I recently overheard a senior manager at a major U.S. corporation describe how her firm had successfully ‘snatched’ a strategically important acquisition from a bevy of competing firms. Her enthusiasm for this acquisition was contagious. Not only did this acquisition add economic value to her firm in the short term, she argued, it also created important long-term strategic advantages.

This manager’s enthusiasm reflects the widespread belief, among managers and academics alike, that merging with or acquiring strategically related firms can increase the economic value of successful bidding firms (Salter and Weinhold, 1979). A great deal of effort has gone into describing the sources of strategic relatedness that exist between a bidding and target firm (Salter and Weinhold, 1979; Lubatkin, 1987), and how this relatedness is translated into abnormal returns for the shareholders of bidding firms once an acquisition is completed (Lubatkin, 1987; Chatterjee, 1986; Singh, 1984; Singh and Montgomery, 1987).

This ‘relatedness hypothesis’ in mergers and acquisitions has not gone untested. Unfortunately, results are not consistent with these managerial or academic expectations. Lubatkin (1987), for example, found no significant difference in returns to bidding firm shareholders for strategically related and unrelated acquisitions. Also, Singh and Montgomery (1987), despite controlling for the type and degree of strategic relatedness between bidding and target firms, found that these acquisitions did not generate abnormal returns for shareholders of bidding firms. Singh and Montgomery (1987) did find that the shareholders of related target firms obtain higher abnormal profits than the shareholders of unrelated target firms.

These results may at least partially reflect difficult sampling, measurement, and other methodological problems associated with the event study methods used in this research (Singh and Montgomery, 1987; Lubatkin, 1987). However, the view developed in this paper is that the theory of mergers and acquisitions that underlies this empirical work is also incomplete. While acquiring a strategically related firm may create economic value, in many circumstances this increased value is distributed in the form of abnormal returns to the shareholders of acquired target firms rather than to the shareholders of successful bidding firms. Thus, strategic relatedness is not a sufficient condition for the shareholders of bidding firms to earn abnormal
returns. In order for relatedness to generate such returns, a variety of specific conditions must be met. The purpose of this paper is to specify the conditions under which relatedness in mergers and acquisitions can be a source of abnormal returns for shareholders of bidding firms.

The paper begins by providing a financial definition of relatedness, and then describing the conditions under which acquiring a strategically related target will not generate abnormal returns for the shareholders of bidding firms. Next, conditions where relatedness will generate abnormal returns for shareholders of bidding firms, including the existence of private and unique synergistic cash flows, inimitable and unique synergistic cash flows, and unexpected synergistic cash flows, are discussed. The paper concludes by discussing the implications of these arguments for research and practice.

A FINANCIAL DEFINITION OF RELATEDNESS

From a financial point of view, two firms are related when the net present value (NPV) of the cash flow of the combination of these firms is greater than the sum of the net present values of the cash flows of these firms acting independently (Copeland and Weston, 1983):

\[ \text{NPV}(A + B) > \text{NPV}(A) + \text{NPV}(B) \] (1)

where NPV(X) is the discounted net present value of the cash flows generated by firm X (Copeland and Weston, 1983). When the inequality in equation (1) holds, a synergistic cash flow is created if firm A acquires firm B.

A variety of possible sources of relatedness and synergy in mergers and acquisitions have been cited in the literature (Williamson, 1975; Benston, 1980; Stillman, 1983; Eckbo, 1983). Salter and Weinhold (1979), for example, argued that key business skills and product market positions are two potentially important sources of relatedness. From a broader perspective, Lubatkin (1983) classified nine types of relatedness between bidding and target firms into three categories: technical economies (e.g. marketing and production economies); pecuniary economies (e.g. market power); and portfolio economies (e.g. risk reduction). In this paper, relatedness between two firms can reflect any one, or any combination, of these sources, as long as equation (1) is satisfied.

Mergers or acquisitions between related firms will have no impact on the wealth of shareholders of bidding firms when the price paid for a target firm is exactly equal to the difference between the NPV of the cash flow of the target and bidder firms combined and the NPV of the cash flow of the bidding firms alone. This price, \( P \), is simply the value added to the bidding firm by acquiring a target:

\[ P = \text{NPV}(A + B) - \text{NPV}(A) \] (2)

Notice that \( P \) does not depend upon the value of the target firm acting as an independent business, but rather on the value that the target firm creates when it is combined with the bidding firm. If a bidding firm pays \( P + k \) for a target, then that firm has acquired a firm that adds \( P \) dollars in additional value (i.e. NPV(A + B) − PV(A)) for the price \( P + k \). If \( k = 0 \), then a bidding firm has paid the price \( P \) for an addition to its cash flow worth exactly \( P \), and thus the wealth of bidding firm's shareholders is unaffected. If \( k > 0 \), then this acquisition represents a real economic loss to the shareholders of the bidding firm. If \( k < 0 \), then the shareholders of the bidding firm will obtain a positive abnormal return. Thus, specifying the conditions under which a bidding firm's shareholders will obtain abnormal returns from mergers and acquisitions reduces to specifying the conditions under which the price of an acquisition or merger will be less than \( P \), i.e. specifying the conditions under which \( k < 0 \).

NORMAL RETURNS TO BIDDING FIRMS FROM ACQUIRING RELATED TARGETS

Strategic relatedness between bidding and target firms, as defined in equation (1), is not a sufficient condition for the shareholders of bidding firms...
Returns to Bidding Firms in Mergers and Acquisitions

ABNORMAL RETURNS TO BIDDING FIRMS FROM ACQUIRING RELATED TARGETS

Thus the existence of bidder and target relatedness, per se, is not a source of abnormal returns to the shareholders of bidding firms. However, if a market for corporate control is imperfectly competitive, then bidding firms may be able to obtain an abnormal return for shareholders from implementing merger and acquisition strategies. Three ways that these markets can be imperfectly competitive—including (1) when private and uniquely valuable

2 Semi-strong capital market efficiency implies that potential bidding firms will have sufficient capital to engage in bidding, for as long as $k < 0$, an acquisition investment will have a positive net present value (Copeland and Weston, 1983). Research in finance suggests that capital markets are typically efficient in the semi-strong sense used here (Copeland and Weston, 1983).

3 The lack of actual multiple bids for a target does not imply that perfect competition does not exist. A bidding firm, in anticipation of other potential bidders, may make an initial bid where $k$ is equal to zero, or even larger than zero. In this case the threat of anticipated competition for a target leads to zero abnormal returns for the shareholders of bidding firms completing an acquisition (Barney, 1986a).
J. B. Barney

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cash flows exist between a bidder and target, (2) when inimitable and uniquely valuable cash flows exist between a bidder and target, and (3) when unexpected synergistic cash flows exist between a bidder and target—are examined below.

Private and uniquely valuable synergistic cash flows

One way such an imperfectly competitive market could exist is when a target is worth more to one bidder than it is to any other bidders—and when no other firms, including bidders and targets, are aware of this additional value. The price of a target will rise to reflect public expectations about the value of a target. Once acquired, however, the performance of this special bidder will be greater than expected, and this will generate abnormal returns for its shareholders.

Consider, for example, the simplest case where the combined cash flow between bidder A and targets has an NPV of $12,000, whereas the combined cash flows of all other bidders and targets have an NPV of $10,000. Suppose also that, while no other firms are aware of A’s unique status, they are aware of the value of the cash flow of all other bidders combined with targets (i.e. $10,000). If the current cash flow of all bidders has an NPV of $5000, then firm A will obtain an abnormal return from acquiring a target if it pays less than $7000 (\( P = 12,000 - 5000 \)), while all other bidders will obtain an abnormal return from acquiring a target if they pay less than $5000 (\( P = 10,000 - 5000 \)). All publicly available information in this market suggests that a target is worth $5000. Thus, the price of targets will rise to this level, ensuring that if bidding firms, besides firm A, acquire a target, they will not obtain abnormal returns.

If there is only one target in this market for corporate control, then firm A will be able to bid $5000 + \( \epsilon \), i.e. just slightly more than any other bidder, to obtain the target. At this level, Firm A obtains an abnormal return of ($7000 - ($5000 + \( \epsilon \))), i.e. the added value of the combined cash flow minus the price of obtaining that additional cash flow. No other firm will bid higher than firm A because, from these firms’ point of view, the acquisition is simply not worth more than $5000. If there are several targets in this market for corporate control, then firm A, along with several other bidding firms, will all pay $5000 for a target. While all other successful bidding firms will not obtain an abnormal return from their bidding activities, firm A will obtain a $2000 abnormal return.

For A to obtain this abnormal return, the existence of its uniquely valuable synergistic cash flows with targets cannot be known by other firms, both bidders and targets. If other bidding firms know about this additional value associated with acquiring a target, they are likely to try to duplicate this value for themselves. Typically, this would be accomplished by other firms duplicating the type of relatedness that exists between A and targets by acquiring the assets or skills that create technical economies, pecuniary economies, diversification economies, or some combination of these types of relatedness between A and targets. Once other bidders acquired the assets or skills necessary to obtain this more valuable combined cash flow with targets, they would be able to enter into bidding, thereby increasing the likelihood that the shareholders of successful bidding firms would earn zero abnormal profits.

The acquisition of these assets or skills would not even have to be completed before bidding began, because bidding firms can anticipate that they will be able to acquire these assets and skills at some point in the future, and thus the NPV of the expected combined cash flow with a target for these bidders is the same as for A (Barney, 1986a). In this setting the price of an acquisition will rise to the point where \( k = 0 \). Firm A is shielded from this perfect competition if other bidding firms are unaware of the higher synergistic cash flow available to A and the sources of this higher synergistic cash flow (Lippman and Rumelt, 1982).

Target firms must also be unaware of A’s uniquely valuable synergistic cash flow for A to obtain abnormal returns from a merger or acquisition. If target firms are aware of this cash flow and its sources, they can inform other bidding firms. These bidding firms could then adjust their bids to reflect this higher value, and the competitive dynamics discussed previously would reduce abnormal returns obtained by bidders to a fully competitive level. Target firms are likely to inform bidding firms in this way because increasing the number of bidders with a more valuable combined cash flow increases the likelihood that target firms will extract all the
economic value created in a merger or acquisition (Jensen and Ruback, 1983; Turk, 1987). Though there may be many different managerial motives behind target firms seeking out ‘white knights’ as alternative merger partners after an acquisition attempt has been made, the effect of such actions is to increase the number of fully informed bidders for a target. This, in turn, reduces the abnormal returns that successful bidding firms obtain.

Thus far, it has been assumed that only one firm had a more valuable combined cash flow with targets (in the example, worth $12,000). However, the argument also applies to the more complex case when several firms have combined cash flows with targets greater than what is publicly known. As long as the number of targets is greater than or equal to the number of firms with these more valuable combined cash flows, each of these bidding firms can complete an acquisition, and each can earn varying amounts of abnormal returns (depending upon the value of each of these bidding firm’s combined cash flows) for their shareholders.

The impact of private and uniquely valuable synergistic cash flows on abnormal returns for shareholders of bidding firms even holds when different bidding firms all have different independent cash flows, and when they all have different combined cash flows with targets, i.e. where each firm acting in a market for corporate control is unique. Consider the example outlined in Table 1. The NPV of the cash flows of firms A, B, C and D in this table vary from $5000 to $2000, and the NPV of the combined cash flows with targets range from $12,000 to $9000. From equation (2) it is clear that firm A must pay less than $9000 for a target to obtain abnormal returns, firm B less than $6000, firm C less than $7000, and firm D less than $7000.

If information is publicly available suggesting that firms with the right assets and skills can obtain an incremental growth in cash flow worth $7000 from acquiring a target, then several things are likely to occur. First, firm B is likely to add to its assets and skills those attributes that allow firms C and D to obtain a $7000 NPV increase from acquiring a target. Next, the price of a target is likely to rise to $7000. If there are several target firms available, all the firms in Table 1 will be able to acquire a target, but only firm A will make an abnormal return (equal to $2000). If only one target is available, only firm A will complete the acquisition or merger, and its abnormal return, though still positive, will be slightly smaller ($2000 − ε). If there are not enough targets for all bidding firms, then which firms (B, C or D) will complete an acquisition is indeterminate, although whichever of these firms does will not obtain an abnormal return. In this case, as well, firm A will complete an acquisition and still earn an abnormal return for its shareholders equal, in total, to $2000 − ε.

Adding a fifth firm (Firm E) that is identical to firm A in Table 1 highlights the requirement that the number of firms with a more valuable synergy with targets must be less than or equal to the number of targets in order for these bidding firms to obtain abnormal returns. If there are two or more targets, then both firm A and firm E can execute an acquisition for abnormal returns. However, if there is only one target, then firms A and E are likely to engage in competitive bidding, perhaps driving the price of this target up to the point where $k = 0$ (i.e. to $9000) and in this process shifting abnormal returns from their shareholders to the shareholders of acquired firms.

Inimitable and uniquely valuable synergistic cash flows

The existence of a firm with private and uniquely valuable synergistic cash flows with targets is not the only way that a market for corporate control can be imperfectly competitive. If other bidders

<table>
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<th>Table 1. NPV of synergistic cash flows and NPV of four idiosyncratic bidding firms ($)</th>
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<td>Firm A</td>
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<td>NPV of synergistic cash flows with targets</td>
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<td>NPV of independent cash flows</td>
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cannot duplicate the uniquely valuable combined cash flow of one bidder and targets, then competition in this market for corporate control will be imperfect, and the shareholders of this unique bidding firm will earn abnormal returns. In this case the existence of uniquely valuable combined cash flows does not need to be private, for other bidding firms cannot duplicate these cash flows, and thus bids that substantially reduce abnormal returns to the shareholders of this special bidding firm are not forthcoming.

Typically, other bidding firms will be unable to duplicate the uniquely valuable combined cash flow of one bidder and targets when the relatedness between this bidder and targets stems from some non-imitable assets or skills controlled by this bidding firm. Barney (1986b) has given several examples of inimitable organizational assets and skills, including a firm's culture, its unique history, its product reputation, etc. If any of these organizational attributes are unique and, when combined with a target, generate a more valuable cash flow than any other bidders can obtain when combined with a target, then the shareholders of these firms will obtain abnormal returns from acquisitions. This would occur even if all firms in this market for corporate control were aware of this more valuable synergistic cash flow and its sources. Because information about this unique synergistic cash flow is publicly available, shareholders of special bidding firms will earn an abnormal return when acquisition occurs. This abnormal return will not be obtained by the shareholders of target firms because competitive bidding dynamics cannot unfold when the sources of a more valuable synergistic cash flow are inimitable.

As before, the number of firms with this special synergistic cash flow with targets must be less than the number of targets for the shareholders of these firms to obtain abnormal returns. If there are more of these special bidders than there are targets, then these firms are likely to engage in competitive bidding for targets, once again shifting abnormal returns from bidding to target firm shareholders.

If the number of bidding firms with these special attributes is less than the number of target firms, then these bidding firms enjoy a monopsony, and the level of abnormal return they obtain will be approximately the same as for bidding firms with private and uniquely valuable synergies (Hirshleifer, 1980). However, if the number of special bidders and number of targets are the same, the market for corporate control takes on many of the attributes of a bilateral monopoly. In this setting, the level of abnormal return obtained by shareholders of bidding firms depends on their negotiating skill (Hirshleifer, 1980), and is thus indeterminant. When all bidders and targets know the value of a target for a particular bidder, this negotiated price is likely to fall somewhere between the value of targets for firms with the highest value combined cash flows and the value of targets for other bidding firms.

Of course, it may be possible for a unique and inimitable synergistic cash flow to also be private. Indeed, it is often the case that those attributes of a firm that are inimitable are also difficult to describe (Barney, 1986b), and thus can be held as proprietary information. In this case the analysis of abnormal returns associated with unique and valuable synergistic cash flows presented earlier applies.

**Unexpected synergistic cash flows**

The analysis thus far has adopted, for convenience, the strong assumption that the NPV of synergistic cash flows between bidders and targets are known with certainty by individual bidders. This is, in principle, possible, but certainly not likely. Most modern acquisitions and mergers are massively complex (Jensen and Ruback, 1983), involving numerous unknown and complicated relationships between firms (Ruback, 1982). In these settings, unexpected events may occur after an acquisition has been completed, making the synergistic cash flow from an acquisition or merger more valuable than what was anticipated by bidders and targets. The price that bidding firms will pay to acquire a target will only equal the expected value of that target when it is combined with the bidder. The difference between the unexpected synergistic cash flow actually obtained by a bidder and the price the bidder paid for the acquisition is an abnormal return for the shareholders of this bidding firm.

Of course, by definition, bidding firms cannot expect to obtain unexpected synergistic cash flows. Unexpected synergistic cash flows, in this sense, are surprises, a manifestation of a firm's
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IMPLICATIONS FOR RESEARCH ON MERGERS AND ACQUISITIONS

This discussion has several important implications for research on mergers and acquisitions. First, the analysis suggests that much of the work on mergers and acquisitions has been conducted at too aggregate a level to inform managers of bidding firms when these strategies will generate abnormal returns for their shareholders (Halpern, 1983). This is true even for research that has investigated the link between strategic relatedness in a merger or acquisition and returns to shareholders of bidding firms. Relatedness, per se, does not generate abnormal returns for bidding firms. Rather, synergistic cash flows stemming from relatedness will lead to abnormal returns for shareholders of bidding firms when those cash flows are private and unique, inimitable and unique, or unexpected. Future research will need to partition related mergers and acquisitions into these much finer categories in order to study how strategic relatedness is translated into abnormal returns for the shareholders of bidding firms.

Second, the role of unexpected synergistic cash flows in generating abnormal returns for bidding firm shareholders from mergers and acquisitions reemphasizes the role of luck in studying returns to the strategic actions of firms (Barney, 1986a; Lippman and Rumelt, 1982). While luck is a difficult variable to work with, especially in prescriptive models of competitive strategy, its continued emergence in analytical work suggests its importance. Simply observing that an acquisition generated abnormal returns for the shareholders of a bidding firm does not imply that a uniquely valuable synergistic cash flow existed between this bidder and the acquired target. Nor do such returns necessarily imply that managers in this firm are skilled in discovering or exploiting relatedness between themselves and targets. Bidding firms can simply be lucky.

Finally, the impact that managerial actions in bidding and target firms can have on the distribution of the value created in a related acquisition deserves further attention. It has already been shown in the literature that target firms can obtain abnormal returns for their shareholders by increasing the number of well-informed bidders (Jensen and Ruback, 1983; Turk, 1987). This process can be short-circuited if managers in bidding firms are able to keep the existence of a uniquely valuable synergistic cash flow with targets private. How managers in bidding firms might be able to keep this information private (McKelvey, 1982), and the implications of this private information for the regulation of securities markets (Bettis, 1983), deserve ongoing attention.

IMPLICATIONS FOR PRACTICE

The arguments presented here also have important implications for managers seeking to implement merger and acquisition strategies. First, while the conditions under which these strategies will generate normal and above-normal returns have been emphasized, this analysis also suggests that mergers and acquisitions can lead to below-normal returns for the shareholders of successful bidding firms. This will occur when bidding firms overestimate the value of targets, and thus the price paid for a target will be greater than the economic value that a target brings to the bidding firm. Research by Salter and Weinhold (1979) and others suggests that bidding firms typically overestimate the value of targets by underestimating the costs of exploiting synergies with targets. Even when markets for corporate control are imperfectly competitive, such miscalculations can generate below-normal returns for successful bidding firms. To avoid these miscalculations, bidding firms must become very skilled at understanding the nature of the strategic relatedness between themselves and target firms.

With this understanding, bidding firms reduce the likelihood of overestimating the value of targets, and increase the likelihood of earning at least normal returns from mergers or acquisitions. To move beyond earning just normal returns from mergers or acquisitions, the arguments presented here suggest that bidding firms must develop a second skill, over and above the ability to evaluate relatedness between themselves and targets. This second skill is the ability of a bidding firm to understand and value strategic relatedness between other bidding firms and targets. Firms cannot expect to obtain above-normal returns...
from acquiring targets when several other bidding firms all value these targets in the same way. In these kinds of markets for corporate control, perfect competition dynamics are likely to unfold, and the economic value of a target in creating competitive advantages for a bidding firm is likely to be reflected in the price that a bidding firm must pay for a target. Thus, in order to obtain expected above-normal returns from acquisitions, firms must complete acquisitions only in imperfectly competitive markets for corporate control.

Distinguishing between perfectly competitive and imperfectly competitive markets depends upon the ability of a firm to value the relatedness of other bidders with targets, and compare that value with their own relatedness with a target. If other bidders value the target in the same way as a particular firm does, perfect competition dynamics are likely to unfold, and successful bidding firms can only expect normal returns. If other bidders value the target at a lower level than a particular bidder, then this peculiar bidding firm may earn above-normal returns from acquiring the target. To earn expected above-normal returns from acquisitions, it is not enough for managers to be good at spotting and valuing relatedness between their own firm and targets; they must also be good at spotting and valuing relatedness between other firms and targets.

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