CONCEPTUAL APPROACHES ON VALUE CREATION IN MERGERS AND ACQUISITION

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ABSTRACT: *Due to increased competition and increased globalization the economic environment has changed in recent years and in light of this, the challenges a company faces have become larger and more demanding. Over time, a wide range of empirical studies have been performed in order to determine if M&A transactions create value. This paper is to give a perspective of some of the studies performed and to evaluate the effects of mergers and acquisitions, as well as illustrating the evidence of value creation.*

KEY WORDS: *value creation, mergers and acquisitions, synergy, value*.

JEL CLASSIFICATION: *G24, G32.*

1. INTRODUCTION

There is a wealth of literature on M&As in general, but limited writings specifically on synergy in M&As. Sources of value in mergers and acquisitions are extensively investigated in literature on M&As. Until now it is not clear that how M&As create or destroy value. Literature provides evidence that shows combined market reaction to acquisition announcements is positive on average, suggesting that mergers create value for shareholders of the merging firms. Prior studies generally focus on the operating synergies gained from acquisitions. The overall motive for the acquirer is value creation and in the light of increasing M&A activity it is relevant to examine whether or not value is created. No overall consensus exists that unanimously documents whether or not value is created for the acquiring firm.

Moeller & Schlingemann 2005 have concluded that value is actually destroyed when engaging in acquisitions. The reason for this conclusion is imputed to the fact that the largest M&As are the ones experiencing massive losses. A part from the 'large loss deals' the remaining companies actually experience gains from M&A. The

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conclusions from this paper are based on US companies and have not yet been fully explored on European companies.

Companies engaging in mergers and acquisitions can be motivated by several different objectives, some of the most obvious as presented by (Sudarsanam 2003) are synergies, increased growth, cost savings and increased efficiency. Apart from these more apparent motives might also include decreased transaction costs, increased knowledge or so forth. Besides the motive for a company to engage in mergers or acquisitions the type of industry in which the company operates also affect the type of merger. The motive for the acquisition in the case of a mature industry could be far different from the motive dominating an immature industry. In paying attention to the motive that drives the acquisition and the industry in which the acquirer operates emphasize the importance of the strategic rationale for a merger or an acquisition.

It is widely recognized that it is decisive for a company to set up a strategy in order to meet the challenges it faces due to a fierce competition and a quickly changing environment. The strategy a company chooses to follow should be in line with an overall goal of value creation. A decision to expand through acquisitions has to correspond to the underlying strategy of the company.

2. VALUE CREATION

The definitive test of corporate strategies is whether they create value for the shareholders of the company. When referring to value creation it is the extent to which the return of an investment over a period of time exceeds the cost of capital for that investment. Investments in the interests of shareholders have changed over time from “retain and invest” to “downsize and distribute”, and recently to “creating shareholder value”. This change has been spurred by changing industry conditions, competition, internationalisation, the influence of institutional investors, and the innovation of hostile takeovers in the 1980s.

The Cycles of M&A, the frequency and value of transactions have increased significantly over decades. As such, due to the risk of destroying shareholder value, it is important to recognize the importance of value creation. Also, not only the increased frequency and size of transactions emphasise the importance of success, but also, M&A is one of the most extensive initiatives pursued which may change the economic and organizational structure of the company extensively. As such, negative outcomes can have a substantial effect. Although corporations should act in the interest of its shareholders it is important to recognize that the objectives of managers may differ from that of shareholders as managers act, as other people, in their self-interest (Rappaport 1986).

The discussion has consequently imposed focus on the conflicts of interest between managers and shareholders. This is also known as the principal-agent theory which requires monitoring of managers by shareholders - this is, however, hardly feasible. As presented by (Parvinen 2003), information asymmetries and limited incentives cause managers to act in their own interest. This issue raises the need for incentive systems that motivate managers and create incentives for them to act in the interest of shareholders. The composition of the right incentive system is extensive and outside the scope of this project. Therefore, no further examination of this topic is carried out.

3. SYNERGIES

Synergy originates from the Greek word *synergos* (Campbell & Goold 1998) which means working together and achieve more than separately. In popular terms, synergy is defined as 1 + 1 = 3 since synergies are business measures that increase the value of the combined business entity more than the sum of its separate units. This section discusses synergistic theory, the valuation of synergies, and ends with a short examination of potential pitfalls of synergies.

A wide range of academics discuss the various types of synergy (e.g. Campbell & Goold 1998; Bradley et al. 1988). For the following determination and discussion, three groupings of typologies of synergies have been selected based on four authors' definitions.

Tabel 1. Overview of authors framing synergy typologies

Patrick A. Gaughan	Michael A. Hitt	Alfred Rappaport / Erik Devos et al
- Operational - Financial	- Operational - Financial - Managerial	- Market - Poweroperational - Financial - tax shields

First, (Gaughan 2007) presents operational and financial synergy. According to Gaughan, operational synergy appears in the form of revenue enhancements and cost reductions. Financial synergy is achieved when the cost of capital may be reduced through the combination of two companies.

Second, (Hitt 2001) presents three components of synergy; operational, financial, and managerial synergies. Operational synergy is achieved when the cash flow from operations is improved whereas financial synergy is achieved by interest tax shields, the change in capital structure, and financing. Managerial synergy is created when additional value is created through the decision makers' ability to integrate the two companies and create competitive advantage.

Operational synergy is achieved through scale economies and financial synergy is created by the mean of reducing risk and lowering the cost of capital. Finally, tax shields are created from increased interests of the combined entity.

From the above presentation of different definitions of synergy, operational and financial synergies are present within all three frameworks. However, the financial determination of synergies is inconsistent with the market efficiency theory and should as such not be feasible as argued by (Mandelker 1974) and further supported by (Devos et al. 2009) who present that an insignificant number of transactions are due to financial synergies and emphasise therefore operational synergies as drivers of value creation.

4. VALUATION OF SYNERGIES

The potential synergies are the basis for the acquisition premium paid. The total synergistic gain of a successful transaction is described as the change in the wealth of the shareholders of the target firm (ΔW_T) plus the change in the wealth of shareholders of the acquiring firm (ΔW_A) (Bradley et al., 1988):

$$\Delta \Pi = \Delta W_T + \Delta W_A, \qquad (1)$$

Paying too high a premium entail failure of the acquisition if the advantages achieved through the acquisition do not exceed the premium paid (Kode, G.V.M.Ford, J.C.Sutherland 2003). Companies must strive to achieve synergies higher than the premium paid or at least achieve positive synergies (Sirower & O’Byrne 1998).

The valuation and assessment of synergies and thus the premium paid for a company is an essential part of the transaction. Therefore, this section is to discuss the methods of valuating synergies in order to examine a feasible technique to justify the premium paid. Also, the Winner’s Curse will be discussed. The risk of overpaying requires managers to pay even greater attention to the valuation ofsynergies as they, as presented above, are a part of the justification of the acquisition price. Synergies are usually valuated by using the Discounted Cash Flow method.

The combination of the DCF method and the Monte Carlo model gives the user the possibility to assess several outcomes of the transaction and come as close as possible to a reasonable price to pay for the company. When assessing the various cases of potential synergies, the company is able to create a spread which it can move within under the negotiations of the price to be paid. The advantages of having a precise assessment and valuation of synergies enables the company to come as close as possible to the target’s stand alone value and hence capture most value (Kode et al, 2003).

When the combination of two companies incur higher costs or lower revenue the combination is said to create negative synergies which is equal to pure value destruction. The value is not only destroyed; competitors get the opportunity for strengthening their position against the acquiring business (Sirower, 1997). In the case of negative synergies due to diseconomies of scale or other costs the initial combination may be divested when companies experience that they cannot operate efficiently as one big company (Fulghieri & Hodrick 2006).

Overall, the foundation of the transaction, the evaluation of synergies, and management are elements of the three approaches to synergy realization. Overall, management is a systematic element of the integration process and therefore, the arrows to the other elements should illustrate management as an overlying crossbar influencing the other aspects of synergy realization. If the above identified elements are given a great deal of attention, the realization of synergies should, theoretically, be possible and hence create value in the merged entity.

5. CONCLUSION

M&A activity has varied over the last century and has been influenced by general economic and financial conditions. Although the efficiency theory was not deemed as the most plausible motive of mergers, academics argue otherwise. Over the years, corporations have changed their perspectives on value creation and value creation for the company's shareholders is now in focus. The mounting value and frequency of M&A place even greater attention on value creation.

Two main types of synergies; cost and revenue, were determined. The premium paid in a deal is highly connected to potential synergies and synergy valuation is of significant importance as it reduces the risk of overpaying and the risk of suffering under the Winner's Curse. Finally, pitfalls of synergies; negative synergies, and the contagion and capacity effects were discussed in order to raise the awareness of potential downsides of synergy achievement.

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