CREATING OR DESTROYING VALUE THROUGH MERGERS AND ACQUISITIONS?

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Abstract: *The avalanche of operations performed and their specificities revealed several motivations for mergers and acquisitions However, although they are concluded with the purpose of value creation, reality has shown that in many cases it was exactly the opposite, these transactions led to value destruction. The paper aims to analyze the operations of mergers and acquisitions starting from the value theories, emphasizing their motivations and consequences regarding value creation. This is a theoretical research and we have used as a research method the qualitative approach in order to identify the motivations and the generating factors of mergers and acquisitions. Mergers and acquisitions can contribute to the creation of value, the main motivation being represented by the improvement of the economic performance of the new entity formed, by achievement of synergies, by increasing market power or by replacing inefficient management teams. However, the reality showed that these operations haven't always a beneficial role for the "health" of a company that wishes to adopt an external growth strategy. Analyzing from an opposite perspective, we emphasized the motivations underlying value destruction by mergers and acquisitions. The existence of conflicts of interest between managers and shareholders, of a free cash flow, the managers' desire to strengthen their position in the company to built an "empire" or even the pride and overconfidence of the managers regarding their abilities to create value are other reasons that underlie the occurrence of these operations.*

Keywords: mergers and acquisitions; value increasing theories; value destroying theories.

JEL classification: G32, G34.

1. Introduction

The research into the theories that represent the foundation of the operations of mergers and acquisitions reveals their multitude, but also the increased interest shown by the researchers in the field. The avalanche of operations performed and their specificities revealed several motivations for mergers and acquisitions However, although they are concluded with the purpose of value creation, reality has shown that in many cases it was exactly the opposite, these transactions led to value destruction. The paper aims to analyze the operations of mergers and acquisitions starting from the value theories, emphasizing their motivations and consequences. This is a theoretical research and we have used as a research method the qualitative approach in order to identify the motivations and the generating factors of mergers and acquisitions. The paper is organized as follows: in second section we analyze the motivations of mergers and acquisitions that are subordinated to the objective of creating value, in the third section we analyze the motivations that are based on subjectivity, the exacerbated ego of managers, the desire to maximize their own interests, and which, as a rule, have the effect of destroying value. In the final part of the paper we present the conclusions.

2. Creating value through mergers and acquisitions

Explanatory theories of mergers and acquisitions are numerous, but usually management teams of initiating corporations justify the opportunity of the operations by improving economic efficiency by various means. Thus, mergers and acquisitions can contribute to the creation of value, as the main motivation is represented by the improvement of the economic performance of the new entity formed.

2.1. Efficiency gains

According to efficiency theory, the operation of economic concentrations through mergers and acquisitions lead to increases in enterprises' economic efficiency through synergies as a result of the pooling of all tangible and intangible assets of the acquirer and of the target company. Mergers and acquisitions are made aiming to increase shareholder value by exploiting synergies between the entities participating in the operation. Regarding the definition of this concept, it can be noted that although the literature contains several definitions, all subscribe to the same view. Synergies correspond to an additional creation of value resulting from the combination of the companies targeted and which would not have been achieved without the actual realization of this combination (DePamphilis, 2010:6). The term "synergy" reflects the creation of an additional value through a process of cooperation between two entities, superior to the value existing prior to performing this process. According to many researchers, as Chatterjee (1986) and Trautwein (1990), synergies represent the fundamental reason for mergers and acquisitions.

The general sense is that mergers and acquisitions operations can generate three types of synergies: operational, financial and managerial.

Operational synergies are generated as a result of the grouping of companies and as a result of an efficient activity in the new company formed. These refer mainly to achieving economies of scale and scope, eliminating duplicate activities, renegotiating contracts with suppliers, reducing transaction costs. The gains of the new entity formed may result from revenue enhancing synergies or cost reduction synergies. Empirical studies have shown that operational synergies generate the biggest gains. Devos et al. (2009), analyzing a sample of 264 large mergers, estimated an average gain from the synergies generated of 10.3% from the combined value of the shares of the merged companies, of which 8.3% represent gains obtained through the operational synergies achieved.

Other studies have focused on the correlation between the type of operation (horizontal, vertical or conglomerate) and the type of synergies generated. Thus, Fee and Thomas (2004) and Shahrur (2005) showed that the most important synergies are generated within horizontal operations, the results of their studies showing that the operations record a positive value creation.

The financial synergies can also be generated from mergers or acquisitions and they can take many forms, such as, for example, increasing the indebtedness capacity of the new entity, reducing the level of risk to which the company is exposed, which can lead to greater stability of cash-flow (Lewellen, 1971), decreasing the probability of bankruptcy, minimizing the cost of access to capital markets or reducing the capital cost with increasing the size of the company (Luypaert and Huyghebaert, 2008; DePamphilis, 2010:7-8, Gaughan, 2011:143). Following the merger or the purchase, the new entity may stabilize its results and the offsetting of gains and losses can result in reduced losses and lowered risk of entering into default and bankruptcy.

The managerial synergies correspond to the transfer of knowledge, know-how or skills from the management team of the purchaser to that of the target company and vice versa. Managerial synergies are generated particularly when it is necessary to solve problems of strategic or organizational nature and the experience of the partner management team can help in this regard.

2.2. Market power

Along with the efficiency theory that propose synergies as the main motivation for mergers and acquisitions, the market power theory propose, as a motivator factor for these operations, the strengthening or enhancing the market power of the companies, which is reflected in the ability of a company to set the selling price of products and/or to increase its profit margin and benefits.
Market power theory suggests that firms merge or acquire other entities in order to increase the monopoly power and thus to set the products and services' prices at an unsustainable level in a competitive market (DePamphilis, 2010:12). Horizontal operations lead to an increase in market power due to the increase of industry concentration. Thus, horizontal operations can lead to a limitation of outputs and an increase of the products and services' prices or a decrease of the input' prices (Rau, 2008:235). The costs in terms of social welfare resulting from an increase in the concentration can not be ignored. If the market structure approaches to a form of monopoly, they can be significant (Gaughan, 2011:158).
The empirical studies focused on this topic provide information that are quite divergent. Thus, while some studies provide empirical support for the hypothesis of the increase in market power as a motivation and consequence of performing the transactions of mergers and acquisitions, many studies challenge this hypothesis. Some research shows that mergers and acquisitions transactions determine an improvement of the operational efficiency rather than an increase in market power. The empirical studies of Eckbo (1983) or Sharma and Thistle (1996) reject the hypothesis of an increase in market power after mergers and acquisitions. The ideas promoted by these researchers are supported by the findings of Shahrur (2005), which concluded that the motivations of the horizontal operations are related rather to efficiency, rather than to an increase in market power. On the other hand, the study by Kim and Singal (1993) found that market power led to certain efficiency gains. Snyder (1998) argues that horizontal operations increase the bargaining power of firms in relation to suppliers, which, if the supplier's market is relatively concentrated, can lead to lower purchase price of inputs. The same idea is supported by the Fee and Thomas (2004) after analyzing a large number of horizontal operations carried out during 1980-1997.
A variety of operations aim to improve the competitive position of the company initiating the merger or acquisition by exploiting or capitalizing the strengths of the target company, which will allow changing the rules of the game in its favor.

2.3. Disciplinary takeovers: the market for corporate control

Another motivation for conducting mergers and acquisitions in order to create value is related to managerial discipline reasons and argues that the most efficient actors of a sector tend to acquire the less performant. The theory suggests that if a firm is undervalued due to inefficient management, a management team from another company will take over the business, which has not reached the desired performance parameters, and will replace the managers. Moreover, Manne (1965), who proposed this theory, argued that mergers and acquisitions promote competition between different management teams in terms of competences and results obtained. Managers who create the most value for shareholders will take the lead of a business until a new management team will be able to create a greater value for shareholders, to further improve the performance of the assets and to maximize the profits of the enterprise.
By takeovers, managers who pursue their own interests or are incompetent will be removed and replaced with more competent and efficient teams. Manne (1965) finds that mergers are a way to transfer resources (reallocation of assets) in the hands of those who can best manage them in order to improve the performance of assets. According to Manne (1965) the share price of a company run by an inefficient management team will be lower, which makes it an attractive target for those who are able to manage it more effectively under the principles of profitable growth.

According to this theory, synergies arise from the use of the skills and competences of the management team of the purchaser in managing the tangible and intangible assets of the target company. Also, if a company performs badly, it requires a reallocation of assets, which are obviously underutilized, to the management teams that have proven their effectiveness. Jensen and Ruback (1983) expressed metaphorically the takeover motivations, claiming that the market for corporate control can be seen as an arena in which managerial teams compete for the right to manage corporate resources.

3. Destroying value through mergers and acquisitions

The study of the literature highlights the complexity of mergers and acquisitions transactions with consideration to the multitude of issues that we have identified as a result of their being studied within international research. Although the main motivation for mergers and acquisitions is represented by the improvement of the firms' economic performance, the reality showed that these operations did not achieve the desired performance and they were rather utter failures. In the following we will try to understand why we are witnessing at many failures of these operations. Are there unrealistic or subjective motivations that lead to a deviation from the goal of creating value?

3.1. Agency costs

This theory focuses on the need for business owners to monitor managers in order to prevent and limit potential opportunistic behavior of the management team (Jensen and Meckling, 1976; Fama, 1980; Nicholson and Kiel, 2007). In the view of the agency theory the enterprise is perceived as an actual "nexus of contracts" in which individuals act rationally, have diverging interests, detain distinct pieces of information and seek to maximize their own interests. Basically, this theory focuses on the relationship shareholders - managers, relationship which is considered the generating factor of conflicts of interest because, as a rule, problems occur in the context of separation between ownership and control. Jensen and Meckling (1976) studied the managers' opportunistic behavior and also their tendency to maximize their own interests at the expense of the owners'. This behavior reflects the lack of managerial ethics, i.e. a situation when managers knowingly cheat.

Agency theory explains the relationships between the principal (shareholders) and agent (managers) and it is based on the assumption that every individual seeks to maximize his/her own utility. As a result, between principal and agent a conflict of interest can arise which may develop if the decisions made by the agent (managers) in order to maximize their own utility, does not at the same time maximize the utility for the principal (shareholders).

According to agency theory the mergers and acquisitions transactions can be a result of the conflict between shareholders and managers, the latter wishing to increase the organization and minimize risk, while the former, the shareholders, wish to maximize gains (Jensen, 1986). Mergers and acquisitions operations whose main motivation is the desire of managers to meet their own interests do not create value but, on the contrary, by increasing the company beyond its optimal size, they lead to the destruction of the firm's value.

3.2. Free cash flow

This theory is originated in the agency theory and it promotes the idea that at the origin of mergers and acquisitions transactions there are the agency costs related to conflict of interest between shareholders and managers regarding the free cash flow. This theory was stated by Jensen (1986), who defined the concept of free cash flow as being the surplus of cash existing in the company after all projects with a positive net present value have been financed. Martynova and Renneboog (2008) state that the existence of a large amount of

liquidity makes managers bolder with respect to their actions and more likely to undertake value-destroying operations at the expense of those creating value. From this perspective, managers of an enterprise that has a significant cash flow may be tempted to use these resources to make various irrational expenses or to initiate operations of mergers and acquisitions, some of which prove economically unprofitable. Assuming the existence of significant cash flows, this theory claims that managers are more likely to use them to finance mergers and acquisitions operations that will not create value or will lead to the destruction of shareholder value. Again, we are talking about the same conflictual situation when managers do not pursue the maximization of shareholder wealth.
In the literature we find other studies that confirm the hypotheses of the theory of the free cash flow. Thus, Lang et al. (1991), Harford (1999) or Lin et al. (2013) showed that purchasers who have significant cash flow make transactions which destroy value, a fact that is reflected by the decrease in business performance and in shareholders' earnings. As seen in each motivational theory of mergers and acquisitions, there are also researchers that found no evidence to support the hypothesis of the free cash flow claimed by Jensen (1986). In this regard, we mention the empirical studies of Gregory (2005), Luypaert and Huyghebaert (2008) or Gao (2011).

3.3. Management entrenchment

Management entrenchment theory is also based on the conflicts of interest between shareholders and managers who, contrary to the purpose for which they were appointed to these positions, namely maximizing shareholder value, use company resources for personal purposes. This theory was proposed by Shleifer and Vishny (1989) as being the process which enables managers to challenge the authority of the board of shareholders, in order to manage their company towards maximizing their own utility function and in a direction quite opposite to the maximization of shareholder value. The entrenchment of managers occurs due to specific investments that make it difficult and expensive to replace them and make it possible for them to obtain greater benefits.
The link between this theory and the operations of mergers and acquisitions is easy to guess given that these operations are actually investments that companies make on long-term, in order to create value. The financial benefits of the managers, and those with respect to power and prestige, are correlated with the company's size (Masulis et al., 2006), and from this perspective, the managers can consider mergers and acquisitions as perfect instruments that can allow them to achieve this goal and thus, by which they may enjoy all these benefits, even with the risk of making investments that will prove unprofitable (Morck et al., 1990).
Mergers and acquisitions correspond to the view of management entrenchment and to the minimization of the risk of managers' replacement from their position, but, as demonstrated in the literature, the transactions based on this reason (and which often involve acquisitions that were much too expensive) fail to create value. Bebchuk et al. (2009) analyzed the correlation between shares returns and the management entrenchment and found that they are negatively correlated, shares yields of the companies decreased significantly when their managers' positions strengthened.

3.4. Managerial discretion

This theory states that managers are concerned about increasing the size of the company they run in order to build real "empires". In many cases managers' compensations are directly related to the size of the company, so they are ambitious to increase it, and a quick way is represented by mergers and acquisitions.
Contrary to the objective of making investments that shall maximize shareholder value, we speak rather of a management of the company in an opposite sense, subordinate to the desire of increasing the "empire" (Morck et al., 1990) even with a view to prevent own companies from becoming themselves acquired (Gorton et al., 2005), of an increase in

remuneration or an increase in the prestige and a strengthening of the status.
Masulis et al. (2006) also argue that managers are sometimes motivated to acquire other businesses to strengthen their influence, convinced that it depends on the size of the company they run.

3.5. Managerial hubris

The managerial hubris theory proposes another explanation for mergers and acquisitions. The theory was proposed by Richard Roll (1986) and fit the idea that these operations have as a motivation a too great pride and confidence of managers in their abilities to perform operations that generate synergies and create shareholder value. The theory is validated and supported also by empirical studies performed by Berkovitch and Narayanan (1993); Seth et al. (2000); Goergen and Renneboog (2004) or Billet and Qian (2007).
The teory refers to those managers who are affected by the so-called hubris or ego syndrome and who have a truncated vision of reality. Thus, although the managers' intentions would coincide with the shareholders' desire to maximize wealth, their pride can lead to an overestimation of the target company (Hayward and Hambrick, 1997; Malmendier and Tate, 2008), and the main beneficiaries will be the shareholders of the latter. The payment of too high acquisition premiums may be associated with the ego syndrome, as demonstrated by Hayward and Hambrick (1997), while Morck et al. (1990) shows that strong companies whose managers are likely to be affected by this syndrome, perform the most inefficient operations.
The ego syndrome is a contributor to the so-called "winner's curse". Multiple bids for the same target company can result in a purchaser finding himself not in the winning position but, rather, in that of a loser. The existence of several bidders may compel the actual purchaser to pay a purchase premium that is too large and thus the value created can be annihilated, leading to the destruction of shareholder value.

4. Conclusions

An important aspect regarding the mergers and acquisitions operations, on which we focused in this paper, is represented by the identification of the motivations underlying these operations, especially since many of the empirical studies on the performance of the operations challenge their beneficial role for the "health" of a company that wishes to adopt an external growth strategy.
The research into the literature enabled us to identify multiple theories that underpin the achievement of mergers and acquisitions in order to explain why such operations take place. According to the theories that support the contribution of mergers and acquisitions to value creation, the main reason is the increase in the economic performance of the newly formed entity. However, the results of the empirical studies show that these operations are rather well-known failures. Thus, other theories that justify the implementation of such operations were outlined. The existence of conflicts of interest between managers and shareholders, of a free cash flow, the managers' desire to strengthen their position in the company to built an "empire" or even the pride and overconfidence of the managers regarding their abilities to create value are other reasons that underlie the occurrence of these operations.
In light of the value destruction theories, after mergers and acquisitions, a transfer of wealth may result, from shareholders towards managers, or, according to the hypothesis of the free cash flow theory or of the managerial hubris theory, the transfer of wealth is done from the shareholders of the acquirer towards the shareholders of the target company.

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