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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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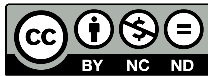

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1. The Challenge

> Anyone who has researched merger success rates knows that roughly 70% fail. (McKinsey 2010)
>
> Globally there have been some 40,000 mergers a year recently compared with about a thousand 40 years ago. (Amel-Zadeh and Meeks 2020a)

Mergers[1] that Succeed

In our college days, the economics tradition was pretty confident about the outcome to be expected from merger and acquisition. Adam Smith, the revered grandfather of modern economics,[2] while not addressing M&A directly (there was scarcely any at the time), had in 1776 identified potential sources of gain which are standard elements of merger proposals today: securing scale economies, replacing weak management, and enhancing market power.

He drew attention to the scale economies which could be achieved through the division of labour when small-scale production was replaced by larger factory organisations. In his famous example of the pin factory, output per man per day for the individual pin-maker working at home was 24 pins (Pratten 1980), whereas his counterpart in a 1776 factory with specialised functions produced 4,800 pins.[3] Greater scale through consolidation brought lower unit cost.[4]

1 We follow common practice in using the terms merger, acquisition, takeover, M&A, and combination interchangeably. In some specialist contexts—such as accounting—they are differentiated.

2 Revered by economists from both orthodox and heterodox persuasions, albeit with contrasting interpretations of some aspects of his approach.

3 By 1980 increasing scale was associated with a rise to 800,000 pins per person per day.

4 But probably not without some painful processes of adjustment.

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A twenty-first century example is offered by the vehicle manufacturer Volkswagen. After a string of acquisitions, including Audi, Porsche, Scania, Seat and Skoda, it was the world's biggest producer of vehicles—some 10 million a year. Shared components for the different subsidiaries could be produced in specialised units at unprecedented scale and reduced cost. Likewise, the fruits of R&D could be shared across the combine.

The second feature Smith (1776/1937) drew attention to was a characteristic of the emerging modern economy of joint stock companies where management was separated from ownership:

> The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. (p. 700).

This problem—which nowadays goes under the heading of the 'principal-agent', or 'corporate governance', or 'stewardship' problem that arises when management is divorced from ownership—also suggested an opportunity. A potential source of profit from M&A, and gain in economic efficiency, would result from a 'turnaround' merger, where stronger management gained control of an underperforming firm, boosting its profit and increasing its valuation. 'The potential return from the successful takeover and revitalization of a poorly run company can be enormous', wrote Manne (1965, p. 113).

A few miles from Adam Smith's birthplace near Edinburgh, another Scotsman, Fred Goodwin, proved himself expert in this mode of M&A two centuries later. As head of Royal Bank of Scotland, he secured massive gains for the shareholders by firing 18,000 employees after he acquired NatWest Bank, earning the nickname 'Fred the Shred'. The acquisition was meticulously planned and ruthlessly delivered. Staff held to be under-performing were removed and backroom functions combined, yielding within two years an increase of over 70% in earnings per share and over 100% in the RBS share price.[5] His

5 Reference for Business (2022).

continued acquisition activities built the largest bank in the world.[6] And M&A earned him more than money—the much-coveted British honour bestowed by the Queen: a knighthood.[7]

In the United States—which lost its monarch in 1776, the very year of Adam Smith's great work—it might be held that *Fortune* magazine awards the honours instead. And the greatest accolade in its gift was reserved for Jack Welch, who, by the end of last century, built GE into the world's biggest corporation.[8] *Fortune* named him 'manager of the century' in 1999. Through a series of almost one thousand acquisitions over two decades he transformed an engineering business into a conglomerate whose activities ranged from broadcasting to finance. His nickname was 'Neutron Jack'—like the neutron bomb, he got rid of people while leaving the surroundings intact. In shedding labour he adopted the formula employed for the armies of classical Rome, routinely 'decimating' 10% in the event of failure. Managers of new acquisitions had to rank the performance of their underlings, and the bottom 10% were fired if they did not improve.[9] In the two decades from 1980 GE's earnings rose from $1.5 billion to almost $13 billion, and the stock price rose even faster.

The acquisitions by Volkswagen, RBS and GE were unequivocally successful at the time for the owners of the businesses. However, establishing whether an acquisition was successful from the perspective of the whole economy requires a more complicated calculation, discussed later in this chapter and in Appendix 1. The gist is that conventional measures of returns to shareholders typically overstate the gains (understate the losses) in operating efficiency. And further, standard measures of operating efficiency typically overstate the gains (understate the losses) to the economy at large. In the larger context, success depends on whether any gains to the owners have just come at the expense of other interest groups. Merger outcome in general may be positive-, zero- or negative-sum, and the discussion later in this

6 By assets in 2008.
7 The reputations of Fred the Shred and Neutron Jack subsequently declined. See Chapter 3 on the former, Gryta and Mann (2020) on the latter.
8 Measured by stock market capitalisation.
9 Gryta and Mann (2020). This applied to existing activities too, and more than 100,000 jobs were cut in the 1980s alone (p. 18).

book concerns the pattern of gains and losses from merger for different interest groups.

Scale economies and more efficient utilisation of labour potentially offer positive-sum outcomes for the economy as a whole[10]—fewer inputs are required to create the same outputs, or better outputs for the same inputs. But the third source of gain from merger foreshadowed by Adam Smith (1776/1937) is often deemed negative-sum. He noted that:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices (p. 128)

The smaller the number of people in 'the same trade', the easier it is to raise prices. One way of looking at this is through a game theory lens (see, for instance Hannah and Kay 1977). A pure monopolist should be able to extract the maximum possible profits from a market. Oligopolists who share a market might collectively enjoy those maximum profits if they cooperate—in a formal or tacit cartel—to mimic the price and output solution for the monopoly. But individual members of the cartel could gain by cheating, against the group's interests, for example by offering under-the-counter discounts—provided that they could avoid detection and retaliation. The probability of detection and the impact of retaliation are likely to be higher the fewer firms supply the market: eliminating rivals via M&A offers an oligopolist the prospect of greater collusion and of securing higher prices and profits.

The US airline industry offers a striking modern example of M&A being used as 'a contrivance to raise prices'—enhancing market power and transforming profits. For most of the hundred years since the original flight at Kitty Hawk, the industry had a dismal history of financial performance. Legendary investor Warren Buffett of Berkshire Hathaway, the 'Sage of Omaha', explained the background in characteristically colourful terms:

> The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money. Think airlines. Here a durable competitive advantage has proven elusive ever since the days of the Wright Brothers. Indeed, if a farsighted capitalist

10 This assumes a buoyant economy in which employees can readily find new jobs.

> had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down. (Buffett 1982)

In an interview in 1999, Buffett said: 'As of 1992 [...] the money that had been made since the dawn of aviation by all of this country's airline companies was zero. Absolutely zero' (Buffett 1999).

Things went from bad to worse after the millennium: the years between 2000 and the financial crash of 2008 saw the US airline industry make further cumulative losses of some $60 billion (Dissanaike, Jayasekera and Meeks 2022).

But then the 'people of the same trade' (airlines) did 'meet together' in a series of mergers: Delta and Northwest in 2008; United and Continental in 2010; Southwest and AirTran in 2010; and American Airlines and US Airways in 2013. The four mergers together resulted in a 4-firm oligopoly within the domestic US industry controlling more than 80% of domestic capacity. Even this measure understates their market power—individual members of the oligopoly tended to dominate local hubs: at 40 of the biggest 100 US airports a single airline accounted for the majority of business (Tepper and Hearn 2019, p. xiv). As textbook theory of monopoly predicts, output was cut back and prices increased (a negative effect on general economic efficiency). But the firms themselves gained: the number of flights was cut even as passenger numbers increased—leaving fewer empty seats. Margins widened, and the airline industry's fortunes were turned round: profits for 2009–2017 summed to $75 billion. Even Warren Buffett invested $10 billion in the airlines (Dissanaike et al. 2022).

First-hand Experience

So when one of us joined an audit firm whose clients were especially active in M&A, we knew what to expect. We would witness the stimulus to profit from M&A which featured in our college economic theory and in the media tales of conquests by heroic managers.

Working as an auditor may well be the closest you can get to being the proverbial fly on the wall. You sit in the client's office for weeks on end, with access to the books, watching their employees at work, and—better than the fly on the wall—you are able to ask questions. However, auditing is famous for its deleterious effect on mental health. Mostly the damage

comes from acute boredom as you review endless tables of numbers—combined with the antipathy of the client's staff whose work you are scrutinising. But in this case, acting as auditor to businesses which had recently been taken over produced acute cognitive dissonance. There was a clash between economic theory and media hagiographies on the one side, and mundane experience in the field on the other. The abiding memory is of cuts in the budgets for staff, investment, maintenance and marketing; of fearful, demoralised employees; of shrinking sales; and of profits flat or in decline.

Given this cognitive dissonance in auditing, the choice of question for one of our PhDs, which followed life as an auditor, was obvious. If the financial performance of a population of acquiring firms was traced, would it conform to the great expectations engendered by a training in economics and the media tales of heroic leaders, or would it reflect the post-marital problems of the merging firms just observed on the front line?

With IT still at a primitive stage, assembling and standardising the accounts for a population of hundreds of acquirers and their targets, adjusting for accounting biases and controlling for other influences on profits was a laborious job. The resulting book, whose conclusion was presented in the title—*Disappointing Marriage: A Study of the Gains from Merger* (Meeks 1977)—and was further developed in journal papers,[11] elicited a range of responses. Economist colleagues were dismissive of the finding that, *on average*, M&A had not enhanced profits ('quite implausible—inconsistent with basic economics: haven't you read Adam Smith and the literatures on scale economies, market power and turnaround takeover?'). Those who made a living from M&A rejected the results angrily: the review by one professional M&A adviser memorably described the book as 'a farrago of nonsense'.

In the light of these responses from the experts we might have retired ignominiously from this field. But unsolicited reassurance that we may not just have made silly measurement errors came from the Editor of the *Financial Times*, who said it chimed with his experience. He was head of one of the most formidable intelligence-gathering operations in world business, one we draw on extensively in the following chapters. And

11 Meeks and Meeks, 1981a, 1981b.

the UK government were also more open-minded in their response: in a Green Paper (HMSO 1978), they summarised this book and other evidence, concluding that it constituted ‘a strong challenge to the previous presumption that the great majority of mergers confer economic benefits’ (p. 105).

Post-merger Performance: Further Statistical Analysis

The subsequent four decades have seen many studies which could have given the lie to our early attempts at measuring the impact of M&A on financial performance. Appendix 1 summarises briefly several dozen peer-reviewed articles and books on this aspect of the subject. Unsurprisingly, there is considerable variety of coverage and approach among them. They adopt different methodologies and rely on different data—some on accounting profits, others on share prices. They try different ways of controlling for other influences on performance. They relate to 10 different countries (though the US dominates, with the UK a strong runner-up). And they cover many different time periods over the last half-century.

No more than our original studies do they show that all M&A has produced the disappointing outcomes one of us observed at some of our audit clients: there are many deals that—along with those by Volkswagen, RBS, GE, and US airlines—have produced significant gains to shareholders. But taken together they do suggest that the central tendency is disappointing. Only a fifth of the studies report that in the mergers they investigated, the average deal, or a majority of deals, produced higher profits for the combined firms, or increased the wealth of the acquirers’ shareholders. The one reliably bright spot is that, in general, target shareholders gain from a premium price paid by the acquirer, but often this is outweighed by the losses to the acquirers’ shareholders: it is a ‘negative-sum’ outcome even if we don’t count the effect on interest groups other than shareholders—the frequent losses to customers, suppliers, employees, lenders, pensioners and taxpayers that we document in later chapters.

One of the most ambitious studies of financial accounts relating to M&A in the US (Ravenscraft and Scherer 1987) had special access to data, allowing the authors to follow the accounts of targets within

the new combinations. They concluded (p. 193ff.) that 'one third of all acquisitions were subsequently sold off [...] On average merged lines later sold off had a negative operating income during the last year before they were resold. Among the survivors, profitability also tended to decline...'; and, surprisingly, their results were often corroborated by the executives who had initiated the deals when they were interviewed by the economists. A subsequent major US study of the effect of acquisition announcements on the share prices of US acquirers in the course of a four-year merger wave (Moeller et al. 2005). was entitled 'Wealth Destruction on a Massive Scale [...]'. It found a loss of 12 cents per dollar spent on M&A—a total loss of $240 bn. Target firm shareholders gained—the bidder usually has to offer a premium to gain control—but bidders' losses exceeded targets' gains by $134 bn. In a very recent study (Amel-Zadeh and Meeks 2020a) we charted the total shareholder return[12] of larger US acquirers in the two years following all 4,450 significant acquisitions with a deal value exceeding $100 million completed in the period 2002–2017. Relative to matched non-acquirers, they suffered a loss—of 5.3% on average over the period as a whole: in only three of the fifteen years was there an average gain.[13]

The Mystery Emerges

The mystery we are exploring in this book is that, as this evidence of disappointing results from M&A accumulated, more and more acquisition activity was initiated. Since the early disappointing results were published some four decades ago, the global total of M&A transactions each year has risen to more than 40,000 in every year from 2006 to 2018.[14] Spending on M&A reached $4 trillion in every year from 2014 to 2018, and 2021 broke all records.

When reading about financial markets, it is easy to become inured to numbers which end in a string of zeros. We need some standard of comparison. How significant are these numbers in relation to the

12 Dividends plus share price appreciation relative to equity.

13 This is despite the increased opportunities in recent years to gain from debt-financed acquisitions as a result of the monetary authorities manipulating the debt market and the tax authorities continuing to privilege debt finance (Chapters 5 and 6 below).

14 Amel-Zadeh and Meeks (2020a, p. 2) provide the main data in this paragraph.

resources available to potential acquirers? Seventy years ago, growth by M&A was a relatively insignificant aspect of strategy, and presumably consumed little of the time and energy of senior executives and their boards. In the US the 1900 peak in such activity was not reached again until the 1960s, antitrust legislation having been introduced in the meantime (Scherer and Ross 1990, p. 154). Spending by listed firms on M&A in 1950s UK was equal to only around 15% of spending on new fixed assets; but it grew rapidly in the sixties.[15] Two Credit Suisse studies (Mauboussin and Callahan 2014, 2015) compare aggregate M&A spending with CAPEX (capital expenditure devoted to buying, maintaining, or improving fixed assets such as land, buildings or machines) from 1980 to 2013 for the US, Europe and Asia Pacific. In the West, M&A caught up with CAPEX and then overtook it, reaching two or three times CAPEX in cyclical peaks.[16] In the East, apart from Japan, the trends were in the same direction but less pronounced.

So, as evidence of disappointing outcomes mounted, Western businesses were devoting to M&A a large and rapidly increasing share of their key strategic resources: investment funds and senior executives' time and energy.[17]

One Apparent Solution

At first sight, one important strand of writing seems to offer an explanation of the failure of so many mergers to reap the operating gains which scale economies, enhanced market power and turnaround mergers would

15 Meeks (1977). It briefly even overtook spending on new fixed assets in 1968, a spike year for promiscuous couplings of humans too in the 'Year of Turmoil and Change' (Archives.gov).

16 CAPEX has, of course, been growing relatively slowly in recent decades as new industries have invested more heavily in intangible assets (see Chapter 9 below).

17 Another feature which will be strategic in unraveling the puzzle is that executives have been focusing not just on the prospect of making acquisitions, but also on the possibility of themselves becoming takeover targets. M&A has become by far the most common cause of corporate 'death'. Of the population of larger companies listed on UK stock exchanges in 1948, 83% had been taken over by 2018 (Meeks and Whittington 2021). In the US, the number of businesses listed on the Stock Exchange has roughly halved since 1996 (Tepper and Hearn 2019), mostly as a result of merger. Sometimes businesses have merged or made acquisitions in order to 'stay alive' themselves—avoiding becoming a target. For example, Kynaston (2001, p. 387) describes the bosses of two major retail banks in the UK, National Provincial and Westminster, agreeing to merge to create 'a bank that would be too big to be taken over by anyone else'.

seem to offer. This explanation emphasises diseconomies of scale, and the difficulties executives face when expanding rapidly through merger.

There is a long-established literature on the diseconomies of scale in business. One strand focuses on the growing distance between the CEO and the 'front line' of production and marketing as businesses expand and reporting lines multiply (Robinson 1931). A related strand focuses on the difficulty of coordinating the different parts of a large organisation. Scherer and Ross (1990) write that 'Hordes of middle managers, coordinators, and expediters proliferate' (p. 104), helpfully adding an explanatory footnote: 'For readers untutored in the ways of bureaucracy, an expediter is a person whose desk is between the desks of two coordinators'.

Compelling accounts of the challenges executives might encounter in the acquisition process are provided in, for example, the early theoretical work of Penrose (1959) and Marris (1963), and the empirical studies of Ravenscraft and Scherer (1987) and Fernandes (2019). Penrose emphasised the difficulties of assimilating large additions to the management team. Other challenges include evaluating the gains to be secured from an acquisition, identifying obstacles to achieving those gains, and devising plans to overcome those obstacles. Managing the assimilation process is especially difficult where the cultures and control systems of the merging firms are very different.

We agree that these challenges and resultant failures are to be found on a significant scale, and they form part of our explanation. But we find them an incomplete explanation of the ever-increasing volume of M&A in the face of ever-increasing evidence of adverse impacts on performance. M&A attracts some of the brightest graduates from the universities—to work on merger within acquiring businesses or in the M&A departments of investment banks, consultancies, legal firms, etc. And a great deal of experience has been accumulated on the challenges of M&A and effective responses to meet them (e.g. Galpin and Herndon 2014, and Fernandes 2019). So it is puzzling that capable executives—supported by talented and highly-trained advisers and monitored by profit-seeking shareholders—having observed or experienced so many failed mergers, would double down on acquisition activity, to lead a forty-fold increase over forty years.

This is the core of the mystery, and the puzzle seems too deep to be explained away merely as the 'triumph of hope over experience'.[18]

What Counts as Success or Failure in Merger?

Table 1.1 presents a stylised income statement (profit and loss account) that provides a framework for our discussion of the mystery. It follows the pattern familiar to anyone who reads business accounts: money in and money out. Column A gives a benchmark for assessing the success or failure of a merger: what the income statement would look like if the two merger participants had remained independent and their two separate statements were simply added together. It shows first the revenue coming into two merging firms, and the costs of operating the firms. Revenue minus costs gives operating profit (or loss). This tends to be what concerns the industrial economist. The statement then shows the profit which has to be paid in interest to those who have lent to the firm, and next the corporation tax payable on post-interest profit. 'Earnings' are the residual—what's left for shareholders. This can be paid out to shareholders as dividends or ploughed back into the business to generate future dividends, and is typically a measure the financial economist will focus on in assessing M&A 'success'.

Table 1.1 Stylised income statements of merging firms

Column A	**Column B**
A benchmark: the sum of the participants' income statements if they had remained independent	**The income statement of the merged firm**
REVENUE	**REVENUE** *Plus any higher revenue from better products* *Plus any higher revenue from monopolistic pricing*

18 Reported by Boswell (1791) as Dr. Johnson's comment on a man's second marriage.

Column A	**Column B**
Minus **COSTS**	Minus **COSTS** *Plus any (net) synergies* *Minus increased executive pay* *Minus merger transaction costs*
Equals **OPERATING PROFITS**	Equals **OPERATING PROFITS**
Minus **INTEREST**	Minus **INTEREST** *Plus any gains from extra borrowing*
Minus **TAX**	Minus **TAX** *Plus extra tax subsidies*
Equals **EARNINGS**	Equals **EARNINGS** (as in Column A, plus *net merger benefits to shareholders*) *Loss of consumer surplus* harms the customer, but not the business

From the shareholders' perspective, a merger is successful if it leads to higher earnings. This is if the post-merger earnings are accurately recorded—a big 'if' in the case of merger, as Chapter 9 explains: merger offers rich opportunities to flatter earnings through creative accounting.

The potential sources of gain from merger for the shareholder are inserted in italics into the statement in Column B. The revenue of the combined firm might be increased—without, or net of, associated cost changes—if the merger results in improved products which command higher prices. For example, one firm might bring design skills which enhance the other's products. Other things equal, this is a win for the shareholders, and it's a win for the wider economy—better products, a social gain.

However, the shareholders would also win if revenue rose and earnings swelled because monopoly power was increased by the merger. For example, the only two airlines operating on a particular route (with exclusive landing rights) could raise fares once competition was eliminated in a merger. But the passengers would lose. The profits which come at the expense of those customers who continue to fly but pay more are recorded in the income statement. But there is an extra cost

borne by those who are priced out of the market. This latter 'consumer surplus' problem is of course the focus of much of the work of antitrust/competition authorities. If the competitive fare before merger was $100, and the monopoly price afterwards was $150, passengers who would have been willing to pay, say, $125 lose out. There is a loss of allocative efficiency—they lose access to a service which could be provided for $100 and is worth $125 to them.

This loss of consumer surplus will not appear in the merged firm's accounts. So a merger which shows improved profit feeding through to earnings for shareholders in the accounts may be a failure on a social calculation because it has deprived customers of benefits. Chapter 2 gives examples of pharmaceutical companies hiking prices after merger—e.g. serial acquirer Valeant raised the price of its diabetes drug, Glumetza, from $572 to $5,148 (Tepper and Hearn 2019, p. 168). With demand for this treatment remaining high ('inelastic' in economist's terminology), the supplier's income statement would be likely to show startling success. Patients dependent on the treatment and priced out of the market might take a different view.

The next part of the income statement—costs—can again offer the prospect of synergies and closer alignment of private and public benefit in merger. This is where evidence would appear after merger of the scale economies associated with Adam Smith's division of labour, or Neutron Jack's or Fred the Shred's slashing of costs in the acquired business. Such cost reductions[19] would feed through to shareholders' earnings.[20] They would also release resources for use elsewhere in the economy—a potential national gain (though the supplier whose margin is in jeopardy, or the worker who is fired, may not see it that way).

Two new costs are generally found in the accounts of a merged firm which would not have arisen if the two firms had remained independent: additional pay for the acquirer's senior executives (commonly) and fees to professional advisers (always). In relation to the massive scale of some firms participating in merger, these expenses may seem scarcely to be material—even at the top end, tens of millions for the executives and a billion or so for the advisers are dwarfed by firm size. But for the recipients of these substantial personal payments they can of course

19 Net of cost changes resulting from any diseconomies of scale.

20 There could be further earnings gains if the opportunity to reduce prices led to a substantial boost in sales.

be highly material, and distort the incentives they face. They may lead to deals which are successful for executives and advisers but not for shareholders or the economy at large. Chapters 2 and 3 explain.

The next two lines of the income statement are: interest and tax. We explain in Chapters 5, 6 and 7 how these appropriations can change in the course of merger, with 'subsidies' enjoyed by shareholders of acquiring firms—as borrowers and taxpayers—at the expense of other groups in the economy. These privileges can result in earnings gains—success—for the shareholders in mergers even where the combinations yield no gains, even declines, in operating profits. If the buyer's capital structure could be modified in merger, by borrowing on favourable terms to buy the target's shares, the acquirer's shareholders could secure the target's post-interest profit for no outlay of their own money. Benefits would also accrue to the acquirer's shareholders if the merger succeeded in reducing the tax payable on the combination's profits.

This accounting framework is suggesting then that promoters of merger are sometimes right that a deal offers the prospects of success both for the shareholders and for the economy at large: it can be positive-sum, with private and social interests coinciding. However, the framework indicates too that merger can offer a quick, legal and easy way of achieving success for the shareholder at the expense of other interest groups (zero- or negative-sum). Of course, the economics of monopoly are well understood by policymakers: eliminating competitors via merger can bring success for shareholders at the expense of customers and suppliers. But there are also other zero- or negative-sum routes to success for shareholders that are less prominent in the literature. Limited liability for shareholders allows them to 'privatise [the] gains and socialize [the] losses', as Fleischer (2020) puts it, associated with a debt-financed merger. And tax systems offer a range of privileges to merging firms.

Many of the studies of the effect of merger on performance employ earnings measures, or stock market measures heavily influenced by earnings measures. But these are typically an upwardly biased proxy for operating profits because of the opportunities offered by merger for tax avoidance and gains at others' expense from borrowing. And operating profits are themselves typically an upwardly biased proxy for the social gains from merger when revenue and costs benefit at customers' and

suppliers' expense because of increased market power.[21] So if even earnings-based measures turn out to be no better than neutral on the gains from merger, this is likely to be bad news for the economy at large.

Appendix 1 discusses further these performance measures and, as mentioned above, reports over 50 studies which have measured operating profit, or earnings, or share price appreciation during and/or following merger. Despite so many potential sources of gain for the shareholders, and on the face of it curiously, the statistical evidence on post-merger earnings does indeed show that often even the acquirer's shareholders fail to gain from increased earnings or share prices.

Plan of the Book

Section A of Part Two below discusses the benefits for prime-movers of M&A—senior executives of the acquirer, and advisers—even where the merger leads to falls in operating profits. These two groups are often faced with incentives to undertake mergers which do not serve the interests of their principals—the owners (shareholders) of the acquirer. A merger is typically a financial success for the executives who lead it (Chapter 2). And a merger deal is almost always financially successful for the advisers (Chapter 3), even if it is adverse for the rest of the economy.

Section B of Part Two then describes some of the financial engineering which can make mergers attractive to shareholders even when they lead to a decline in operating profits. In this case, the action takes place in Column B of the income statement in Table 1.1. Chapter 5 discusses the lure of debt-financed merger: limited liability provisions for the borrower skew the borrower's calculations—much of the burden of downside risk is shifted to other interest groups, while the full upside benefit accrues to the borrower. The benefits of debt-financed acquisition do not end there: they are magnified by the privileged treatment of interest payments under most current tax regimes (see Chapter 6). And even where mergers are not debt-financed, in most jurisdictions they offer target shareholders the opportunity to convert 'income' into 'capital gains' which enjoy privileged tax treatment. Finally, cross-border mergers

21 Reported profits will also be an upwardly biased proxy for operating gains if the acquirer takes advantage of the rich opportunities afforded by merger for creative accounting designed to inflate the profits reported by the amalgamation (Chapter 9).

with companies headquartered in jurisdictions with low tax rates on profits can sometimes be used to reduce the acquirer's tax bill. Chapter 7 describes some of the most sophisticated financial engineering—practised by private equity funds.

Section C of Part Two, 'Information Asymmetry', concerns the information available to investors on the performance and prospects of merging firms. Share prices in imperfect markets deviate from the prospective earnings they are supposed to reflect; and this creates opportunities for acquirers to make speculative gains from deals which do not augment (even lower) operating profits. Creative accounting by bidders ahead of an offer can magnify information asymmetries between executives and shareholders and facilitate mergers which are not in the latter's interests. Accounting for the deal itself provides rich opportunities to flatter post-merger profits (and conceal post-merger losses). And conventions for accounting in post-merger years can allow executives to misrepresent the outcome of deals.

Part Three of the book, 'Review and Reform', first pulls the strands of the book together by charting the experience of two acquiring businesses which combined many of the problems identified in earlier chapters. It then outlines potential ways of eliminating or at least mitigating those problems.