

MERGERS AND TENDER OFFERS: A REVIEW OF THE LITERATURE

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I. Introduction

Mergers and tender offers are one of the most researched areas in finance. However, some basic issues still remain unresolved. Most empirical research focuses on daily stock returns surrounding announcement dates. There are fewer studies that look at the long-run performance of acquiring firms after merger.

“Many researchers have addressed the question of wealth gains from acquisitions. They typically find three patterns: (i) target shareholders earn significantly positive abnormal returns from all acquisitions, (ii) acquiring shareholders earn little or no abnormal returns from tender offers, and (iii) acquiring shareholders earn negative abnormal returns from mergers. The evidence is usually based on returns computed over a pre-acquisition period starting immediately before the announcement date and ending on or before the effective date.” (Loughran and Vijh (1997)).

II. Mergers vs. Tender Offers - General Results

A merger is a transaction in which the acquirer secures title to the outstanding shares or assets of the target firm. The merger proposal must be approved by the board of directors of the target firm. Then, stockholders must vote to approve or reject any merger proposals that management recommended. However, stockholders do not get an opportunity to approve merger proposals that managers reject. Usually merger proposals involve an offer to purchase the target shares at a price substantially above the pre-proposal market price and stockholders of acquired firms receive large capital gains in mergers. Unlike mergers, tender offers do not involve the veto power of incumbent management. In tender offers, the acquirer invites target shareholders to tender their shares for a specified amount of cash or securities. The decision to accept or reject the offer is made by each individual stockholder and the success or failure of the offer depends on the proportion of stockholders tendering their shares.

A. Abnormal Returns for the Shareholders of Target Firms

Most of the studies show that target firms earn significant abnormal positive returns on the day of the announcement of the proposal.

Examining the pre-merger time period for the merging firms, Langetieg (1978) finds the target firms to have significantly negative average cumulative abnormal returns over time interval (-72, -19) and significantly positive stockholder gain, averaging 10.7%, over time interval (-6, -1). It is argued that the negative pre-acquisition abnormal return is an indication of an inefficient management in the target firm.

Dodd (1980) uses a data set of 151 merger proposals from 1970-1977, which includes all completed mergers and all proposals that were later canceled. For the sample of merger proposals, one event under analysis is the announcement of the proposal. The abnormal performance of these firms relative to the date of first public announcement is calculated using the market model. His results show the large positive abnormal return earned by stockholders of the target firms on the day of the announcement of the proposal and the day before. The market reaction to the announcement is represented by the 2 day abnormal return at days -1 and 0. The average abnormal return on day 0 is 4.30% and on day -1 is 8.74%, with *t* statistics of 11.71 and 23.80, respectively. Stockholders of target firms in both completed and canceled merger proposals earn large, positive abnormal returns on the day of first public announcement of the proposal. The final approval of the merger by stockholders has little impact. The mean cumulative abnormal return from the date of first announcement of the proposal until final approval by stockholders is 11.20%. On the day of publication of the termination announcement, day 0, stockholders of target firms earn a negative abnormal returns of -4.52% and -4.16% on day -1.

Dodd and Ruback (1977) report that target firm stockholders earn large and significant positive abnormal returns of 20.58% for successful offers and 18.96% for unsuccessful offers in the month of the first public announcement of the tender offer.

Franks, Harris, and Titman (1991) study 399 U.S. takeovers from 1975 to 1984. For the entire sample, targets experience substantial announcement gains averaging 28%.

Jensen and Ruback (1983) summarize thirteen studies up to that date. Results indicate that target of successful takeover attempts realize substantial and significant increases in their stock prices, ranging from 16.7% to 34.1%, in the announcement month. In mergers, unsuccessful target returns tend to fall back after the termination announcement. In contrast to the behavior of stock prices of targets of unsuccessful mergers, stock prices of targets of unsuccessful tender offers remain substantially above their pre-offer level. However, those targets of unsuccessful tender offers that do not receive additional offers in the next two years lose all previous announcement gains.

B. Abnormal Returns for the Shareholders of Acquiring Firms

Results to the question whether acquiring firm shareholders are better off after an acquisition than they were before are not all one-sided. While some studies report insignificant abnormal returns, others report significant negative abnormal returns.

Langetieg (1978) employs four alternative two-factor market-industry models in combination with a matched non-merging control group. He reports that the cumulative excess return over the time interval (-72, -7) for the acquiring firms is significantly positive. This positive pre-merger excess return might be interpreted as a motivating factor for the merger. However, he finds that post-merger abnormal performance is not significantly different from that of a control firm in the same industry. Dodd and Ruback (1977) also find evidence that for the twelve months prior to the tender offer, stockholders of acquiring firms earn significant positive abnormal returns. They find that in the month of the offer, only successful acquiring firms earn large positive abnormal returns. They report that the stockholders of acquiring firms which initiate unsuccessful tender offers neither gain nor lose. Franks, Harris, and Titman (1991) examine whether the negative abnormal returns found in prior studies are due to an incorrect adjustment for risk. The portfolio performance evaluation literature emphasizes that correctly adjusting returns for risk requires a benchmark that is mean-variance efficient. They evaluate post-merger performance with efficient multi-factor benchmarks. Acquirer returns are examined using monthly data beginning the month after the final bid date in order to avoid picking up share price reactions in the final bid month. They suggest that using equally-weighted index confirm negative post-merger performance, however this result is not robust to the choice of the benchmark; the value-weighted benchmark yielded positive post-merger performance. Their results exhibit no statistically significant abnormal performance for the acquiring firms. Jensen and Ruback (1983) find evidence of positive returns to successful acquiring firms in tender offers and generally negative returns to unsuccessful acquiring firms in both mergers and tender offers. They argue that results are mixed because the measurement of returns to acquiring firms in mergers is difficult.

On the other side of the debate, Agrawal, Jaffe, and Mandelker (1992) find that stockholders of acquiring firms suffer a statistical significant loss of about 10% over the five-year post-merger period. They use data from 1955 to 1987 and a model that was adjusted for the firm size effect and beta risk. The cumulative average abnormal returns (CAARs) are significantly negative for holding periods of two, three, four, and five years. For the five-year period the CAAR is -10.26% ($t=-2.37$). In addition, results of 10 years of post-merger data indicate that the abnormal returns level off after the fifth year.

Loughran and Vijh (1997) argues that the methodology of Franks, Harris, and Titman (1991) and Agrawal, Jaffe, and Mandelker (1992) may be considered

equivalent to forming equally weighted portfolios of sample companies in event time and rebalancing portfolios every month. Monthly rebalanced returns may not be a good estimate of how a buy-and-hold strategy performs over five years. Reluctance to sell shares and incur capital gains taxes is often cited as a motive in stock mergers, which makes rebalancing a less likely description of the usual portfolio strategy in cases where the acquirer's stock is used for payment. A rebalancing strategy also incurs excessive transaction costs. Loughran and Vijh therefore measure abnormal returns by the difference between five-year holding period returns of sample stocks and matching stocks (chosen to control for size and book-to-market effects). The average return difference between the mergers and matching firms -15.9% (*t* statistics -2.36). The average return difference between tender offers and matching firms is 43.0% (*t* statistics 1.67). The evidence suggests that mergers underperform matching firms whereas tender offers outperform matching firms.

C. Combining Pre- and Post-Acquisition Period

Most of the studies do not report the overall wealth gains by combining the pre- and post-acquisition period. Loughran and Vijh (1997) examine the cumulative abnormal returns from holding the target stock from two days before the first announcement date to effective date and then rolling over the proceeds for another five years by investing in the acquirer's stock. On average, the target shareholders who follow this strategy do not earn significantly positive excess returns from stock acquisitions. Some of their earlier gains are reversed and remaining is not significant. In the two diagonal cases of stock mergers and cash tender offers, the target shareholders earn, on average, 14.9 and 138.3% more than matching stocks over the combined pre-acquisition and post-acquisition period.

III. Where Does the Difference in Acquiring Firms' Results Come From?

There is a debate over whether the acquiring firm stockholders earn abnormal negative returns or the abnormal results are insignificant. Some possible explanations from the literature are as follows:

A. Beta Risk and Firm Size Effect

Agrawal, Jaffe, and Mandelker (1992) argue that prior studies do not properly adjust for the firm size effect. Evidence in Dimson and Marsh (1986) suggests that an adjustment for firm size is important in studies of long-run performance. This adjustment is likely to be particularly important in a study of mergers since acquirers are usually large firms. The resulting bias can be significant when abnormal returns are cumulated over a long period. Over 60% of Agrawal, Jaffe, and Mandelker's sample of acquiring firms clustered in the top

deciles of the population of firms on the NYSE. They adjust for both beta risk and size by forming a set of size control groups. Their result showed a -10% post-merger abnormal performance.

Franks, Harris, and Titman (1991) also used a size-adjusted method and used ten-factor and eight-portfolio benchmark. Their results show that smaller firms clearly outperform larger firms by 1.62% per month. However, their findings suggest no significant abnormal returns for the acquiring firms.

Even though adjusting for size is a good approach, it does not explain much the different results. Using changing β over time, as applied by Agrawal, Jaffe, and Mandelker (1992) is also a good approach since we know that risk changes over time. This is important especially in the merger event studies because after a merger acquiring firm's riskiness should change substantially.

B. Different Time Periods Used in the Studies

After testing the results of their findings for the subperiods, Agrawal, Jaffe, and Mandelker (1992) find interesting results. They originally used data from January 1955 to December 1987, and find -10% negative cumulative abnormal returns for the five-year period after the mergers. They first examine whether the underperformance is limited to acquisitions over certain time periods. They subdivide the sample into five subperiods: (1) the fifties, (2) the sixties, (3) the seventies, (4) the eighties, and (5) 1975-1984 sample period of Franks, Harris, and Titman (1991). There is a distinct difference between the performance in the decade of the seventies and the other decades. In the fifties, the sixties, and eighties, the CAARs are significantly negative. During these decades, the average investor lost about 15% to 23% of their investment over the five years after the merger. However, in the seventies, the CAARs are insignificant. The post-merger performance over the 1975-1984 time period, used by Franks, Harris, and Titman, shows no abnormal performance during this time period, a result consistent with that of Franks, Harris, and Titman. It is shown that 1975 to 1979 is the only five-year period when the post-merger performance is significantly positive. This period constitutes one half of Franks, Harris, and Titman's sample. Over the remainder of their sample period, 1980 to 1984, the post-merger performance is significantly negative. Thus, the performance over the combined period, 1975 to 1984, is insignificant. Agrawal, Jaffe, and Mandelker conclude that Franks, Harris, and Titman's results are specific to their sample period.

C. Value-Weighted Index vs. Equal-Weighted Index

Franks, Harris, and Titman (1991) find that the value-weighted index generates significant positive post-merger abnormal performance of over 0.3% per month, whereas the equally-weighted index generates monthly abnormal performance of about -0.2%. So, selection of the index also might effect the results

significantly. Again, taking the Agrawal, Jaffe, and Mandelker's comment about the sample period used by Franks, Harris, and Titman, this index selection criteria requires further research.

D. Mean-Reversion Effect

Even though there are not enough studies or evidence, one possible explanation might be mean-reversion. Studies showed negative abnormal returns for the target firms well before the merger or tender offer announcements and positive abnormal returns at and after the announcement date. This is consistent with the value-maximizing hypothesis on the target firm size. However value-maximizing hypothesis is not consistent with the negative abnormal returns of the acquiring firms. Acquiring firms show significant positive abnormal returns before the mergers. Since the risk is increasing, even if there is higher probability of positive abnormal return for the acquiring firm shareholders, and there is already high abnormal return pattern, mean-reversion effects may cause abnormal returns to decrease and even become negative for acquiring firms. The results may differ because of the magnitude of the mean-reversion effect.

Agrawal, Jaffe, and Mandelker's (1992) results indicate that, using up to 10 years of post-merger data, the abnormal returns level off after the fifth year. This might also be result of the mean-reversion. So, some future research might be focused on this issue.

IV. Some Other Aspects of the Mergers and Tender Offers

A. Post-Merger Operating Cash Flow Return

Healy, Palepu, and Ruback (1992) examine post-acquisition performance for the 50 largest U.S. mergers between 1979 and mid-1984. Merged firms show significant improvements in asset productivity relative to their industries, leading to higher operating cash flow returns. There is an agreement that target stockholders benefit from mergers, as evidenced by the premium they receive for selling their shares. Their results indicate that acquiring firms generally breakeven, and that the combined equity value of the acquiring firms and target firms increases as a result of takeovers. Healy, Palepu, and Ruback argue that these increases in equity values are typically attributed to some unmeasured source of real economic gains, such as synergy.

They use industry performance as a benchmark to evaluate post-merger performance. Results show that the merged firms have increases in post-merger operating cash flow returns in comparison with their industries. These increases arise from post-merger improvements in asset productivity. They find no evidence that the improvement in post-merger cash flow is achieved at the expense of the merged firms' long-term viability, since the sample firms maintain their capital

expenditure and R&D rates in relation to their industries. Healy, Palepu, and Ruback's results differ from the findings reported by Ravenscraft and Scherer (1987) and Herman and Lowenstein (1988), who examine earnings performance after takeovers and conclude that merged firms have no operating improvements.

Because recent studies show negative abnormal returns for acquiring firms' stocks, Healy, Palepu, and Ruback's results of positive cash flow returns are questionable. They also contradict with other studies. Maybe the reason for this contradiction is the small sample size (50 merging firms) and short-time interval (1979-1984). Interestingly, this time interval is close to the 1975-1984 sample period of Franks, Harris, and Titman (1991). Since this sample period represents some anomalies as argued by Agrawal, Jaffe, and Mandelker (1992), positive post-announcement abnormal cash flow returns might not be generalized.

B. Mode of Acquisitions

Mergers are usually friendly deals that enjoy the cooperation of incumbent managers. Tender offers are made directly to target shareholders, often resulting resistance from incumbent managers. Some studies examine the abnormal returns when the takeover is hostile or friendly.

Kummer and Hoffmeister (1978) use monthly rate of returns for 1958-1974, and consider only cash tender offers. The sample of 88 target firms indicates that firms subject to takeover experience abnormally low returns prior to the announcement of the attempted takeover. The CAAR is -0.094 up to 3 months prior to the take-over announcement. The average abnormal return (AAR) displays slightly positive values in months -2 and -1 with the largest shift occurring in the announcement month, 0.1868. Passive-successful takeovers follow a similar pattern as the overall sample. However, the magnitude of the CAARs is not as great as the overall sample. In the resisted-unsuccessful takeovers, the pre-announcement CAARs are greater in absolute magnitude than both the overall and successive-passive categories. The behavior of the CAARs reflects the capital market participant's assessment of the probable success of the tender offer. In other words, the positive reaction of the announcement is met with negative returns when the market perceives the tender will be resisted and subsequently unsuccessful. However, the CAARs do not return to their pre-announcement level which may reflect the likelihood of an eventual take-over by a friendly firm or a change in policy by the target firm. Resisted-successful takeovers display a downward trend in the level of CAARs prior to the announcement month. Over the -24 months to -3 months the magnitude of the downward shift appears greater than the observed shift for the passive subsample. The findings support the contention that firms subject to takeovers have experienced abnormally low returns prior to a take-over announcement. Kummer and Hoffmeister suggest that the abnormally low returns are reflective of unrealized gains subject to the replacement

of incumbent management. The takeover of these firms is consistent with a competitive marketplace for corporate control that leads to the efficient utilization of corporate resources.

Healy, Palepu, and Ruback (1992) also test whether post-merger performance differs for hostile and friendly transactions. They do not find any evidence of post-merger cash flow performance or merger-related abnormal stock return differences among any of these transaction types.

Loughran and Vijh (1997) also test this issue by looking at the mergers versus tender offers, which are mostly resisted. They find that acquiring firms that make merger bids earn, on average, 15.9% less than matching firms whereas acquiring firms that make tender offers earn 43.0% more than matching firms during a five-year period after acquisition.

C. The Medium of Exchange

An acquirer must determine the medium of exchange of the offer in takeovers, that is, whether the payment will be in form of cash, debt, equity, or some combination. With symmetric information, no transaction costs, and no taxes, the medium of exchange is irrelevant. However, this is not the case. Many reasons influence the method of payment in corporate acquisitions. These reasons include characteristics of the acquirer and target firms and characteristics of the environment.

Martin (1996) notes that tender offers tend to be cash financed. His results support the idea that higher acquiring firm investment opportunities lead to an increased use of stock financing in corporate acquisitions. Other results indicate a nonlinear relationship between acquiring firm management ownership and probability of stock financing. Higher ownership between 5% and 25% implies a lower probability of stock financing. This result is attributable to the dilution of control that managers would suffer. Acquiring firms that have lower cash balances relative to the price of the acquisition tend to use stock financing.

Loughran and Vijh (1997) argue that firms will issue stock only when it is overvalued and that firms will prefer to pay cash if their stocks are undervalued. They show that stock acquirers earn 24.2% less than matching firms whereas cash acquirers earn 18.5% more than matching firms.

Agrawal, Jaffe, and Mandelker (1992) note that in both tender offers and mergers, post-acquisition returns are lower for stock-financed acquisitions than for cash-financed acquisitions.

Hansen (1987) presents a theory for the choice of exchange medium in mergers and acquisitions. It assumes that when a target firm knows its value better than a potential acquirer, the acquirer will prefer to offer stock, which has desirable contingent-pricing characteristics, rather than cash.

Eckbo, Giammarino, and Heinkel (1990) provide both a theoretical and empirical analysis of the payment method. They develop a model which holds that two-sided information asymmetries between the acquirer and target firms can lead to an optimal mix of cash and stock as payment in the transaction. They examine the model empirically on a sample of 182 Canadian takeovers, of which 56 use a mix of cash and stock as payment method. The average announcement month abnormal stock return is significantly positive and larger for mixed offers than for either all-stock or all-cash bids. However, there is little or no support for their specific model predictions.

D. Conglomerate vs. Non-conglomerate Mergers

It is often claimed that conglomerate mergers are less likely to succeed, because managers of acquiring firms are not familiar with the target industry or they waste free cash flow on bad acquisitions.

Agrawal, Jaffe, and Mandelker (1992) examine this issue. They subdivide their sample into conglomerate and non-conglomerate mergers. The CAARs for both groups of acquirers show negative performance over the five-year post-merger period. In contrast with popular belief, the underperformance of acquirers is worse in non-conglomerate mergers than in conglomerate mergers. The t-statistics are actually higher in magnitude for non-conglomerate mergers. The finding of negative post-merger returns is unlikely to be explained by the inferior performance of conglomerate mergers. It seems unlikely that concentration in poorly performing industries can explain the poor post-merger performance of acquirers in non-conglomerate mergers.

Mandelker (1974) comments about the power gained by acquisitions. It is frequently stated that the acquiring firms gain some monopoly power by acquisitions which then result in high returns. His findings are consistent with the hypothesis that the acquiring firms earn normal returns from mergers. This raises the question whether there is any real need to regulate merger activity. He also argues that, since acquired firms earn negative abnormal returns prior to the merger announcement, efforts to limit merger activity may result in misallocation of resources, and regulation may lead to a less efficient economy.

Further readings about the anti-merger laws and their effects are available, but they will not be reviewed here because of their relative importance with the financial data and abnormal returns. Two related papers are Ellert (1976), Eckbo (1985, 1992).

E. Efficiency

An important question after looking at the abnormal return patterns of mergers and tender offers is whether these results are consistent with the market efficiency hypothesis. In an efficient market, prices fully reflect the value of the

firm. The abnormal positive returns of the target firms' stocks is consistent with market efficiency because the event is incorporated into the prices quickly. However, the long-term abnormal returns of the acquiring firms' stocks raises the question.

Agrawal, Jaffe, and Mandelker(1992) argue that their finding of significant post-merger underperformance is consistent with two alternative hypotheses. The first hypothesis is that the market adjusts fully to merger news at the time of its announcement, and the subsequent underperformance occurs because of unrelated causes. The second hypothesis is that the market is slow to adjust to the merger announcement. In the latter case, the long-run post-merger performance would reflect that part of the net present value of the merger to the acquirer not captured by the announcement period return. Support for the latter hypothesis would be inconsistent with market efficiency. Their results do not support the latter hypothesis. There is no relation between post-merger abnormal returns and the acquisition's relative size, a result not consistent with slow adjustment to the merger event.

Loughran and Vijh (1997) emphasize that their tests of long-term returns are joint tests of market efficiency and wealth gains from mergers and tender offers. The large post-acquisition returns are inconsistent with market efficiency. They suggest that markets systematically overestimate or underestimate the efficiency gains from acquisitions.

Is the market efficient or not? Tests do not support clear inferences. Joint-hypothesis problem will always be a problem to decide whether market is efficient or not.

V. Three Hypotheses for Merger Activity

Malatesta (1983) states three hypotheses concerning mergers: the investment hypothesis, the size-maximizing hypothesis, and the improved-management hypothesis. These hypotheses have different implications for abnormal changes in merging firm values.

Under the investment hypothesis, both firms involved in a merger are assumed to be value-maximizers. A value-maximizing firm will not invest resources in merger activity if the net present value of that investment is negative. So, investment hypothesis is consistent with positive cumulative abnormal returns for acquired firms in successful mergers. The size-maximizing hypothesis assumes that potential target firms act to maximize value. Size-maximizing firms may engage in activities which have negative net present values. It assumes that at the margin merger attempts are negative net present value investment for acquiring firms. The total impact of a successful merger on acquiring firms may be positive or negative under the size-maximizing hypothesis. The improved-management hypothesis retains the assumption that firms maximize value, but assumes that

potential target firms are controlled by inefficient management. Under this hypothesis corporate mergers shift control of an acquired firm's assets from a relatively inefficient management to the superior managers of the acquiring firm. Mergers are viewed as a response to the sub-optimal management policies of target firms. Negative cumulative abnormal returns to successfully acquired firms are consistent only with the improved-management hypothesis.

Malatesta (1983) reports that acquired-firm shareholders suffer wealth losses during the period before a merger. This is consistent with the improved-management hypothesis. Their result, however, indicates that acquiring-firm stockholders suffer wealth losses before a merger. Based on this evidence, he concludes that a merger is a negative net present value project for acquiring firms.

Martin and McConnell (1991) also investigate the disciplinary role of tender offer takeovers, which is related with the improved-management hypothesis. First, they test whether the pre-takeover cumulative market model prediction errors and cumulative industry-adjusted returns of the sample of disciplinary takeovers are significantly less than those of the nondisciplinary sample. Second, they test whether the cumulative market model prediction errors and cumulative industry-adjusted returns for the sample of disciplinary takeovers are significantly less than zero. If the results indicate that disciplinary takeover targets are performing poorly prior to the takeover, they support the contention that the takeover market helps to protect shareholders from the actions of nonvalue maximizing managers. Their results indicate that the targets of takeovers in which there is a change in the top manager soon after the takeover are, on average, performing significantly worse than those target firms in which there is no change in the top manager. This is true whether market model prediction errors or industry-adjusted returns are considered. The data support the hypothesis of improved-management. First, the data indicate that turnover in the top manager position of target firms increases significantly following takeovers. Second, there is a strong link between top executive turnover and the pre-takeover performance of target firms.

VI. Some Unanswered Questions

- 1- Is there an abnormal return pattern for acquiring firms' stockholders? Studies give controversial results. Some conclude that the abnormal returns are insignificant whereas others argue that there are significant negative abnormal returns.
- 2- If answer to the question one is "Yes", what are the causes of abnormal returns?
- 3- Why is the result of abnormal returns of the acquiring firms' stock sensitive to the time period used? Abnormal returns are positive for 1975-1979 time interval whereas they are significantly negative in any other period.

- 4- Does selection of the stock index affect the inferences?
- 5- Is there a mean-reversion effect so that we observe negative abnormal returns while they were significantly positive for a long time before the takeovers?
- 6- Does cash flow return pattern help explain the abnormal returns and is there a significant cash flow return pattern using different, possibly longer, sample periods?
- 7- Why do stock returns differ in mergers and tender offers? Is it because of the method of exchange, since tender offers are mostly made by cash while mergers are financed by stock offers?
- 8- Why are the results consistent with the improved management hypothesis rather than the investment hypothesis? Firms should maximize the shareholders value and undertake acquisitions that have positive net present value. But, evidence does not support this hypothesis. Why doesn't management act on the best interest of the firm's stockholders?

VII. Conclusion

Mergers and tender offers are studied extensively in finance literature. However there are still some controversial issues. There is no contradiction that target firms earn substantial positive abnormal returns during the mergers and tender offers. However, there are controversial results about the abnormal returns to the acquiring firm shareholders. Some studies suggest no significant abnormal return while others suggest negative abnormal returns.

If negative abnormal returns exist, we do not know what causes this. Whether it is because of the market inefficiency or not can be explained by answering some of the proposed questions or other questions. Further research is needed to understand one of the most important and biggest events of corporate finance and their effects to the stock market.

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