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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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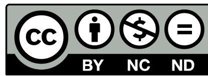

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2. Incentives for Executives

> Even in mergers where bidding shareholders are worse off, bidding CEOs are better off three quarters of the time. (Harford and LI 2007)

The prime movers in M&A are the senior executives of the bidder, especially the CEO and CFO. Their formal role is to pursue the interests of their principals, the shareholders. Yet their shareholders have often lost out from M&A. We need to explain why executives may proceed with deals that do not serve the interests of their shareholders, let alone their other stakeholders or the economy in general. We begin by exploring the incentives facing senior executives, focusing on the consequences of M&A for their pay, perks, power, protection, and prestige.

Pay

We use the shorthand term 'pay' for all the monetary benefits paid to executives. The typical package for a CEO in Western companies comprises base salary, which doesn't vary with profits or share price, and short-, medium- and long-term bonus schemes which relate payments to the achievement of performance targets, payments which sometimes come in the form of shares or share options.

In determining base salary, remuneration committees often hire remuneration consultants, who provide benchmarks such as the average paid to executives of similar firms (plus a bit, of course, for the 'Lake Wobegon Effect'—everyone in the fictional town being convinced they were better than average). One key 'similarity' is company size: the taller the pyramid of managers—the more layers of management in an organisation—the higher the pay of the boss tends to be. Statistical studies have found a strong correlation between firm size and the pay of the top managers, independent of performance (e.g. Meeks and

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Whittington 1975; Blanes et al. 2019). So expanding the size of your firm is one way of securing a pay rise.

How to achieve rapid expansion? Hargreaves (2019, p. 47) reports that the average British CEO is in office for five years, 'so if they want to make their mark, along with their fortune, they need to get a move on.' Just keeping pace with the growth of the market will often not produce much growth and rise in pay in those five years. For instance, in Western countries from 2014–2019, if you managed to expand sufficiently to maintain your market share, and the market was growing in line with the GDP of the countries you supply, your business might typically grow by perhaps 2% a year.[2] Growing by M&A instead is seen as much easier than increasing market share or developing new markets.[3] The $27 billion acquisition of Refinitiv by London Stock Exchange Group (LSE) in 2021 tripled the acquirer's revenue in a month (Elder 2021b). The Chief Executive was 'rewarded with a 25 per cent increase in base salary [...] to reflect the LSE's increased size following the Refinitiv purchase' (Stafford 2021). Stafford notes that in the same month, LSE shares fell 25%—on concerns about 'LSE's ability to extract synergies from its acquisition of Refinitiv'.

Of course, expanding size to justify a bigger salary may well bring no benefits to the wider economy. Executives and commentators sometimes speak of growth of the firm as if it equates with growth of the economy, and brings corresponding social benefits, such as more output, more capital assets, or a greater range of products and services. But there is a fallacy of composition here:[4] the growth of a firm by M&A can mean just a reallocation of share ownership, with no change to the size of the economy. Promoters of M&A are, of course, only too pleased to conflate the two—expansion of the economy on the one hand and reallocation of ownership of a part of the economy on the other. And they don't mention the resources that are consumed just to achieve a reallocation of share ownership: the substantial transaction costs of a merger deal, which we illustrate in the next chapter.

2 The average annual growth rate of GDP in constant prices for all OECD countries for 2014–2019 was 2.2% (OECD.Stat).

3 Kay in Kynaston (2001, p. 748).

4 The error of assuming that what is true for the member of the group (the firm) is true for the group as a whole (the economy). On economic growth itself, see the qualifications in note 8 of this chapter.

From the perspective of the economy, some critics would describe merger not as ‘growth’ but as corporate ‘cannibalism’. Similarly, the critics sometimes describe the acquisition of a domestic firm by a foreign one not as direct ‘inward investment’, but as ‘the sale of the family silver’. In neither case does the acquisition in itself expand the productive capacity of the economy.

In the last three decades, although executive pay is still correlated with firm size and growth, increased emphasis has been placed on better aligning managers’ interests with those of shareholders through performance-related pay (PRP). Jensen and Murphy (1990) were among the academics calling for this development after noting that:

> Public disapproval of high rewards seems to have truncated the upper tail of the earnings distribution of corporate executives [...] The resulting general absence of management incentives in [...] corporations presents a challenge for social scientists and compensation practitioners. (p. 227)

Among the businesses responding enthusiastically to this ‘challenge’ was Enron, for several years named ‘America’s Most Innovative Company’ by *Fortune* magazine, and itself the product of a merger and the initiator of significant M&A deals. Enron’s experience gives a hint of potential problems with PRP. Performance-related benefits were important in swelling the compensation of its senior executives to $845 million (over $150 million to the chairman alone) in the year ending in its bankruptcy (Ayres 2002).

The *Financial Times* Lex column (2017) analysed the role of PRP in a specific large acquisition by Reckitt Benckiser (RB)—of Mead Johnson. A performance-related pay scheme for the Reckitt Benckiser CEO included ‘a yearly award of shares through “long-term incentive plans”. These pay out in proportion to growth in earnings per share (EPS).’ Lex reported that the debt-financed acquisition was estimated to result in extra EPS growth for Reckitt Benckiser of 7%, 12% and 16% in the years 2017, 2018 and 2019. And the consequent payouts from the incentive plan would sum to around $15–17 mn.

Now at first sight this arrangement—targeting and rewarding EPS—appears to be an efficient way of aligning the interests of the CEO with those of the shareholders: more earnings per share for the owners brings more ‘pay’ for the CEO. But a problem arises which, in other economics

contexts goes under the name 'Goodhart's Law'.[5] In essence, this says, 'When a useful measure becomes a target, it ceases to be a good measure'. In the context of M&A, those who stand to benefit from reaching a target may look for ways of appearing to achieve the performance target without genuinely improving underlying performance (or, worse, while delivering weaker underlying performance); and in the case of M&A, there are powerful means for doing that. In Chapters 9 and 10 we explore devices associated with M&A accounting which boost reported EPS without any improvement in underlying operating profits (even despite a deterioration). In Chapters 5, 6, and 7 we investigate the way that financial engineering with M&A may do the same (especially in a debt-financed deal), again delivering higher EPS while operating profits are unchanged or diminished. In Ford's (2020) words:

> Existing contracts that are poorly designed allow bosses of quoted companies to become rich by using leverage to game earnings per share and performance targets.

In extreme cases the required 'performance' has simply been to make the acquisition: the acquirer's boss has been directly rewarded just for pulling off what proved to be an unfortunate deal, without having to show change in a targeted performance measure. Hargreaves (2019, p. 79) cites the case of Vodafone's acquisition in 2000 of

> Mannesmann for $181billion—[at the time] the largest corporate deal in history—its boss [...] received a special pay deal of $10million to reflect the success [in completing the deal]. However the merger went badly wrong and is now taught as a case study in business schools as one of the most value-destroying takeovers in the corporate world. (p. 79)

Vodafone wrote off some $43 billion of its purchased goodwill in 2006, mostly in relation to its purchase of Mannesmann (Amel-Zadeh et al. 2016).

In that same deal, it was alleged that the executives of the acquiree also benefitted very directly from the acquisition. Mannesman's CEO and five other directors were taken to court by shareholders, accused

5 The 'law' was developed in the 1980s when the British government used the supply of money as the policy target in the attempt to control inflation. The former strong correlation between money supply and inflation broke down: inflation accelerated despite tight control of the money supply.

of having received excessive payouts by Vodafone to give up resistance to the deal (*Guardian* 2004).[6] Sweeteners for the acquiree's executives featured also in the Reckitt Benckiser case: the *FT*'s Lex concluded that the CEO of Mead Johnson, the target, 'should get an [...] impressive $13.7m pay-off if he steps down, as expected'.

The pattern of benefits to the acquiree's executives in these examples is not exceptional. In a statistical study, Hartzell et al. (2004) found that executives in the acquired business often gain significant financial benefit from M&A, and those gaining particularly generously have tended to agree lower acquisition premia for their shareholders. The misalignment of incentives identified by Harford and Li (our quote at the head of this chapter)—bidding executives gaining even where shareholders lose out—can therefore sometimes be seen in the acquiree too.

Perks: Benefits in Kind

Greater size often means a bigger geographical spread of subsidiary companies for the boss to monitor, and the associated luxury travel is a welcome perk for some: glamorous hotels and private jets become 'essential'. The CEO of serial acquirer GE, Jeffrey Immelt, travelled in one private (company-funded) jet, and this was followed by a second GE private jet (Muolo 2017). The purpose of the second jet is unclear; but rumour has it that in one other notorious case a second jet carried a CEO's pet dog. Again, as with pay, if M&A delivers a large increase in size, the CEO's peer group changes, and this affects the accepted norms for benefits. Hargreaves (2019) quotes Warren Buffett: 'CEO perks at one company are quickly copied elsewhere. "All the other kids have one"' (p. 48).

Given such packages of financial incentives it is hardly surprising that senior executives avidly seek out acquisitions even where they promise little or no gain in operating performance. But this is not all: there are other powerful incentives to do deals which benefit neither shareholders nor the wider economy. These are to do with power, security and prestige.

6 The court decided that their actions did not constitute wrong-doing.

Power and Protection

Writers on the role of merger in industrial organisation and public policy have given most attention to the effect of merger on market power: increased prices charged to consumers and reduced prices paid to suppliers (including labour) once competitors are eliminated. We gave a striking illustration for the US aviation industry in Chapter 1. Detailed statistical and case evidence on various industries is provided by Philippon (2019) and by Tepper and Hearn (2019). Part of the mystery we are addressing is the puzzle of why—given the opportunities for merging firms to secure more favourable prices—we don't see more evidence of gains in operating profit for the merging companies. And part of the solution is that the benefit from increased market power *may* take the form not of higher profits for shareholders, but of enhanced power and protection for the acquirer's executives.

In elaborating the theory of monopoly, Nobel Laureate John Hicks (1935) commented: 'the best of all monopoly profits is a quiet life' (p. 8). Subsequent writers developed the argument. For example, Leibenstein (1966) argued that in circumstances where pressure from competitors is light, many managers will opt for less effort and search, and enjoy the utility of feeling less pressure. Then Cyert and March (1963) predicted that, other things equal, the costs of firms that hold dominant positions in the market will tend to rise.

Wu (2018) describes Facebook's use of M&A to secure a 'quieter life'—to stifle competitive threats and protect high profits. Instagram 'gained 30 million users in just eighteen months of existence [...] was poised to become a leading challenger to Facebook based on its strength on mobile platforms, where Facebook was weak [...] Facebook realized it could just buy out the new [competitor]. For just $1billion, Facebook eliminated its existential problem...' (p. 122). And then 'Facebook was able to swallow its next greatest challenger, WhatsApp, which offered a more privacy-protective and messaging-centered competitive threat' in a $19billion buyout...' (p. 123). 'In total, Facebook managed to string together 67 unchallenged acquisitions', consolidating its monopoly power.

Similarly, Philippon cites a study of predatory acquisitions in the pharmaceutical industry, where incumbents have been found to pre-empt

future competition by acquiring a firm which is developing a product which would rival its own, and shelving the innovative competitor: 'A large incumbent may want to acquire a target and shelve its products. Cunningham, C., Ederer, F., and Song Ma (2018) call this a "killer acquisition" [...] A drug project is less likely to be developed when it overlaps with the acquirer's portfolio of existing products'(p. 82).

As well as protecting executives from pressure in the markets for the acquirer's output and inputs, M&A can also reduce the pressure in the 'market for corporate control'—pressure arising (as Chapter 1 noted) from the threat of being taken over oneself, perhaps putting their own executive positions at risk if performance flags. In an early statistical study for a substantial set of firms, Singh (1975) found evidence that 'as a survival strategy, attempting to increase relative profitability may well be inferior to attempting to increase relative size, particularly for larger unprofitable firms'(p. 510). Consistent with this, Meeks and Whittington (2021) show that, with just one exception (Tesco—a 'minnow' in 1948), it has only been very large firms that have survived long periods without being acquired. Bayer paid $63 billion for Monsanto in 2018 'because this promised to make the chemicals group invulnerable to takeover' (Guthrie 2020). From a shareholder's perspective this deal, according to one analyst (Bender 2019), 'ranks as one of the worst corporate deals in recent memory': Bayer's share price fell by over 40% in the year after deal completion.

Another use of surpluses resulting from the elimination of competitors is to gather political support to protect the executives' privileged position (with the access of large corporations to political power that the Harvard economist Galbraith (1967) had begun to observe in the 1960s). The means by which influence is secured vary from country to country: it may include hiring lobbyists, funding politicians, and creating revolving doors between government and business (Meeks, Meeks and Meeks forthcoming). And the influence can be deployed to resist more stringent competition policies, and gain government contracts, as well as to protect the distorted accounting, morally hazardous legal arrangements, and privileged tax codes which we discuss in later chapters.

Prestige

In professional sport, the prestige of different teams is typically reflected in their performance ranking in leagues. And those rankings are of course based on success measures such as number of wins, and goals or points or runs scored. In business, the rankings are very often based on measures of size. This is rather as if football league rankings were to be based on the size of the respective clubs' stadiums.[7] Media admiration of Neutron Jack (Welch) typically highlighted his creation of the *biggest* corporation in the world: he was a celebrity, best-selling author, management guru. Fred the Shred took special pleasure in building the *biggest* bank in the world; and as noted in Chapter 1 he joined distinguished figures such as Nobel Laureates and military and sporting heroes in being knighted by the Queen.

Sometimes the more sophisticated media use a rather more dynamic metric when ranking businesses. For example, the *FT* publishes rankings by revenue growth (FT 2021). And at first sight this seems congruent with the still most widely used indicator of national economic advance (though one that is flawed as a measure of gain in well-being),[8] the

7 For example, the *Fortune* 500 is a league table ranked by revenues; so are Statista's Top 100 Companies: UK and Top 100 Companies: USA; and also 'Top 100 Companies in the World' published by corporateinformation.com.
Some, such as *Forbes* Global 2000, combine pure size measures (assets, sales) with ones reflecting performance (market value, profits); but still a merger boosting size but not performance would advance a business in the league table.

8 As the European Commission (2022) puts it, 'Economic indicators such as GDP were never designed to be comprehensive measures of prosperity and well-being'. Though representing countries' levels of production (subject to qualifications concerning depreciation, unpaid work and so on), GDP data fall seriously short if (mistakenly) held to reflect economic welfare—neglecting, for instance, negative externalities such as environmental degradation (Pigou 1920; Mishan 1967) or distributional issues affecting health and educational outcomes (Sen 1999): in Sen's words, 'without ignoring the importance of economic growth, we must look well beyond it [... for] an adequate conception of development' (p. 14). Principles of well-being—which have a very long pedigree—have gained increased policy prominence in recent decades, with Bhutan's preference since 1972 for its GNH (Gross National Happiness) measure, the UNDP's establishment of the HDI (Human Development Index) in the 1990s; the European Commission's 'Beyond GDP' initiative launched in 2007; the Commission on the Measurement of Economic Performance and Social Progress's Report in 2009 (Stiglitz, Sen and Fitoussi), with follow-up work continuing, supported by the OECD; the UN supported World Happiness Reports from 2012 onwards (Helliwell, Layard and Sachs 2012); and, from the UK Treasury, the Dasgupta (2021) Review. This caveat is relevant also

growth of GDP. But as we suggested earlier, the analogy between business growth and GDP growth is seriously misleading in the presence of M&A. M&A in itself does not expand the production or incomes of an economy: the deal simply reallocates control over an existing bundle of assets. And it consumes resources in the process—the transaction costs we discuss in the next chapter. Yet in spite of this, growth by M&A is widely admired, much as a spurt in GDP growth is standardly taken to add lustre to the reputation of a country's president or prime minister.

The *FT*'s Collins (2014) captures the attraction for the CEO:

> Think of the impact of a 'transformational' deal, the thrill of the chase, the media spotlight, the boasting rights and—of course—the massive pay rises. You will be number one! [...] By the time it all ends in tears, the executives who have laid waste to the shareholders are long departed with their winnings. [...]
>
> So when the investment bankers send round their hottest M&A boys, the executives are vulnerable to a sales pitch.

In the next chapter we report on why 'the investment bankers send round their hottest M&A boys'—the incentives facing these investment bankers and other professional advisers on M&A.

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to the post-merger economic performance measures discussed in Chapter 1 and Appendix 1.