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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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12. Remedies?

In this final chapter we recap the main lines of enquiry in our investigation of the mystery. We have identified a series of efficiency failings in the M&A market that help to explain merger activity that so often brings no operating gains. For each of the main failings we now suggest possible policy responses. The sequencing of the failings is different from that in the preceding chapters. There they were ordered according to underlying economic concepts—misaligned incentives, distorted financing, and asymmetric information. Here they are ordered according chiefly to which authorities would need to initiate the suggested changes, starting with government, concluding with boards of directors, and including several others in between.

We have been trying to solve the mystery of why ever-increasing acquisitions go ahead despite ever-increasing evidence that many yield no operating gains. We have identified incentive misalignment: even where merger brings no operating gains, it may boost pay (and other benefits) for key players including senior executives of acquirer and target, advisers, and fund managers. Also, M&A can create opportunities to extract rents (in the economist's sense: gaining wealth without increasing wealth) at the expense of stakeholders including employees and some creditors. Such rents can mean that earnings for equity-holders rise even where operating gains are negative. Then asymmetric information can create opportunities for deals which are lucrative for the buyer even if the acquisition yields zero or negative operating gains. And information problems often impede thorough scrutiny of deals *ex ante* or monitoring *ex post*.

Table 12.1 details the specific rents, information asymmetries and incentive problems we have analysed. It suggests measures that could be deployed to eliminate or mitigate these problems. And it identifies who has the authority to implement such measures—ranging, as mentioned,

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from government to non-executive directors. We only suggest the general thrust of potential reforms. Designing precise mechanisms requires more expertise in law, regulation, taxation, banking and governance than we can claim.

Table 12.1 Policy responses to prevent or deter mergers which yield no socially useful operating gains.

Challenge	**Response**	**By whom?**
Rent extraction		
Moral hazard	Protection for non-equity stakeholders	Government
Tax avoidance	Remove tax break for interest	Government
	Eliminate tax privilege for capital gains	Government
	Equalise national corporation taxes	Governments
Rigged debt market	End interest rate manipulation	Central bank
Price gouging	Antitrust	Government
Asymmetric information		
Creative accounting to inflate bidder's share price	Rigorous accounting standards	Accounting regulators
Weak *ex ante* evaluation of bids	Greater and more consistent disclosure	Non-executive directors (NEDs) Accounting regulators
	Independent evaluation of proposals	Listing authorities Takeover Panel
Weak *ex post* monitoring of deal outcomes	Tighter accounting rules	Accounting regulators

Challenge	Response	By whom?
Misaligned incentives		
Fund manager short-termism	Modify contracts: defer bonuses	Institutional investors
Advisers rewarded for completing deal, not for success of deal	Modify contracts: just costs reimbursed on completion; deferred rewards based on performance outcomes	NEDs
NEDs' pay not linked to merger outcomes	Deferred pay linked to outcomes	Shareholders
Perverse incentives for top executives	No bonuses just for completion Weaken link between size and pay Deferred rewards linked to outcomes	NEDs

Curbing Rent Extraction Arising from Distorted Financial Engineering

One device for rent extraction has been an acquisition financed largely by debt (Chapter 5). Running the business with a very small equity cushion magnifies the gains for equity-holders if things go well. But it also increases the risk of bankruptcy; and limited liability provisions shift much of this downside risk onto other stakeholders—moral hazard. Chapters 5 and 11 document the resulting losses incurred by suppliers and employees, and the weak protection afforded to such groups by existing regulation.

Prima facie, the logical response to the abuse of limited liability protection for equity-holders is to reduce the protection for those responsible for decisions on how much debt to contract. Such a reform has repercussions far beyond the M&A market and is currently being debated by academics and practitioners (e.g. Goodhart and Lastra 2020).

Another approach is to strengthen the protections for vulnerable victims of moral hazard—especially unsecured creditors and pensioners. As Chapter 11 above reports, the protections currently offered in the UK have been attacked in parliamentary discussion of the Carillion failure as inadequate. The framework and institutions have existed in the UK—the Prompt Payment Code to protect suppliers, and the Pension Protection Fund for retirees—but they have proved to be weak.

The moral hazard problem is also linked to remuneration practices, as quoted earlier: '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.' (Ford 2020a). Debt-funded acquisitions which increase risk can boost earnings per share when operating profits are unchanged (or even diminished) as a result of merger (Chapter 5). It is within the power of board remuneration committees to mitigate this distortion. Also, greater reliance on deferred remuneration (discussed below) might exert a moderating influence on the debt-equity choice: executives of the acquirer would share more of the pain if the firm failed in years following the acquisition.

Anomalies in tax systems have offered further opportunities for rent extraction in M&A (Chapter 6). In most jurisdictions the interest payable on debt is deductible when calculating corporation tax—a gift to borrowers at others' expense, and a further stimulus to morally hazardous reliance on debt. Criticism of the tax deductibility of interest payments is heard in many contexts apart from M&A.[1] We have read no compelling defence of the status quo. Removing the privilege would not be technically difficult: governments have the powers to eliminate this distortion. And similarly, the privileged tax treatment of capital gains (versus income) seems to have no basis in fairness or efficiency: M&A offers rich opportunities to convert 'income' into (privileged) 'capital gains', opportunities exploited to great effect by Private Equity (Chapter 7). Again, government has the powers to remove the bias. But they face powerful vested interests, who threaten to move their earnings to tax havens if their privileges are withdrawn.

Such threats to national governments arise from substantial differences between tax rates in different jurisdictions, the last of the

1 E.g. Fleischer (2020), Wolf (2021a).

tax-based distortions we highlighted in Chapter 6: 'tax inversion' using cross-border merger to redomicile a firm to a lower tax jurisdiction. This too is technically easy to eliminate by harmonising tax rates. But countries using low tax rates to attract footloose multinationals resist such proposals. The OECD and the Biden Administration in the US are supporting such reforms to prevent the international tax system from 'collapsing under the weight of its own complexity and competition in tax rates' (Devereux, in Smyth and Giles 2021).

Foroohar (2022) gives a colourful account of another opportunity to extract rents via debt-funded M&A, one provided by central banks which in recent years have 'in some profound way, manipulated the market'.[2] They have pumped 'unprecedented amounts of money into the US economy [...] [which] encourage ever more risky behaviour on Wall Street', as we illustrated with the highly leveraged acquisitions in Chapters 6 and 7. Foroohar describes the result as '[...] a dysfunctional dance in which the fortunes of asset owners versus everyone else moved further and further apart.' And her policy prescription is that 'both interest rates and balance sheets need to be normalised.'

Central banks mostly agree, and they have the tools to normalise, but face powerful resistance from the asset owners who have benefitted from the rigged interest rate, as well as from finance ministries which find artificially low interest rates helpful in meeting the interest payable on high levels of public sector debt.

Chapters 1 and 2 gave further examples of rent extraction where mergers eliminated competitors and permitted price gouging at the expense of customers and suppliers. Not only income distribution is affected—allocative efficiency is impaired when customers who would be willing to buy a product for what it costs to produce[3] (or somewhat more) are priced out of the market.

Although earlier chapters gave examples of such behaviour in the airline, pharmaceutical, and social media industries we have not explored this subject in any detail. That is not because it is considered unimportant—far from it. It is because it has already been extensively

2 Foroohar's comments come in a review of Leonard's (2022) study of central bank policy.

3 Including the cost of capital.

analysed by economists for many decades,[4] and we discuss it in some detail in a 'sister' publication (Meeks, Meeks and Meeks forthcoming). Historically, the first vigorous intervention to limit such rent extraction is associated particularly with US President Theodore Roosevelt early last century. In Europe, government controls on mergers which diminish competition began to be introduced from the middle of the twentieth century. In more recent years, restrictions on merger have become tighter in Europe than in the United States.

Compelling critiques of the passivity of antitrust policy in the US have been published recently. Wu reports that '[i]n the United States, between 1997 and 2012, 75% of American industries became more concentrated' (p. 21). Tepper and Hearn complain: 'Mergers that materially reduce the number of competitors should be prevented. Today, merger enforcement is dead' (p. 242). And Philippon concludes that 'many private companies have grown so dominant that they can get away with bad service, high prices, and deficient privacy safeguards. Only two decades ago, the United States was effectively the land of free markets and a leader in deregulation and antitrust policy. It must remember its own history and relearn the lessons it successfully taught the rest of the world' (p. 288).[5]

4 It is also difficult to explore this process fully with the accounting model and data we have available and deploy in Chapter 1 and Appendix 1. The accounting data for operating profit in company reports include gains from increased efficiency, better products/services, etc., along with the rents from price gouging. An improvement in operating profit may reflect more efficient operations, or the exercise of monopolistic or monopsonistic power. However, because market power rarely diminishes as a result of merger, we can generally be confident that a decline in reported operating profit (the outcome often observed—see Appendix 1) signals diminished efficiency.

5 The case for tougher antitrust goes beyond the concerns about rent extraction which relate to our main mystery theme—why mergers which yield no operating gains proceed with increasing frequency. It has been argued that deals which yield operating efficiencies may still be contrary to the public interest. One reason has been that some M&A is associated with concentration of political—not just market—power, which in turn entrenches the inequality of income and wealth (Meeks, Meeks and Meeks forthcoming). Another is that cross-border mergers may threaten national security: such concerns led Norway to block the sale of Bergen Engines to TMH, a buyer from Russia, which was seen as a military rival (Pfeifer and Milne 2021).

A broader concept of national interest lay behind the call for a ban on the proposed purchase of the UK's Arm Holdings by US Nvidia. Critics of the deal emphasised the central role of Arm in the UK's IT ecosystem, and the public funding of research and education which underpinned its success. And they contended that Nvidia's previous acquisition of a UK tech business ended in the UK operation being closed,

Reducing Information Asymmetry

Deficiencies of information impinge on M&A in several ways. When insider managers have better information than outsider shareholders, incentives can arise for acquisitions funded by share exchange which yield no operating gains: 'acquisitions are made by overvalued acquirers of relatively less overvalued targets' (Shleifer and Vishny 2003, as quoted in Chapter 8). Then, as well as taking advantage of opportunities created by asymmetric information, firms may manage information so as to create such opportunities—there is a 'powerful incentive to get their equity overvalued, so that they can make acquisitions with shares'. Chapter 9 and Appendix 2 explain the creative accounting techniques which have been available in recent decades to achieve such overvaluation.

Chapter 3 recounted criticisms of the limited amount and reliability of information provided to non-executive directors (and sometimes shareholders) about the prospective gains from an acquisition. This is a matter of concern to the International Accounting Standards Board (IASB 2020). For some deals in the UK the Listing Authority and the Takeover Panel demand the provision of some forward-looking data. But, although assembled typically by advisers, these are ultimately the responsibility of management, whose interest may lie in presenting a flattering picture of prospective gains (research shows that their projections have typically been over-optimistic (Chapter 9)).[6] In Chapter 3 we noted the expert advice given to the parliamentary 'inquest' on RBS: 'it should be the norm that independent advice is taken, which is

the staff fired, and the HQ and IP being shipped abroad (Hauser 2020). This bid may be diminishing the efficiency of ARM. The 2020 proposal was eventually abandoned in February 2022 after opposition from the antitrust authorities in spring 2022. Hill (2019 and 2022) discusses the efficiency losses when targets are left in limbo for long periods while bids are unresolved.

In the UK at the time of writing, a National Security and Investment Bill is under consideration which 'will take a more intrusive approach to foreign takeovers' (Pickard, Bradshaw and Thomas 2021). This is targeted at tech industries. There have been 'only 12 public interest interventions by the government on national security grounds since 2002'.

6 Scrutiny and verification of forecasts would be aided by a framework for disclosures and measurement specified by standard-setters. We recognise, of course, that specifying a particular measure invites manipulation (Chapter 9).

not remunerated on the basis of success with the transaction'[7] (where 'success' means simply completing the transaction, the current basis for advisers' success fees, not completing a *profitable* transaction—see below).

Information problems intrude at other stages of the bid and acquisition process. Earnings management ahead of bids can mislead the market, distort the prices of acquirers' own shares used to pay for targets, and lead to self-serving mergers which might otherwise not proceed. Then accounting for the integration of acquirees offers rich opportunities to flatter performance measures which influence executive pay and share prices, and facilitate further acquisitions. Accounting standard-setters have been energetic in foiling such techniques, but new ones are always being invented. The UK's arch critic of creative accounting, Terry Smith (1996), after praising the achievements of the UK's Accounting Standards Board in eradicating many creative accounting devices, commented that standard-setting is 'a bit like painting the Forth Bridge. Once it is finished you start all over again [...] whatever rules you put in place, smart people will find a way to express a distorted or flattering picture of their performance'(p. 10).

Accounting procedures after merger could more effectively hold executives to account for their spending on acquisitions. Accounting standard-setters proposed measures to achieve this late last century: compulsory charges against profit to amortise the goodwill representing the vast sums expended on acquisitions over and above the fair value of the separable assets that came with the target. But in the US, and then international, standards these proposals were thwarted by executives' lobbying (Chapter 9 and Appendix 2). Impairment tests were adopted instead but proved to be vulnerable to manipulation (Appendix 2). At the time of writing, the US Financial Accounting Standards Board is minded to revert to amortisation (Lugo 2020), and the International Accounting Standards Board has the subject under review (IASB 2020).[8]

7 Sir David Walker (in HoC 2012). Such independent assessment—free of management bias and advisers' conflict of interest—could also be part of the information provided to shareholders in those cases where the Takeover Panel or the Listing Authority mandate such disclosures.

8 Reverting to amortisation could have a further benefit for efficiency—mitigating the intangibles anomaly outlined in Chapter 9, whereby generating some intangible

Better Aligning Incentives

Chapters 2 to 4 identified four key players in M&A who often have strong incentives (or weak disincentives) to support a deal even if it brings no operating gains: the bidder's CEO; the CEO's immediate 'supervisors'—the non-executive directors; the directors' advisers (investment bankers and other professionals); and the managers of funds which own shares in the target.[9] In each case contracts could be redesigned to eliminate or weaken incentives to complete an unpromising merger, and strengthen incentives to support those which promise operating gains.

'If you are a fund manager holding an investment that attracts a bid at a 40 per cent premium, you'll vote to take it', observed Somerset-Webb (2017). 'Can't be bad for the performance numbers on which your bonus is based, can it? [...] Pointing out that short-termism in investment as a problem is not exactly new'. A major pensions provider has made a general argument against bonuses based on performance fees: 'Scottish Widows sees no evidence to suggest that performance fees improve customer outcomes' (Cumbo and Wiggins 2021). Eliminating them would weaken the perverse incentive to opt for the premium offered by the bidder now when retaining shares in the target would be in the shareholder's long-term interest.

As for the acquirer's advisers, we already noted the expert's recommendation in the parliamentary report on the failure of RBS after its acquisition of a large segment of ABN/AMRO: an independent assessment of the bid proposal should be made available to the board (and where appropriate to shareholders); and the advisers completing that assessment should not have a financial interest in the bid going ahead. Where different advisers were employed to help execute the deal, a conventional contracting device to align their interest with the acquirer shareholders' interests would be to defer any 'success fee', linking it to the post-merger performance of the acquirer.[10]

A similar prescription was offered at the parliamentary hearing for non-executive directors of the acquirer:

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assets internally can lead to lower reported profits than buying them in an acquisition.

9 And the acquirer's shares in cases where the acquirer's shareholders have a say, such as class 1 deals by listed companies in the UK.

10 Paying the cost of the advice in the meantime.

> there is a strong case for more substantial deferment of pay. I would include in that non-executive directors, so that related to some performance measure their fee [...] is not available to them, or in some part not available to them, for three or four years, by which time the company will have demonstrated success or failure.[11]

Replacing the NED's fixed salary with such an arrangement might encourage him to scrutinise prospective bids more critically, and take independent advice, rather than—as one NED we quoted in Chapter 4 put it—see his (highly paid) role at the board as just being to 'applaud' the CEO.

Two items of evidence about M&A that we emphasised in Chapters 1 and 2 were McKinsey's estimate that '70% fail', and Harford and Li's finding that 'even in mergers where bidding shareholders are worse off, bidding CEOs are better off three quarters of the time'. It is surely bizarre that in these circumstances some NEDs award large bonuses to executives just for carrying out an acquisition. It is not so bizarre that executives are frequently awarded a permanent rise in base salary for the increase in firm size resulting from M&A: the argument is that they carry heavier responsibilities (more employees to supervise, more assets to protect). But Chapter 2 discussed suggestions that M&A actually often lightened the burden of running the acquirer: it could secure a quieter life by eliminating challengers, and make the acquirer less vulnerable to becoming a target itself.

Greater reliance on deferred pay which is contingent on post-merger performance is likely to encourage fewer mergers that fail to produce operating gains—all the more so if accompanied by some of the measures outlined above to reduce rent extraction, and to limit the opportunities for executives to manipulate performance measures.

The list of proposed measures in Table 12.1 is diverse and daunting. But in a market with expenditure of several billion dollars a year the potential gains from even modest improvements in efficiency can be considerable. And the correctives suggested could also mitigate some of the highly regressive impacts of merger on income distribution—only touched on in this book, but explored in our forthcoming study, *Rising Inequality: The Contribution of Corporate Merger*. A wide range of measures

11 Sir David Walker in HoC 2012, para 88.

is needed because we are dealing with, as Phalippou put it, 'a complex environment riddled with multiple layers of agency conflicts' where 'misleading information does proliferate' (see Chapter 7). A central message of our book is that misaligned incentives, distorted financial engineering, and asymmetric information interact and cumulate to produce a dysfunctional market. But this is not to say that progress on a single front among these would not be worthwhile in its own right, as a partial advance. Equally, although our analysis indicates that the suggested measures taken together and well implemented give the prospect of significantly increasing efficiency in this market, still they may fall short of providing a complete remedy. For chief executives, for instance, some psychological enticements to undertake mergers that fail to yield operating gains might remain even if the major lure of winning enhanced pay is effectively constrained. As Collins (in Chapter 2) summed up the combination of inducements:

> 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*. [emphasis added]