

## Stern Stewart Research

## The Americas

# M&A

## Why Most Winners Lose

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American companies in 2000 continued the explosion of M&A activity that began after the economic slump in the early 1990s. Reported transaction value reached a record \$1.75 trillion—22.6% higher than 1999. But what have been the benefits of all this acquiring and merging, and what lessons can managers find in the distribution of those benefits?

Research into the wealth effects of M&A activity identifies three outcomes:

- Mergers and acquisitions create substantial wealth for stockholders of the combined companies, but most, if not all, of the newly created wealth accrues to target stockholders.
- Stockholders of target companies realize significantly positive wealth effects from all acquisitions—both tender offers and mergers.
- Stockholders of acquiring companies realize little or no wealth impact from tender offers and actually suffer a loss of wealth in mergers.

In view of the overwhelming evidence that acquisitions create wealth for all security holders as a group, it is worth considering why most acquisitions fail to benefit the stockholders of acquiring companies:

- Senior executives erroneously believe that the stock market rewards EPS growth and therefore, pursue acquisitions as the surest means of growing.
- Incentive compensation systems typically reward EPS growth—not EVA®.
- Executives also are rewarded in direct proportion to the company's size—sales, assets or number of employees—causing many to become acquisitive without regard to the consequences acquisitions may hold for stockholders.
- Corporate executives in general and CEOs in particular are accustomed to winning and, as a result, define “success” in M&A as closing the deal.

Although the evidence indicates that stockholders of acquiring companies do not appear to benefit and may in fact lose wealth in M&A transactions, it also offers these keys to achieving truly successful acquisitions:

- Evaluate the likelihood of achieving synergies.
- Be wary of diversification.
- Avoid EPS-itis and other GAAP-induced illnesses.
- Be generous with debt financing and do not be deceived that equity is “cheap.”
- Avoid buying public companies if possible and, instead, look for bargains in the private market.
- Make sure incentive plans reward wealth creation—not EPS or size.

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In 2000, American companies were involved in 8,505 deals with a total value of \$1.75 trillion.<sup>1</sup> These data include all completed mergers, acquisitions, and divestitures priced at \$5 million or greater, as well as purchases of partial interests involving at least a 40% stake in the target company or an investment of at least \$100 million. While the number of deals in 2000 decreased 8.7% compared to the prior year, their dollar value increased a whopping 22.6%.<sup>2</sup> This continued the explosion of M&A activity that began after the economic slump in the early 1990s.

The staggering pace of M&A activity is indicative of a vibrant market for corporate control—an essential ingredient if capital is to flow freely to its most productive uses in the economy. But other than report the obvious, the financial media have had little to say about whether the current wave of M&A activity has benefited stockholders or, for that matter, contributed to overall economic efficiency. What have been the benefits of all this acquiring and merging, and what lessons can managers find in the distribution of those benefits?

The best measure of a company's success or failure in creating wealth is its market value added, or MVA, which is calculated as the difference between the market value of all its securities and the total investment in the company by lenders and stockholders alike. If MVA registers a statistically significant increase or decrease as the result of a transaction, it may reasonably be argued that stockholder wealth was enhanced or destroyed.<sup>3</sup>

If company A acquires company B, B's MVA will increase so long as the purchase price exceeds B's market value (or  $MVB_B$ ). The increase in company B's MVA (or  $MVA_B$ ) will be equal to any premium paid by company A over B's market value.<sup>4</sup> Since acquirers must pay a premium to acquire control, it is not surprising that stockholders of targets almost always realize an increase in wealth. Of greater interest is the wealth impact on the buyer's stockholders.

If the stockholders of company A are to realize an increase in wealth as the result of acquiring company B, the purchase price must be less than B's value to A. For this to be true, the value of company B under the ownership and management of company A ( $MV_{BA}$ ) must be greater than its value under B's ownership and management ( $MV_B$ ). The difference between these two values is the synergy value (SV) that A creates through its acquisition of B (i.e.,  $SV = MV_{BA} - MV_B$ ). But positive synergy value does not guarantee that the deal creates wealth for A's shareholders. For this to be the case—for both groups of shareholders to win—SV must be greater than the purchase premium ( $MVA_B$ ). That is, the impact on the wealth of company A's stockholders ( $MVA_A$ ) is  $SV - MVA_B$ . Rearranging that equation, we also see that  $SV = MVA_B + MVA_A$ .

**For a transaction to create wealth, the value of synergies must exceed the premium paid by the acquirer.**

The combined changes in the MVAs of A and B ( $MVA_B + MVA_A$ ) also are the total wealth effect (TWE) of an acquisition or merger. Thus, the total wealth effect of any transaction is defined by its synergy value (i.e.,  $MVA_B + MVA_A = TWE = SV$ ). Accounting considerations are irrelevant. Since stockholders of target companies will almost always realize positive wealth effects (i.e.,  $MVA_B > 0$ ), the relevant question is whether stockholders of acquirers also benefit from acquisitions (i.e., is  $MVA_A > 0$ )? If they do not, do acquisitions in general create or destroy wealth? Is  $TWE = MVA_B + MVA_A > 0$ ?

## EMPIRICAL EVIDENCE

The wealth effects associated with M&A activity have been addressed by numerous



researchers who typically identify three outcomes:

1. Stockholders of target companies realize significantly positive wealth effects from all acquisitions—both tender offers and mergers.
2. Stockholders of acquiring companies realize little or no impact on wealth from tender offers.
3. Acquiring stockholders lose wealth in mergers.

Mergers are typically friendly deals that involve the cooperation of incumbent managers. Tender offers, in contrast, are made directly to target stockholders—often to overcome resistance from incumbent managers—and may indicate greater confidence on the acquirer's part in its ability to realize synergistic benefits from the acquisition. Mergers are more often financed with acquirer's stock, whereas tenders are predominantly financed with cash. Hostile takeovers are almost always structured as cash tender offers.

### **TENDER OFFERS**

**Tender offers create substantial wealth almost all of which is realized by target stockholders.**

The wealth effects in tender offers were the subject of research by Michael Bradley, An and Desai and E. Han Kim.<sup>5</sup> Their findings provide strong support for the proposition that acquisitions effected with tender offers create substantial wealth, almost all of which is realized by target stockholders. They found that a successful tender offer increases the combined value of the acquiring and target companies by an average of 7.4%, based on the cumulative abnormal return<sup>6</sup> from five days before the first offer to five days after the last offer made for the target, and that 75% of the acquisitions effected with tenders produced positive wealth effects. In 95% of the transactions, targets realized positive wealth effects, averaging 31.8% of the pre-tender value. Acquiring stockholders also realized positive, but minimal, wealth benefits. Their gains averaged just 1.0%, and fewer than half (47%) of the transactions actually were accretive to acquiring stockholders' wealth.

The Bradley, Desai and Kim study is based on a sample of 236 successful tender offer contests occurring over the period 1963-1984. The study also analyzed three sub-periods: July 1963-June 1968, July 1968-December 1980, and January 1981-December 1984. As noted by the authors, the first period (1963-1968) is important because prior to 1968 cash tender offers were free of government regulation. Cash tenders were considered private transactions between the acquiring company and the stockholders of the target company. In July 1968, the Williams Act brought tender offers within the purview of the Securities and Exchange Commission.

The last period (1981-1984) is characterized by three factors that altered the M&A environment. First is the *laissez-faire* attitude of the Reagan Administration toward corporate takeovers. Second is the development of sophisticated legal and financial tactics to repel takeovers, such as poison pills, targeted stock buybacks, lock-up provisions, and supermajority and fair-price amendments. Third is the emergence of investment banking companies—in particular, Drexel Burnham Lambert—that specialized in raising below investment grade debt (so-called junk bonds) to finance corporate takeovers. Bradley, Desai and Kim's findings are summarized in Exhibit 1.

### **Exhibit 1: Synergistic Gains from Successful Tender Offers**

Mean percentage synergistic gains to 236 successful tender offer contests effected between 1963 and 1984 for combined, target, and acquiring companies. All dollar amounts are stated in millions of 1984 dollars.



	Subperiod			Total
	7/63 – 6/68	7/68 – 12/80	1/81 – 12/84	7/63 – 12/84
No. of contests	51	133	52	236
Combined				
<b>% Return</b>	<b>7.78</b>	<b>7.08</b>	<b>8.00</b>	<b>7.43</b>
% Positive	78	74	73	75
TWE	\$81.1	\$87.4	\$218.5	\$117.1
Targets				
<b>% Return</b>	<b>18.92</b>	<b>35.29</b>	<b>35.34</b>	<b>31.77</b>
% Positive	94	98	90	95
MVA	\$70.7	\$71.6	\$233.5	\$107.1
Acquirers				
<b>% Return</b>	<b>4.09</b>	<b>1.30</b>	<b>-2.93</b>	<b>0.97</b>
% Positive	59	48	35	47
MVA	\$25.0	\$31.8	-\$27.3	\$17.3

% Return = cumulative abnormal return from five days before the first offer to five days after the last offer made.

Source: Bradley, Desai and Kim (1988)

The data indicate that tender offers produce significant positive wealth effects—between 7% and 8%—that are remarkably stable across all three subperiods. The dollar gains increased dramatically in the 1981-1984 subperiod. In constant 1984 dollars, the average synergistic gain was \$219 million, compared to \$81 million and \$87 million in the two earlier subperiods.

The increase in dollar gains but not in percentage gains is due to the larger size of targets. The average pre-offer market value of targets increased from \$379 million in the first period to \$550 million in the last period, while the average size of acquirers actually dropped from \$1,624 million to \$1,477 million. This may be explained by the more relaxed attitude of the Reagan Administration toward corporate takeovers, the emergence of junk bonds as a means of financing leveraged acquisitions, and the popularity of two-tiered offers which reduced the cash outlays required of buyers.

As Exhibit 1 shows, the great majority of the gains from tender offers is realized by target stockholders. The mean dollar gain to target stockholders was 91% of the mean total dollar gain. What's more, returns to target stockholders increased over time while returns to acquirer stockholders decreased. The mean abnormal return to targets increased from 18.9% in the first sub-period to 35.3% in the third sub-period, while the mean abnormal return to acquirers fell from 4.1% to -2.9%. Since cash tender offers resulted in total wealth effects of essentially the same percentage magnitude across all three sub-periods, it would appear that government regulations and other changes that have occurred in the tender offer environment have been a zero sum game. That is, target stockholders have benefited at the expense of acquirer stockholders.

**Returns to acquirer stockholders have decreased over time.**



**The presence of competing bidders only serves to decrease returns to acquirers. It does not pay to be a “white knight.”**

**Stock-swap mergers—like tender offers—create substantial wealth, most of which accrues to target stockholders.**

Bradley, Desai and Kim conclude that:

- Successful tender offers generate significant synergistic gains and lead to a more efficient allocation of corporate resources.
- Stockholders of both targets and acquirers realize positive abnormal returns, most of which are captured by the sellers.
- Both the rate of return and dollar gains to target stockholders increased over time, in contrast with declining returns to acquirer stockholders. In fact, in the 1981-1984 sub-period, acquirers suffered significant losses.

The authors also found that the presence of competing bidders brings about increased returns to targets and decreased returns to acquirers. But unlike regulation, competition is not a zero sum game: Total synergistic gains are greater in multiple-bidder than in single-bidder acquisitions. And once again, target shareholders are the winners. In fact, competition among bidders reduces the average gain to acquirers to a level insignificantly different from zero. And the extent of the adverse impact from competition on acquirers is greatest among late entrants. It would appear that it does not pay to become a “white knight,” since they tend to overpay.

In an earlier paper, Bradley, Desai and Kim found that the positive wealth effects of cash tender offers are not due to investors’ reassessment of previously undervalued securities. The positive revaluation of the target’s shares is permanent only if the tender offer is successful and the resources of the two companies are combined.<sup>7</sup> This evidence is consistent with the synergy theory of tender offers, which states that by acquiring control of the target the buyer can utilize the combined resources of the two companies more efficiently.

### **STOCK-SWAP MERGERS**

The wealth effects on stockholders and bondholders in pure stock-swap mergers were the subject of a study by Lance A. Nail, William L. Megginson, and Carlos Maquieira.<sup>8</sup> This analysis of 260 stock-swap mergers over the period 1963-1996 suggests that the distribution of net wealth effects—gains or losses—is best explained by the degree of similarity between the merging companies’ businesses. Mergers of related companies tend to produce significant increases in wealth—not only for all security holders as a group, but also for the acquirer’s stockholders and even for the bondholders. In contrast, conglomerate mergers tend to generate little net wealth for all security holders as a group and typically reduce the wealth of acquirer stockholders.

Synergies potentially come in two forms. “Operational” synergies are improvements in operating efficiency resulting from economies of scale or scope or the elimination of redundant resources. Operational synergies are positively related to the similarity between the businesses of the merging companies. “Financial” synergies, in contrast, are the result of less-than-perfectly correlated cash flows of merger partners. One theory in support of financial synergies is that the reduced volatility of cash flows of the newly-merged company will result in lower borrowing costs and, hence, a lower cost of capital. Lower capital costs in turn will boost economic value added (EVA<sup>®</sup>) and stock price. Another source of financial synergy in conglomerate mergers is the presence of internal capital markets, with the ability to fund negative cash flow businesses with excess cash generated in cash-rich businesses. This reduces the transactions costs usually incurred in raising capital.<sup>9</sup> In contrast to operational synergies, financial synergies are negatively related to the similarity between the merging companies’ businesses.

One little noted Catch 22 in the financial synergy theory is that there will be no net increase in wealth in a stock-swap merger in the absence of operational synergies. In



this zero sum game, any gains experienced by one group of security holders must be offset by losses suffered by another group. Wealth is not being created but merely redistributed. Since conglomerate mergers are supposed to result in financial synergies, bondholders should experience positive wealth effects as the result of lower interest rates. Alternatively stated, the “quality” of their bonds rises while the coupon remains fixed, so the value increases. But since there are no net wealth gains expected in conglomerate mergers, bondholders can only benefit at the expense of stockholders. Stock-swap mergers represent an ideal opportunity to test for wealth creation and redistribution effects because there are no cash outflows or asset changes.

**Mergers of companies in related businesses create significantly greater wealth than conglomerate mergers. Corporate diversification generally destroys wealth.**

As shown in Exhibit 2, mergers, like tender offers, generally create substantial wealth for stockholders of the combined companies, but most of the newly created wealth accrues to target stockholders. Mergers of companies in related businesses create significantly greater wealth (for acquirer and target stockholders combined) than conglomerate mergers—on average, 8.6% versus 3.3%. (The median difference—8.6% versus 2.0%—is even greater.) But more important is the distribution of these wealth effects between stockholders of acquirers and targets. Stockholders of acquirers realize an average wealth benefit of 6.1% in related mergers but lose 4.8% on average in conglomerate mergers. These findings are consistent with other studies that show that corporate diversification generally destroys wealth.

#### **Exhibit 2: Wealth Effects on Stockholders and Bondholders in Stock-Swap Mergers**

	Mean % Return	Median % Return	% Positive
<b>Common Stocks</b>			
<b>Conglomerate mergers</b>			
Acquirers	3.28	1.98	56.3
Targets	-4.79	-7.36	36.2
	41.65	38.79	83.0
<b>Related mergers</b>			
Acquirers	8.58	8.55	66.4
Targets	6.14	4.64	61.8
	38.08	24.33	80.0
<b>Corporate Bonds</b>			
<b>Conglomerate mergers</b>			
Acquirers	0.44	0.28	53.0
Targets	0.33	0.24	52.3
	1.22	3.89	51.6
<b>Related mergers</b>			
Acquirers	1.44	0.82	59.6
Targets	1.90	1.39	64.0
	0.50	0.24	50.5
<b>Net Wealth Effects (All companies, all securities)</b>			
Conglomerate mergers	3.08	1.14	48.2
Related mergers	6.82	6.79	64.0

% Returns are calculated as the difference between actual post-merger values and predicted post-merger values.

Source: Nail, Megginson, and Maqueira (1998)



**Conglomerate mergers fail to produce meaningful financial synergies that benefit bondholders.**

**Five-year post-acquisition returns to acquiring stockholders suggest the difficulty buyers face in making reasonably-priced deals and integrating acquired companies successfully.**

Unsurprisingly, stockholders of target companies win in both types of mergers: an average positive wealth effect of 38.1% in related mergers and an average benefit of 41.7% in conglomerate mergers. These findings are consistent with the notion that a redistribution of wealth from acquirer to target stockholders occurs in both conglomerate and related mergers.

Consistent with the premise of operational synergies in related mergers, bondholders of acquiring companies realized average wealth increases of 1.9% as compared to only 0.3% for bondholders of acquirers in conglomerate mergers. The wealth impact on bondholders of target companies was just the opposite—1.2% in conglomerate mergers and 0.5% in related mergers.

More surprising is the scarcity of support for the existence of financial synergies in conglomerate mergers. Since no net wealth gains are expected in conglomerate mergers, bondholders can only benefit at the expense of stockholders. Conglomerate mergers produced only slightly positive wealth benefits to stockholders of the combined companies—on average 0.4%. And the impact on bondholder wealth—on average 0.3%—was statistically not significantly different from zero. The only type of wealth redistribution occurring in conglomerate mergers appears to be that from acquirer stockholders to target stockholders.

Considering the combined wealth effects on stockholders and bondholders together, related mergers significantly outperformed conglomerate mergers—6.8% versus 3.1% on average and 6.8% versus 1.1% at the median. Fewer than half (48.2%) of conglomerate mergers created positive wealth effects for security holders, while almost two-thirds (64.0%) of related mergers were wealth-creating.

In summary, Nail, Megginson, and Maqueieira provide impressive evidence that managers who execute mergers with companies in related businesses are on average acting in their stockholders' best interests, while those who execute conglomerate mergers are systematically destroying the wealth of their stockholders. In view of these findings, the de-conglomeratization of corporate America that began with hostile takeovers and LBOs in the early 1980s may help to explain why U.S. stock markets have performed so well during the past two decades.

## **LONG-TERM WEALTH EFFECTS OF CORPORATE ACQUISITIONS**

The studies cited thus far measure the wealth effects of tender offers and mergers based on returns computed over a pre-acquisition period starting shortly before the announcement date and ending around the completion date. These studies implicitly assume that stock prices respond fully and quickly to any anticipated synergistic benefits from business combinations, as would be expected in a fully efficient market. But what if it takes time for the market to figure out the true effects of a combination? Tim Loughran and An and M. Vijh examined the post-acquisition returns of 947 companies over the period 1970-1989.<sup>10</sup> They analyzed the overall wealth effects by combining the pre-acquisition and post-acquisition returns.

Loughran and Vijh measured post-acquisition cumulative abnormal returns from holding the target stock from two days before the first announcement date of the deal to its effective date and then rolling over the proceeds for another five years by investing in the acquirer's stock. Abnormal returns were measured as the difference between five-year holding period returns of sample stocks and matching stocks that were chosen to control for size and market-to-book-value effects.



**Cash acquirers create long-term value, while stock acquirers destroy value.**

The study's findings may be summarized as follows: Acquirers' post-acquisition stock returns are related both to the means of payment (stock versus cash) and the form of acquisition (merger versus tender offer). Almost half the mergers in the sample were financed with stock, and the remaining half were financed about evenly with a mix of cash and stock. Almost five out of six tender offers were financed with cash, and the remaining one in six was split between stock and a mix of cash and stock.

Out of the total sample of 947 deals:

- Acquirers in all transactions—regardless of the form of transaction or the means of payment—earned a total return of 88.2% over a five-year period following the transaction, or 6.5 percentage points less than the 94.7% earned by matching companies. This suggests the difficulty managers face in making reasonably-priced acquisitions and integrating acquired companies successfully.
- Acquirers that completed mergers earned on average 15.9 percentage points less than matching companies (81.2% versus 97.1%).
- Acquirers that made successful tender offers earned on average 43.0 percentage points more than matching companies (131.7% versus 88.7%).
- Stock acquirers earned 24.2 percentage points less than matching companies (61.0% versus 85.2%).
- Cash acquirers earned 18.5 percentage points more than matching companies (113.2% versus 94.7%).

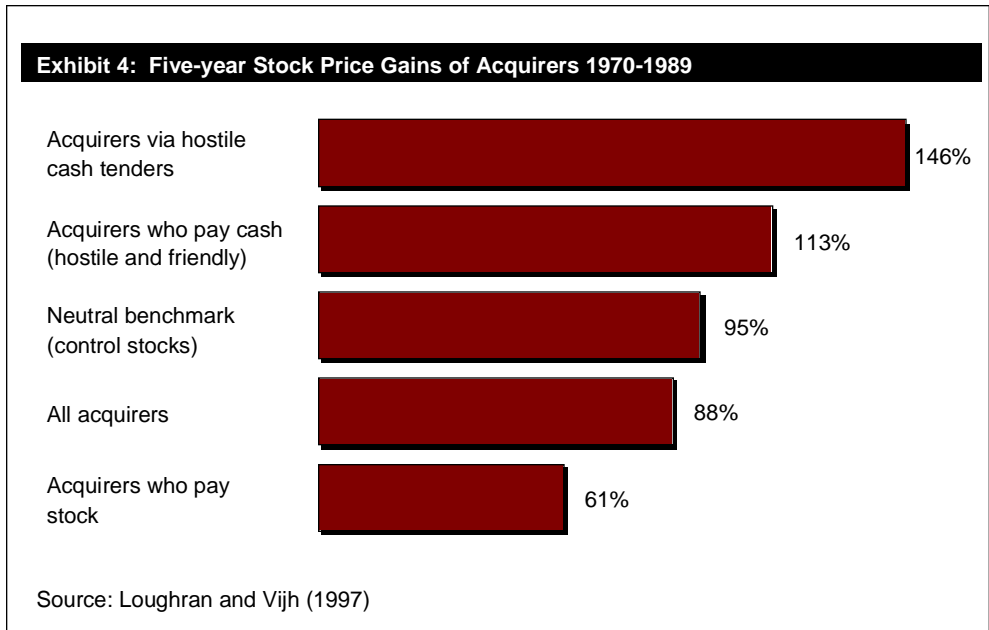
Considering all four subsets across means of payment and form of acquisition (i.e., cash mergers and stock mergers, and cash tenders and stock tenders), only stock mergers earned significantly negative excess returns, -25.0%, while cash tenders earned significantly positive excess returns of 61.7%. The performance of cash mergers approximated that of the matching companies, while there were too few stock tender offers (eight in all) from which to draw meaningful conclusions. Loughran and Vijh's findings are summarized in Exhibits 3 and 4.

**Tender offers create long-term wealth for acquirers while mergers, whether stock or cash, destroy wealth.**

### Exhibit 3: Long-term Returns to Corporate Acquirers

Form of Payment	Statistic	Mergers	Tender Offers	All Acquisitions
Stock	Acquirer % return	61.9	4.8	61.0
	Matching % return	86.9	40.9	85.2
	<b>% Difference</b>	<b>-25.0</b>	<b>-36.1</b>	<b>-24.2</b>
Cash	Acquirer % return	97.7	145.6	113.2
	Matching % return	102.6	83.9	94.7
	<b>% Difference</b>	<b>-4.9</b>	<b>61.7</b>	<b>18.5</b>
All	Acquirer % return	81.2	131.7	88.2
	Matching % return	97.1	88.7	94.7
	<b>% Difference</b>	<b>-15.9</b>	<b>43.0</b>	<b>-6.5</b>

Source: Loughran and Vijh (1997)



**Large post-acquisition returns are inconsistent with market efficiency.**

These findings not only constitute tests of long-term wealth effects of mergers and tender offers, but also of market efficiency. The large (positive and negative) post-acquisition returns are inconsistent with market efficiency. They suggest that investors systematically overestimate or underestimate synergistic gains. The findings also suggest that investors may not fully appreciate in the short term the information conveyed by whether the acquisition is financed with cash or stock. These results are consistent with other studies of the long-term stock returns following stock issuances and repurchases. Seasoned companies that issue additional new shares underperform similar-size matching companies for a period of five years,<sup>11</sup> and companies that buy back their stock—which is the opposite of a stock issuance—outperform for a period of four years.<sup>12</sup>

**Target stockholders should sell the acquirer's shares received in stock-swap mergers, but in cash transactions they should use cash proceeds to purchase the acquirer's stock.**

Loughran and Vijh also examined the effect on excess returns if target stockholders in stock-swap mergers were to hold the acquirer's stock for five years after the effective date of the merger. On average, stockholders who followed this strategy did not earn significantly positive excess returns. Some of the premium realized at the time of the transaction was reversed, and what remains is not significant—14.9 percentage points more than matching companies. This would imply that target stockholders should sell acquirer shares received in stock-swap mergers or risk losing their short-term gains. However, if target stockholders in cash tender offers were to roll their proceeds over for another five years by investing in the acquirer's stock, they would earn 138.3 percentage points more, on average, than matching stocks over the pre-acquisition and post-acquisition periods. The implication is that stockholders who receive cash for their shares should use the proceeds to purchase the acquirer's stock.

Loughran and Vijh also noted that the weak performance of stock acquirers and the strong performance of cash acquirers is consistent with both the information asymmetry hypothesis and the market under-reaction hypothesis. The former reasons that managers of acquirers use their stock as an acquisition currency when they believe it to be overvalued, and they use cash when the stock is likely to be undervalued. The market under-reaction theory reasons that if investors under-react to the information conveyed in the terms of the deal, then a large part of either overvaluation or undervaluation could materialize as post-acquisition abnormal returns.



**CEOs of high PE companies often mistakenly believe the company's common stock is a "cheap" acquisition currency.**

An alternative explanation to the information asymmetry hypothesis that was not addressed by Loughran and Vijh is EPS-itis, or the mistaken belief that earnings per share, rather than underlying economic performance, drives stock prices. The more severe the EPS-itis, the more likely CEOs are to overpay—especially those whose common stock commands a high PE—when they use their stock as an acquisition currency. So long as an acquirer in a stock-swap merger pays a PE lower than its own PE, its EPS will *always* go up. If companies are using their common stock as an acquisition currency because they can report more favorable EPS results, it is easy to understand how managers can lose sight of the economics of the deal and instead be blinded by its accounting treatment. The inevitable outcome is overpayment and the destruction of stockholder wealth.

Cash tender offers, on the other hand, are typically financed with borrowed funds, thereby increasing the leverage of the acquirer. The need to make timely payments of interest expense and repay debt principal is likely to exert significant influence on managers' behavior. Faced with decisions involving trade-offs between maximizing cash flow versus increasing reported EPS, most managers—certainly those who are rational—will seek to maximize cash. Such behavior is consistent with EVA maximization, and not unexpectedly contributes to excess returns of 61.7 percentage points relative to matching companies in cash tender offers.

### **CORPORATE TAKEOVERS AND MANAGEMENT TURNOVER**

The synergy theory of tender offers posits that the buyer is able to utilize the combined resources of the two companies more efficiently. The synergy theory implies that additional wealth may be created through a business combination of two companies even if managers of each company individually are efficient operators. But what if managers of the target are ineffective or incapable of operating the company efficiently, or if agency conflicts—such as corporate perquisites, excessive compensation, or the deployment of corporate resources to self-enriching or self-aggrandizing projects—interfere with wealth creation? In such circumstances, disciplinary takeovers can achieve positive wealth effects without combining the operations of two companies. Instead, the gains are generated by altering the behavior of target managers or through their replacement. A takeover may be classified as “disciplinary” if the target CEO is replaced shortly after the transaction.

**The positive relationship between the removal of incumbent managers and stockholders returns suggests that there is real value to having real control.**

The stark contrast between the negative wealth effects of mergers and the positive wealth effects of tender offers is consistent with the fact that tender offers are often hostile to incumbent managers and that the appointment of new managers may create additional value. In the case of mergers, which tend to be friendly and enjoy the cooperation of managers, additional value creation is less likely to occur.

### **WHY ACQUIRERS OVERPAY**

In view of the overwhelming evidence that acquisitions create wealth for all security holders as a group, it is worth considering why most acquisitions fail to benefit the stockholders of acquiring companies. Often cited are the acquirer's being overly optimistic about market potential, overestimating synergies, underestimating the difficulty of integrating the target, performing an incomplete due diligence, and diversifying into an unrelated business.<sup>13</sup> While these are all valid explanations, they are merely symptoms of why acquisitions fail and not the root cause. In our experience the underlying reasons are more fundamental:



- *Managers erroneously believe that the stock market rewards EPS growth.* Consequently, the price they are willing to pay is heavily influenced by how the transaction is structured and its impact on reported earnings. For example, many CEOs are under the misguided notion that they can afford to pay more to acquire a target in a stock deal than if they pay cash—especially if the PE of their own stock exceeds that of the target—and, in fact, it appears from the evidence they do overpay. The fact that stock-swap mergers destroy shareholder value of acquirers is tragic testimony to the high cost of pursuing EPS growth without concern for wealth effects. But the problem extends far beyond stock-for-stock mergers. Acquisitions are large corporate investments and, as such, often present the easiest and fastest avenue for growth, especially for companies operating in mature industries.
- *Incentive compensation systems typically reward EPS growth—not EVA.* Unlike EVA-based incentives, most compensation plans do not hold managers accountable for capital, so it is tempting to buy earnings. The irony is that corporate executives are increasingly being compensated in stock options and other forms whose value is tied to the stock price. Agency conflicts should be minimized in direct proportion to the percentage of managers' wealth that is linked to the stock price. But once again the culprit is EPS-itis and the fact that companies' reward systems encourage behaviors that may not result in the best outcomes for stockholders. CEOs are increasingly motivated to get the stock price up. They simply do not know how to do it, and their investment banking advisers, eager to reap fees for transactions, are certainly of little help.
- *Incentive compensation schemes frequently reward managers in direct proportion to the company's size—sales, assets or number of employees.* Not only do salaries increase with corporate size, but most other forms of compensation do as well. For example, target bonuses usually are expressed as a percentage of base salary. Pensions and other benefits also are linked to salary. It pays to become larger.
- *Corporate managers in general and CEOs in particular are accustomed to winning.* Unfortunately, in M&A transactions “winning” is usually defined in terms of which company is the successful bidder, not the effects on the company's stockholder wealth. In a difficult negotiation or protracted bidding contest, it is easy for managers to lose sight of their ultimate goal—the creation of stockholder wealth. The longer the drama plays out, the more likely the participants develop vested interests in its eventual outcome. What's more, many managers suffer from hubris. In the heat of a bidding contest, ego replaces judgment. Overconfidence that synergies will be realized causes managers to overpay. In certain respects this is the most unfathomable reason of all given the large body of evidence testifying to the difficulty acquirers experience in creating stockholder wealth. In the same vein, CEOs see themselves as leaders, and they are expected to lead. In no other corporate endeavor does the CEO take command and lead his troops into battle as he does in a transaction. Once the adrenaline begins to flow, it is imperative for the CEO to emerge the victor. After all, how can a CEO expect to lead his troops and inspire confidence in the wake of failure?



## A FINALWORD

Although the evidence indicates that stockholders of acquiring companies do not appear to benefit and may in fact lose wealth in M&A transactions, the picture is not entirely bleak. The evidence does offer these keys to achieving truly successful acquisitions that add to the wealth of the acquirer's stockholders:

*Be wary of diversification.* Buyers can significantly increase the probability of success by not straying to far from home in selecting acquisition targets.

*Avoid EPS-itis and other GAAP-induced illnesses.* Although stock-swap mergers consistently under-perform cash tenders, this does not mean that companies should avoid using their common stock as an acquisition currency. Although the reasons why stock-swap mergers fail are not entirely clear, two lessons must be remembered. First, the temptation to finance the deal with common stock in order to maximize reported pro forma EPS must be avoided. High PE companies are most vulnerable because of their ability to buy earnings "cheaply." Second, it appears that there is a benefit to having "real" control. In cash tenders—which in many instances are hostile takeovers—stockholders of acquirers fare best even though the premiums paid paradoxically are typically highest. Acquirer CEOs may be well advised to pay more, if necessary, to acquire the control necessary to remove incumbent managers and get on with the business of managing the target for maximum wealth creation.

*Be generous with debt financing.* The discipline imposed by debt service requirements on acquirers may contribute to the finding of Loughran and Vijh that cash tender offers outperform matching companies by a whopping 61.7 percentage points. Too many CEOs and CFOs are reluctant to employ debt because of the need to confront lenders. Unless a company can draw down on pre-committed credit facilities, it must subject its acquisition strategy, pricing and terms to the scrutiny of sophisticated lenders in "road shows" and one-on-one meetings. Management must justify the economic benefits of the acquisition to finance the transaction. Unfortunately, many CEO are unwilling to face this market test.

*Avoid buying public companies if possible and, instead, look for bargains in the private market.* All of the studies cited herein pertain to acquisitions of public companies. In the highly competitive market for corporate control, the disclosure of a company's intention to acquire another company—especially if the terms are agreeable to the target—is likely to serve as an invitation to other suitors. The inevitable outcome is a bidding contest—or the threat of one—and ultimately a higher price. Acquirers of private companies or divisions or subsidiaries of public companies are more likely to avoid an auction process and pay a smaller premium. The problem presented by limiting acquisition targets to the private market is related to size: It is much more difficult to realize growth ambitions by limiting the universe of acquisition candidates to private companies or units of public companies. But no one ever said creating stockholder wealth via acquisition would be easy.



ENDNOTES

<sup>1</sup> “2000 M&A Profile,” *Mergers & Acquisitions*, Volume 36/Number 2 (February 2001)

<sup>2</sup> In 200 and 1999, prices were revealed in 3,358 and 3,719 deals, respectively. The data include only transactions in which American companies were on both sides of the deal or were on at least one side as buyer or seller.

<sup>3</sup> Corporate executives and investment bankers often argue that the short-term stock price response to an announced acquisition is an unreliable indicator of the ultimate benefit of the transaction. Such protests may be self-serving, however, in view of the fact that investors’ responses to announcements of acquisitions are based on their expectations of the impact on future free cash flows or EVA.

<sup>4</sup> Since B’s market value is comprised of debt and equity,  $MVAB = \text{Purchase Price} - MVB$  only when the market value of B’s debt is not affected by A’s acquisition of B.

<sup>5</sup> Michael Bradley, An and Desai and E. Han Kim, “Synergistic Gains from Corporate Acquisitions and Their Division between the Stockholders of Target and Acquiring Firms,” *Journal of Financial Economics*, 21 (1988).

<sup>6</sup> “Cumulative abnormal return” adjusts for differences in the riskiness of individual common stocks, as reflected in their beta values, and for broad stock market changes during the measurement period.

<sup>7</sup> Michael Bradley, An and Desai and E. Han Kim, “The Rationale behind Interfirm Tender Offers: Information or Synergy,” *Journal of Financial Economics*, 11 (1983).

<sup>8</sup> Lance A. Nail, William L. Megginson, and Carlos Maqueira, “How Stock-Swap Mergers Affect Shareholder (and Bondholder) Wealth: More Evidence of the Value of Corporate ‘Focus’,” *Journal of Applied Corporate Finance*, Volume 11 Number 2 (Summer 1998).

<sup>9</sup> The conglomerate form of organization may facilitate an internal capital market but at the expense of an external capital market. Positive cash flow business units provide funding for negative cash flow businesses instead of the latter having to raise capital on their own. Corporate management in effect determines which businesses receive funding rather than investors. The risk in conglomerate organizations is that such cross-subsidization results in an inefficient allocation of financial resources.

<sup>10</sup> Tim Loughran and An and J. Vijn, “Do Long-term Shareholders Benefit from Corporate Acquisitions?” *Journal of Finance*, Vol. LII, No. 5 (December 1997).

<sup>11</sup> Katherine D. Spiess and John Affleck-Graves, “Underperformance in Long-run Stock Returns Following Seasoned Equity Offerings,” *Journal of Financial Economics*, 38 (1995).

<sup>12</sup> David Ikenberry, Josef Lakonishok, and Theo Vermaelen, “Market Underreaction to Open Market Share Repurchases,” *Journal of Financial Economics*, 39 (1995).

<sup>13</sup> For an excellent discussion of this topic, refer to Mark L. Sirower, *The Synergy Trap*, Freedom Press (1997).

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