non-state-regulated industries. Specifically, the authors focused on cases where the target company operates in an industry that is highly regulated or where the involvement of state-owned enterprises is significant. However, it may be difficult to define precisely what a

[93] See supra note 61

[94] Id

[95] See supra note 91

regulated sector means, as all industries are more or less regulated. Thus, a focus on the number of SOEs in an industry can help to give some idea of the restrictiveness of the industry. The authors' data show that the average cumulative abnormal returns for targets and acquirers are significantly lower for mergers in regulated industries. Indeed, we find a difference of between 1.3% and 5.2% in returns depending on the level of regulation in an industry. Furthermore, positive returns for targets in regulated industries obtain insignificant results under certain windows. For acquirers, we obtain somewhat similar results with variations of 1.0% to 3.5%[96].

Overall, these results may reflect the existence of regulatory frameworks in some sectors that represent a hostile environment, which hinders the success of merger processes. Given that regulatory laws in some industries in Europe can be strict, we can ask whether this could be an important influencing factor in European mergers.

IV. Conclusion

According to various studies and a recent report by the Harvard Business Review, the failure rate of mergers and acquisitions is between 70% and 90%. This shows that M&A is a complex, non-automatic process and that a lot of upstream research is needed to minimise the risks of a failed merger. In our thesis, we have distinguished four types of mergers, horizontal, vertical, concentric, and conglomerate. Horizontal mergers are the most common as they involve mergers of companies in the same industries. Conglomerate mergers, although rarer, have experienced a period of strong expansion throughout history.

We have seen that the motivations for this type of operation can be multiple, there can be strategic reasons which can be offensive or defensive such as the desire to access new markets or to prevent the actions of a competitor. We can also mention managerial or financial reasons. During our study, we analysed several different studies in order to observe the main factors that can affect value creation. Indeed we can now answer our initial question. Mergers and acquisitions can create value in the short term, but this depends on several factors. We found that, in the first place, takeover bids and hostile mergers generate higher returns for targets than friendly M&A announcements. On the other hand, the opposite is true for

[96] Id

acquirers, whose returns on the day of the announcement are significantly lower in hostile bids than in friendly deals. Secondly, cash deals seem to bring higher abnormal returns than those paid in shares, although this is not entirely true for a study conducted in Europe. Furthermore, the empirical studies clearly find that the effect of cross-border acquisitions is positive for the shareholders of the target company. Finally, for the European case, it has been shown that the average cumulative abnormal returns for targets and acquirers are significantly lower for mergers in regulated sectors. Over the years, antitrust laws have tried to regulate M&A more and more, but these transactions still attract as many companies as ever and show that M&A will surely be present in the corporate world for a long time to come.

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