On the Post-merger Operating Performance of U.S. Companies

Bachelor Thesis in Corporate Finance

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Executive Summary

Problem

During the last decade, renowned management consulting firms have not been reluctant to publish research reports which claim that the majority of the M&A deals are not profitable. For instance, The Boston Consulting Group recently reported that more than half of the M&A transactions among public firms destroy value for the acquiring firm in the long term. In 2003, they stated that even 64 % of the deals destroy value for the acquiring firm`s shareholders. McKinsey & Company regularly states that the fraction of M&A deals that fail is astonishingly high with failure rates reaching roughly 70 %. These reports have reinforced the conventional wisdom that the majority of all M&A transactions destroy value. But, what does it mean for M&A deals to “fail” or “destroy value”? What does academic research tell us about the success and profitability of M&A transactions? How do researchers measure the value created or destroyed by such transactions? The present thesis sheds light on these questions.

Methodology

The primary means for investigating the value creation or destruction of M&A transactions in academic research is the event study design. Many studies examine the abnormal stock market returns of companies involved in M&A deals surrounding the announcement of such transactions. The majority of these studies support the view that M&A transactions – on average – create value. In his review of evidence, Bruner (2002) lists a number of studies which show that combined returns, i.e., the weighted returns to acquiring and target firms` shareholders, are mostly positive and in about half of the studies statistically significant. However, these studies usually fail to provide evidence for a causal relationship between stock market gains and superior financial performance after the merger. This calls for a closer examination of the post-merger operating performance. This study updates the existing empirical research on post-merger operating performance changes by examining a recent sample of U.S. M&A transactions. Conceptually, my study is strongly influenced by the work of Ghosh (2001), Healy, Palepu, and Ruback (1992), and Barber and Lyon (1996). I examine the operating performance defined as operating cash flows divided by sales across the three years prior and subsequent to the merger completion year in a research design sometimes referred to as the “change model”.

Particularly, I investigate whether the operating performance changes in the post-merger period relative to pre-merger levels for a sample of 242 transactions among U.S. public

companies completed between 1998 and 2008, inclusive. To avoid biases introduced by economy-wide or sector-specific factors, I adjust the operating performance of merging firms by the performance of corresponding control firms which are matched based on size, industry, and pre-merger performance. The adjusted operating performance is often referred to as "abnormal" operating performance.

Furthermore, I examine the relationship between merger-induced changes in the abnormal operating performance and the method of payment. The whole empirical analysis is conducted with the statistical software package Stata.

Results & Interpretation

I find that merging firms exhibit statically significant superior median abnormal operating performance 1.36 % in the first and 1.88 % in the second year after the transaction completion year. Relative to pre-merger levels, the abnormal operating performance significantly increases between 0.74 % and 0.97 % in the post-merger years. These findings suggest that managers of acquiring firms are able to increase the post-merger operating performance of the combined entity relative to pre-merger levels, which is in line with the hypothesis derived in the paper. I hypothesize that the post-merger abnormal cash flow margins increase relative to pre-merger levels because of considerable acquisition premiums paid for the target firms. More precisely, based on a simple theoretical equation found in Koller, Goedhart, and Wessels (2010), which states that an acquiring firm only creates value with an acquisition if the value of the future operating performance improvements of the combined entity outweigh the acquisition premium paid over the current market capitalization of the target firm, I expect that the managers of public acquiring firms are under considerable pressure to enhance the operating profitability of the combined entity in post-merger years. Furthermore, operating synergies are among the mostly cited rationales for conducting acquisitions, therefore I would expect them to actually materialize in the post-merger period.

Moreover, transactions solely financed with cash do not exhibit significantly positive operating performance changes while stock and mixed (i.e., the consideration for a target firm is paid by a combination to the acquiring firm`s stock and cash) financed transactions do – on average – experience abnormal operating performance improvements between 2 % and 3.2 %. However, these results contradict my hypothesis that transactions solely financed with cash experience stronger increases in post-merger operating performance compared to acquisitions solely financed with stock or a combination of stock and cash. I derive this hypothesis partly from empirical findings. There is empirical evidence that firms which issue stock in secondary offerings (which is often necessary to fully finance an acquisition with stock) underperform control firms in terms of operating performance in post-issuance years and that companies manage their earnings in the period prior to mergers and acquisitions to inflate the value of their own stock, which leads to inferior post-merger performance. There also exist theoretical models on preemptive bidding in tender offers which indicate that bidders tend to offer cash when they give the target firm a high valuation. Finally, this hypothesis is supported by the disciplinary effect of debt which is often raised to finance cash transactions.

I attribute this difference between my findings and my expectations to three possible factors. Due to record high cash holdings in recent years, U.S. acquiring firms are less likely rely on debt financing to conduct acquisitions, in contrary, they tend to conduct less rigorously reasoned acquisitions putting the low interest bearing excess cash on their balance sheets to work. Another explanation may lie in the notion that the premises on which I derive my hypothesis do not necessarily have to hold for my merger sample. Finally, the surprising findings may stem from the systematic size differences between firms conducting acquisitions using the different payment methods.