

GEOFF MEEKS AND J. GAY MEEKS

THE MERGER MYSTERY

WHY SPEND EVER MORE ON MERGERS
WHEN SO MANY FAIL?





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8. Inefficient Mergers in an ‘Efficient’ Market

acquisitions are made by overvalued acquirers of relatively less overvalued targets. (Shleifer and Vishny 2003, p. 305)

This chapter advances a claim which is contentious and at first sight counter-intuitive: that an ‘efficient’ stock market can facilitate and stimulate M&A which brings no gain in operating profit for the merging firms, and sometimes losses.¹

Theory

Our students find it confusing that in one course they are being taught that the stock market is ‘efficient’—indeed many academic studies rely on this proposition in interpreting movements in share prices—but in another course they are being told that the stock market sometimes enables or even induces inefficient mergers. An important reason for the confusion is that there are several different concepts of stock market ‘efficiency’ in economics; writers do not always make it clear which one they are using; and sometimes, one suspects, we find it too convenient to slide from one concept to another in order to make our arguments more compelling—claiming more generality than is warranted for our conclusions. To minimise confusion in this and the next chapter, we’ll outline which concepts of efficiency we are considering at each point.²

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- 1 We are not claiming that stock markets such as the American and British are reliably efficient in any of the senses discussed below. Rather, the argument is that, *even if these markets were efficient in these senses, they would facilitate and stimulate some M&A which yielded no gain in operating profit. If the markets are inefficient, the arguments hold a fortiori.*
 - 2 These conceptual issues are further explored and explained particularly clearly by Dissanaïke (2010).

Two Nobel Laureates are helpful. Nobel Laureate James Tobin (1984) spells out a hierarchy of concepts of ‘efficiency’:

1. The least ambitious is his ‘information arbitrage efficiency’. Share prices in a market that is efficient in this sense take full account of the available information. On average an investor cannot gain by trading on the basis of available information. Within this category there is a crucial further distinction which we pursue in the next chapter. This was spelled out very clearly by Nobel Laureate Eugene Fama (1970):

- i. a market which is informationally ‘semi-strong’ efficient incorporates all *publicly available* information, and
- ii. a ‘strong form’ informationally efficient market incorporates *all information, including inside* information.

In Chapter 9 we explore how, with semi-strong efficiency the selective or biased release of inside information distorts the M&A market, enabling deals which depress operating gains.

2. More ambitious is Tobin’s next category, ‘fundamental valuation efficiency’. In a market which achieves this level of efficiency the price of an asset (in our case a share in a business) ‘accurately reflects the future payments to which the asset gives title’. In this chapter we consider how deviations from this ideal of efficiency (but conformity with semi-strong information efficiency) can lead to M&A which fails to yield extra operating profit, or even leads to reduced profit.

Estimates of the ‘future payments to which the asset gives title’ are challenging for shareholders. They are entitled just to a share of whatever earnings the business generates over the rest of its lifetime, about which there will typically be many ‘known unknowns’ and some ‘unknown unknowns’.³ The lack of hard information about the many future years that are relevant can make for swings of sentiment. And these can translate into substantial short-term swings in share price (Botsari and Meeks 2018). Such swings in share price attract speculators into the market. And Tobin quotes a famous piece by Keynes (1936) suggesting that in markets with negligible fundamentals (great uncertainty) speculative profits can be made from successfully guessing the sentiment of other

3 Terms familiar from and usually attributed to Donald Rumsfeld’s famous response in a Defense Department meeting in 2002, but also used earlier by others in specialist risk assessments.

speculators. Keynes likened professional investment in the stock market to:

[...] those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view [...] [We] have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. (p. 156)

And, in Tobin's words, this speculation 'multiplies several-fold the underlying fundamental variability of dividends and earnings'. Tobin writes that the 'speculations on the speculations of other speculators who are doing the same thing [...] dominate, of course, the pricing of assets with negligible fundamentals'. Such assets can include shares in merging firms.

Evidence

Nobel Laureate Robert J. Shiller (2001, 2015) has assembled compelling evidence that the fluctuations in stock market prices are indeed much greater than is warranted by the variation in subsequent real dividends which they would reflect in a market which was fundamentally valuation efficient. And at the level of the individual firm, evidence has accumulated that 'investors have overly optimistic expectations about the cash flows of some firms and overly pessimistic expectations about the cash flows of other firms' (Engelberg et al. 2019). This follows earlier evidence of 'overreaction'—stock market prices reacting more positively than is warranted to good news and vice versa (Chopra et al. 1992, Dissanaikie 1997).

Work by Scherer (1988) links such findings to the M&A market. He cites numbers provided by Black (1986, p. 533) in his Presidential Address to the American Finance Association, when he imputes to the market a rather modest standard for valuation efficiency:

[We] might define an efficient market as one in which price is within a factor of 2 of value, i.e., the price is more than half of value and less than twice value. The factor of 2 is arbitrary, of course. Intuitively, though, it seems reasonable to me, in the light of sources of uncertainty about value and the strength of the forces tending to cause price to return to value. By this definition, I think almost all markets are efficient almost all of the time. ‘Almost all’ means at least 90 per cent.

Take one extreme case where, in Black’s account, the share price of a business in an efficient market is temporarily almost ‘twice value’, and the executives of the business—possessing more complete inside information—are confident of this overvaluation. Then the business has the opportunity to use its own inflated shares as currency for buying other businesses whose share price just reflects ‘value’. This can be in the interests of the acquirer’s shareholders even if the deal offers zero or negative operating gains: they make a gain on the deal at the expense of the target’s shareholders who don’t have the information to recognise that the acquirer’s shares they receive in payment are overvalued.

Of course, overvaluation is often a market-wide phenomenon—the ‘hot’ stock markets, the ‘boom’ and ‘hysteria’ phases of bubbles famously described by Minsky (1986). The swings in sentiment in markets with asymmetric information are familiar from other branches of economics. In his analysis of the 2008 financial crash Wolf (2015, p. 122) revives Galbraith’s (1997) lively account of the cyclical changes in deceit and distrust in capital markets:

In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle [deceit] increases rapidly. In depressions all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise.

This cyclical pattern helps to explain a surprising feature of M&A—firms make more acquisitions when the price of the targets is unusually high (Botsari and Meeks 2018). If you are looking to buy assets, you would normally benefit from buying them when their price is depressed. But Shleifer and Vishny (2003) explain the economic logic of buying in hot markets as quoted at the head of the chapter: ‘acquisitions are made

by overvalued acquirers of relatively less overvalued targets' (p. 305). It can still be rational to embark on share for share acquisitions which offer zero or negative operating gains, provided that the acquirers' shares are more overvalued than the target's. Andrade et al. (2001) report that almost 60% of M&A in the 1990s was financed entirely by share exchange (before the more recent domination of debt financing). Statistical evidence supporting the proposition of Shleifer and Vishny is provided by, for example, Dong et al. (2006) and Gregory and Bi (2011).

Then take the opposite extreme case in Black's account—a depressed market where a company's share price has been driven down to a little more than 'half of value'. This represents an opportunity for a potential bidder, even if that bidder's own share price is equally depressed. In this case, the deal should be financed with cash (cheap and easy to borrow in recent years, as we discussed in earlier chapters).

So in the financial crisis of 2007–2009, Bob Diamond was able at the height of the panic to buy for Barclays a large component of insolvent Lehman, yielding a 'day one accounting gain' of several billion dollars (Thayer 2010). Violent movements in another financial market targeted by speculators—for foreign exchange—create opportunities for M&A. In the immediate aftermath of the unexpected 2016 UK referendum vote for Brexit, Japanese SoftBank's Masayoshi Son 'bet with a big size', acquiring the British semiconductor and software design company, Arm Holdings. One month after the Brexit vote the further fall in sterling had meant that such British assets cost Japanese buyers almost 30% less than they did a year earlier (Vincent 2016a). And more recently, in the 2020 pandemic, England and Kerr (2020) reported that 'Gulf sovereign wealth funds including Saudi Arabia's Public Investment Fund [PIF] and Abu Dhabi's Mubadala are mobilizing to buy assets whose valuations have been hardest hit by the outbreak.' Again, Thomas and Hollinger (2021) quote a fund manager in the wake of the pandemic and Brexit: 'There are a swath of well-managed UK mid-caps that trade at well below replacement cost'; and note that 'this has made them vulnerable to opportunistic bids'. In each case, the buyers stood to make a large capital gain. There need not have been any operating gain to be had from the deal—indeed the capital gain might have been sufficient to outweigh a significant operating loss. The transaction could have been zero-sum or negative-sum.

Such deals may just be taking advantage of the market's swings between excessive pessimism and excessive optimism. But given the fragility of valuations by the imperfectly-informed market, Shleifer and Vishny argue that bidders can exploit their superior, insider access to (and control of) information in order to inflate the value of their equity and make bargain acquisitions. We explore this process in the next chapter.