Chapter 2: Literature Review

2.1 Types of M&A

M&A of firms are the realization of an expansion strategy that is vital to the well being of a firm. Generally, merger means the combination of two of more firms to form a single firm in which the surviving company acquires both the assets and liabilities of the merged company. Mergers are distinguished into three types: (1) horizontal, (2) vertical, (3) conglomerate mergers[2]. Horizontal mergers involve firms in the same line of business while vertical mergers involve different stages of production operations. Conglomerate mergers involve firms with unrelated types of business activity that are often to do with product extension to broaden product line and geographic market extension. The pure form of conglomerate merger involves unrelated business activities that do not qualify in either the former or latter mentioned. Wilcox et. al. (2001) found that M&A activities far beyond the current focus of a firm's business, such as those in conglomerate mergers, are not as attractive in terms of market valuation. They suggested that the reasons for this is the uncertainty related to products and services emerging from unrelated diversification.

Alternatively, according to Mat Nor (1996), an acquisition is understand as any transaction in which buyer acquires all or part of the assets and business of a seller, or all or part of the stocks or other securities of a seller. There are several forms of

[2] According to Bringham and Besley, economists classify mergers into four groups: (1) horizontal, (2) vertical, (3) congeneric, and (4) conglomerate. However, many classify mergers into only the three mentioned above.

acquisition, such as an asset acquisition and a stock acquisition. An asset acquisition is when the buyer acquires all or part of the assets and business of the seller while a stock acquisition is a transaction in which all or part of the outstanding stocks of the seller are acquired from the stockholders of the seller. Copeland and Weston (1992) made a distinction between purchase and pooling of interest under merger and acquisition from an accounting standpoint. A purchase is regarded to as an acquisition of a much smaller entity, which is absorbed by the acquiring firm while a pooling of interest represents the joining of two firms of not greatly unequal size, followed by operations in which their identities are continue to a considerable degree. Although there is an obvious distinction between merger and acquisition, the two terms have been used in tandem or synonymously with each other.

2.2 Cross-border vs. Domestic M&As

Over the past years, telecommunication companies have gone beyond its local borders. Singtel, the Singapore-based company, derives more than 60 percent of its revenue from overseas. The unpredictable circumstances in the industry with respect to its rapid technology changes and in some cases excess supply situation has made the telecommunication companies resorting to seek funding by joining forces with other players in its region. This has sparked several international or cross border M&As not only in America and Europe but also Asia. Park et. al. (2002) proved that international M&As have an adverse impact on the investors' perceptions of the acquiring firm's performance by measuring the market reactions of the M&A

announcements and post-M&A market returns (both international and domestic) as explained by the synergy trap theory. As maintained by Reed and Lajoux (1998), M&A deals will become more complex as cross-border cultural, financial and monetary effects are factored in, as mergers "go international". A survey by Arthur Anderson also indicated that two-thirds of businesses in the fields of technology, media and communications report that M&As generate negative impacts on their business. This is caused by a lack of success in overcoming systems and cultural integration issues and resistance to change that is usually prevalent in a cross-border M&A. Hopkins (1999) noted that there are three problems that plague international M&As derived from previous empirical research – inspection problem, negotiation problem and integration problem. The inspection problem states that information asymmetry between a buyer and seller often results in the buyer paying more than the seller's intended offer price. The information asymmetry induces the bidder to place a higher value on the target to be sold. The negotiation problem particularly pertains to international M&As due to the inherent complex process of cross-border deals arising from acquirers' lack of information about the target country and cultural differences.

2.3 Motivations behind M&A

Many studies have been conducted on the mergers and acquisition (M&A) in the telecommunication industry in the U.S.A as well as Europe. The M&A activities among telecommunication companies in both regions occurred incidentally at the revision of the American Telecommunication Act in 1996, a WTO Agreement in

1997 and the Integration of the European Union in 1998. The rationale behind these consolidations was primarily explained through an increase in competition and a decrease in profitability as the industry became more privatized and liberalized. A paper by Grover and Vaswani (2000) examined an extensive collection of mergers, acquisitions, and partnerships in the U.S telecommunication industry. In their research, they identified key objectives behind these alliances, covering both economic and strategic objectives which included the creation of new value through pure play and converging alliances, the control of technology, increasing market access, and gaining economies of scale or scope. According to Park et al. (2002), the three basic principles determined by the EU Committee that were applied to all member countries; the extension of importing competition in a monopolized area, the harmonization of the European Market, and the application of general competition rules in the EU telecommunication were the cause of the wave of M&A throughout the region.

Das et al. (1998) examined strategic "technological" and "marketing" alliances in the telecommunication industry. Technological alliances typically involve activities upstream in the value chain such as R&D, engineering, and manufacturing. These tend to be near alliances, seeking value creation through synergy. Marketing alliances tend towards the downstream activities of sales, distribution, and customer service. Market access is a key goal in these predominately far alliances. Das et al. (1998) found that the positive abnormal returns from technological alliance announcements

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are greater than those from marketing alliance announcements highlighting the importance of the value created through technological alliances such as cost reductions attributable to the creation of economies of scale and scope, eliminating duplicate R&D efforts, reduction of transaction costs, protection of proprietary knowledge, and easing the transfer of tacit knowledge. Ghoshal (1987) developed a framework encompassing a range of different issues relevant to global strategies describing international M&As. He maintains that several sources of competitive advantages can be strategic motives for international M&As: national differences, scale economies, and scope economies.

Additionally, Hopkins (1999) identifies the motives of M&As suggested in prior studies as four distinct but related motives: strategic, market, economic, and personal motives. Strategic motive is concerned with improving the strength of a firm's strategy, e.g., creating synergy, utilizing a firm's core competence, increasing market power, providing the firm with complimentary resources, products, and strengths. Market motive aims at entering new markets in new areas or countries by acquiring already established firms as the fastest way, or as a way to gain entry without adding additional capacity to the market that already may have its full capacity. Establishing economies of scale is included in economic motives; the agency problem and management hubris are included in personal motives.

It is believed that M&A is only relevant when it has the ability to increase shareholder's wealth. Incidentally, Gitman (1997) argued the maximization of the owner's wealth as reflected in the acquirer's share price. Thus, specific motives of M&As, including growth or diversification, synergy, fund raising, increased managerial skill or technology, tax considerations, increased ownership liquidity, and defense against takeover, are assumed to be consistent with owner wealth maximization.

2.5 Measurement of M&A Success

According to Bruner's (2001) research offers four approaches to measure M&A success. *Event studies* examine the abnormal returns to shareholders in the period surrounding the announcement of a transaction. The raw return for one day is simply the change in share price and any dividends paid, divided by the closing share price the day before. These studies are regarded to be forward-looking on the assumption that share prices are simply the present value of expected future cash flows to shareholders. These studies have arguably dominated the field. According to Cording et. al. (2002) the event study methodology has several attractive features. First, the data is publicly available, permitting empirical studies on large data samples. Second, it relies upon the well-respected efficient market hypothesis. Third, because "abnormal" returns are calculated, the data is not subject to industry sensitivity, enabling a broad cross-section of firms to be studied.

In *accounting studies,* there is the use of reported financial results (i.e., accounting statements) of acquirers before, and after, acquisitions to see how financial performance changed. The focus of these studies ranges across net income, return on equity or assets, EPS, leverage, and liquidity of the firm. The best studies are structured as matched-sample comparisons, matching acquirers with non-acquirers based on industry and size of firm. In these studies, the question is whether the acquirers outperformed their non-acquirer peers. Accounting measures, however, are subject to one of the same limitations as are long-term stock price measurements - factors other than the merger or acquisition may be driving the numbers. Additionally, according to Montgomery & Wilson (1986), accounting measures reflect the past rather than present financial performance expectations. Nor do they reflect changes in the firm's risk profile.

Some academics such as Cannella & Hambrick (1993) and Capron (1999) have opted to use survey measures to elicit the management team's views on whether or not the merger was a success. In *surveys of executives*, it is simply asking managers whether an acquisition created value seems like an obvious course. These present a sample of executives with a standardized questionnaire, and aggregate across the results to yield generalizations from the sample. Krishman, Miller and Judge (1997), for example, hypothesized that the ability of top management teams to work effectively together would drive M&A success, measured by return on assets.

The most complicated among the four is *clinical studies*. These focus on one transaction or on a small sample in great depth, usually deriving insights from field interviews with executives and knowledgeable observers. By drilling down into the detail and factual background of a deal, the researchers often induce new insights.

2.6 Synergy

It is commonly believed that M&As strengthens businesses by making their operations more synergistic. Strategy theory explains that value is created in an M&A through the identification and exploitation of synergy. According to Chatterjee (1986), while different terminology is used, three broad classes of synergy are the usual focus of researchers. First, operating synergies arise when economies of scale or scope are captured across a variety of the firm's activities. Financial synergies are driven by reductions in the cost of capital due to a reduction in bankruptcy risk, an increase in the size of the firm, or internal funding of the target's investment projects at a cost lower than that available in the capital markets. Collusive synergies - sometimes called "market power" - enable the firm to either extract a higher price for its products or services or pay suppliers a reduced price. This is similar to theory on economies of scale.

According to Rumelt (1974) and Salter & Weinhold (1978), diversification theory claims that related acquisitions should have greater potential for synergy creation than unrelated acquisitions. This is because the greater the points of contact and

overlap between two firms' value chains, the higher the potential for capturing operational synergy. Singh and Montgomery (1987) hypothesize that because all three forms of synergy are theoretically available in related acquisitions, and that because only financial synergies and administrative efficiencies are available in unrelated mergers, related acquisitions would create more value than unrelated ones. Lubatkin (1987) found no statistically different results in related versus unrelated mergers, while Elgers and Clark (1980) found that unrelated mergers outperformed related ones.

Recent evidence indicates that the failure of M&As to create synergy is prevalent in the international context. Very and Schweiger (2001) document that in cross-border acquisitions the acquiring firms would likely be operating in a new environment characterized by difference in languages, cultures, laws, and socioeconomic conditions. Such differences may make access to information to forecast revenues, costs, assets, and liabilities that are difficult to garner and interpret. Consequently, if pricing is based on unrealistically high projections or cash flows that cannot be achieved after an acquisition, then the price paid was too high and value is not created or lost.

In his discussion about the synergy trap, Sirower (1997) argues that synergy rarely justifies the premium paid, and many acquisition premiums require performance improvements that are virtually impossible to realize even for the best managers in the

best of the industry conditions. In the case of the American telecommunication companies, the AT&T acquisition of TCI cable to develop a new technology-based service, i.e. bundled digital phone service, has yet to bring about any synergism to the post-M&A AT&T. This could be because of the infrastructure development and technology integration that need considerable thought and capital to pull through such a service for the market. Thus, in the case of M&A in the telecommunication industry, the benefits of synergism remains but a theory that has yet to be proven.