Mergers and Acquisitions

Earlier, when discussing internal analysis we examined firms as bundles of unique resources and capabilities. The more valuable, rare, inimitable, and organized these resources are the more likely they are to be a source of sustainable competitive advantage for the firm. Where do firm resources come from?

Firm resources are obtained three ways, internal development, alliances, and purchase. If you think about it, all firms start with two resources, an entrepreneur and capital. The entrepreneur uses capital to enact their vision for their business by acquiring additional resources and capabilities. These may be human resources (employees), more specific capital resources (a store or production line), or something else. We can usually track these expansions by viewing them as dimensions of corporate strategy (e.g. diversification, geographic diversification, vertical integration, etc.). However, whatever the resource is, it can be obtained only three ways, the entrepreneur developing it in house, making a deal with someone else for it (e.g. an alliance), or buying it. Therefore, mergers - joining of two "equal" companies - and acquisitions - the absorption of another company, including "hostile" takeovers - can simply be viewed as a way for firms to buy preexisting *bundles* of resources. Therefore, these activities are simply a gateway to corporate strategy dimensions such as vertical integration, consolidation (e.g. horizontal mergers - acquiring another firm that is in your current industry), diversification, and restructuring. However, our main concern is how can mergers and acquisitions (M&A) result in a sustainable competitive advantage for a firm?

The preliminary evidence for M&A activity creating a sustainable competitive advantage is not very good. M&A activity is not generally successful for firms with many spectacular failures (see WSJ 2/6/2002; 10/30/2000). Finance journals have basically summarized the results of M&A as follows: a. Target shareholders (i.e. those being acquired) benefit; b. Wall Street gets lots of fee revenue; and c. On average buying shareholders do not suffer. Therefore, M&A activity, on *average* should not take place because it does not benefit the firm. Yet, there is lots of M&A activity and some are clearly successful. Why?

There are numerous justifications for M&A including increased market power, overcoming entry barriers, increased speed to market, and lowering the risk of introducing new products (Hitt, Ireland, & Hoskission, 2003: 289). However, these all collapse into our building blocks of corporate advantage, creation of specific assets, sharing resources, and transferring competencies. The problems of M&A are similar to ones that occur in all large corporations; information asymmetry – the target firm knows more about itself than the acquiring firm; adverse selection – the target firm is only available because it isn't very attractive; and implementation (i.e. bureaucratic costs such as setting transfer prices). While these problems occur in companies that do not have a lot of M&A activity, M&A adds a new problem, hubris coupled with efficient financial markets, which merits further consideration.

Hubris, or pride, is simply the human tendency of successful people to view their success as a result of their actions.[1] The resources that facilitate M&A activity (high returns in the present business, high stock price/multiple) are highly correlated with success in business. Therefore, it is understandable for managers of firms that are doing well to believe that they are extremely capable and can do better than extant rival managers at another firm. This can be aided by the large number of people, e.g. investment bankers, lawyers, and consultants, who have a financial stake in seeing M&A activity occur. Hubris, encouraged by these vested interests, leads to a lot of M&A activity.

The problem, especially in the U.S., is that financial markets are relatively efficient.[2] Therefore, it is unlikely that new managers will do better than existing ones. What financial studies demonstrate is that on average, whatever net benefits will occur because of M&A activity are captured by shareholders of the **acquired** (i.e. target) firm via the market, NOT the acquiring shareholders. This is often reflected in the stock market when a merger or acquisition is announced, usually the stock of the acquiring company drops while the target company's soars.[3]

Ownership (via Internal Development -or- M&A) versus Alliances versus "Spot" Market Transactions

As we've described it, there are three basic ways for firms to obtain resources. They may purchase the resource as the need arises from vendors in the spot market. They may form an ongoing cooperative relationship with another firm to provide the resource – an alliance. Or they may obtain the way to create the resource as needed by owning it.

So when should you use each of the three different ways of obtaining resources for your firm or organization? I suggest three variables – asset specificity, partner uncertainty, and environmental uncertainty. The most important is the idea of specific assets. How specific, or customized, is the resource you are seeking? If the asset is not specific, then you can probably go buy it very easily in the market. However, if it is specific, you'll probably need to create it yourself. The next is partner uncertainty or opportunism - how trustworthy is the other party? For example, if you pay a vendor will they deliver? Finally, there is environmental uncertainty including both technological and demand uncertainty. How stable and well understood is the market? If uncertainty is low, you can risk making the investment yourself in the resource. However, if the environment is uncertain, you would prefer to just purchase the asset as you need it. This is summarized in the table below:

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[1] This is the idea from psychology used to great effect in management of Locus of Control, our tendency as humans to attribute our successes to our abilities and efforts and our failures to external issues. When tied to decision making we termed it illusion of control.

[2] Recall that finance scholars have mostly shown that U.S. equity markets are efficient in semi-strong form in that the market very quickly moves to adjust to all publicly known information.

[3] Note: M&A can make much more sense internationally than domestically in the U.S. This is for two reasons, first financial markets are less efficient overseas and second, management talent is potentially scarcer.

Method -> Variable	Market Transaction (Purchase as needed)	Alliance (Ongoing Relationship)	Ownership (Int. Develop/M&A)
Asset Specificity *	Not Specific	Moderate to High Specificity	Highly Specific
Partner Uncertainty	Low – Partner is Reliable	Low to Moderate	High - Few Trustworthy Partners
External Environment Uncertainty	High - Unstable	Moderate to High	Low – Stable

So, in the absence of any asset specificity or partner uncertainty (opportunism) and in the presence of environmental uncertainty you should always use a market transaction.[4] In the presence of asset specificity and low partner uncertainty an alliance is an effective way to proceed. In the presence of extreme asset specificity, high partner uncertainty, ownership, is the preferred solution.

How to use the table. Read down the first column and try and classify the resource you are attempting to obtain. Is it specific? Is who you could buy it from, e.g. your partner, reliable, is there any uncertainty about their ability or willingness to deliver? Finally, what is the environmental uncertainty? Is the market stable and well understood or is it highly volatile. Once you classified each of these, you can read along the top to determine which method of obtaining them would theoretically be best. Note that there is rarely one clear choice, this is what makes strategy so interesting!

For ownership, M&A is better than internal development if expediency (i.e. time pressure) is a factor, i.e. you need it NOW! However, in the presence of extremely efficient financial markets. internal development is usually better than M&A.

Some Examples. Consider two resources that you need – bread to eat and a place to live. Unless you are quite discriminating, you probably don't care too much where you buy your bread, it's NOT specific, so you use the "market", e.g. Wal-Mart. But let's say you do care, you only want the best of a special type of bread, this asset is now a little more specific than before, so you only go to (say) Panera to buy your bread. While you are still using the market, you've basically made an alliance with Panera to be your "exclusive bread vendor." Now think about where you live, do you rent or buy? Most undergraduates rent an apartment, why? Well their living space needs are pretty modest and therefore not specific. However, they face considerable environmental uncertainty, most will not get a job where they go to school, so using the market, e.g. renting, is way to go.

Despite the evidence that on average M&A activity leads to normal returns for acquiring shareholders, a recent successful example may be Exxon's merger with Mobil. Significantly larger costs savings from what was initially expected could be evidence of this (Reuters, 3/5/02).[5]

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[4] Note: This can include services, such as payroll, information technology, and legal activities.
[5] Plant closings and layoffs are difficult because in this case you're getting rid of specific assets - refineries and people with lots of knowledge about Mobil.

Since these savings were unanticipated, they were reaped by the acquiring firm, not the target's shareholders.

A classic case of successful internal development is Johnson and Johnson in the surgical staple business. This market was pioneered by U.S. Surgical Corporation (USS). The development of this market was a tremendous threat to J&J's existing suture (e.g. "stitches") business. However, huge price premiums on U.S. Surgical, because the market efficiently recognized the tremendous value of these products, precluded a purchase by J&J. Therefore, they developed the product internally, marketed it through their existing direct sales force and wiped out USS.

Other common examples of internal development are consumer product companies use of "me too" or "copy cat" products. This happens frequently in mature industries because it is much more efficient to just develop the product internally than to buy the entire bundle of resources that consists of the rival firm, e.g. Diet Coke with Lemon versus Diet Pepsi Twist.