The Effects of Mergers and Acquisitions on Corporate Management and Financial Performance

Guijiayi He(✉)

Department of ECONFIN, Durham University, Durham, England
qkcd36@durham.ac.uk

Abstract. Over the past thirty-five years, there have been more than one million M&A cases worldwide, but the failure rate is 70–90%. Although mergers and acquisitions are useful approaches for corporations to expand the scale, it is double-edged. Therefore, it is important to critically examine its influence on corporate performance on both positive and negative sides, in order to warn companies not to choose M&A blindly. This paper firstly emphasizes that the volatility of staff turnover rate will negatively affect corporate managerial performance after consolidation. After that, this paper points out that how will the probability, liquidity and stock price will change due to the announcement of M&A. Furthermore, the paper explains how M&A will bring different effects to the business, owing to the distinction between different M&A instruments. The whole research mainly collects secondary data from previous studies and analyses it further with reference to LVHM's consolidated financial statements.

Keywords: M&A · Managerial effects · Financial effects

1 Introduction

Businesses are making efforts to maximize profits and expand rapidly to survive in the market, with mergers and acquisitions being one of the main strategies. The first wave of M&A began from 1987, however, the majority of the deals were failed to accomplish until 20 centuries. King (2019) described mergers as the amalgamation of two or more corporations that results in the formation of a new entity; acquisition is interpreted as business activity which targets more than half of the equity of another firm [1]. When two or more companies consolidated, the combined company is more likely to create greater synergies than competing individually. From an operational standpoint, Nelson (2018) proposed that M&A promote the expansion of companies and raise operational profitability, this is because the associated operating costs will decrease as production scales up [2]. They enable corporations to investigate new customer database and strengthen the market power. Meanwhile, with increased equity returns and shareholder wealth, the company's debt capacity will also increase, even as it gains some tax-related advantages by increasing its leverage level. Over the last 35 years, the global number of mergers and acquisitions transactions has surpassed one million [3]. However, only 10,000 cases

F. Balli et al. (Eds.): ESFCT 2022, AEBMR 226, pp. 871–877, 2022.
https://doi.org/10.2991/978-94-6463-052-7_99

were finally completed finished in 2020, marking the lowest dip since 2014. Although M&A is a major approach of expansion, it is double-edged that may magnify the negative effects of consolidation if the company does not successfully achieve synergies. In the area of personnel management, Kuvandikov (2020) found out the employment rate of post-merger business would decrease 10–20% after the combination of companies [4]. As a company grows in size, the accompanying financial and management issues will become tricky once. Therefore, this study is necessary which analyzes the impact of M&A through actual cases in order to warn companies not to focus only on the benefits of them. This paper will firstly emphasize the effects brought by M&A to the financial and management performance of companies and justify the benefits and drawbacks of them from a critical perspective. Moreover, this paper will secondly investigate the impact of different M&A approaches on the success or failure of M&A. The study mainly collects secondary data to obtain the financial data and management trends of LVHM before and after mergers and acquisitions for further comparative analysis, and eventually reach the results.

2 Managerial Effects

Mergers and acquisitions have become affordable alternatives of employing high-level employees when the labor market is devoid of resources. Established and mature firms purchasing nascent technological companies is a regular phenomenon, as there is evidence indicates that technological M&A boost acquirers' innovative productivity once the transactions are completed. Between 1990 and 2011, there was totaling 4000 number of high-tech start-ups acquired by other corporations in the United States, which brought them around 350,000 start-up employees.

However, based on the rationale of M&A, synergies can be increased by lowering operational expenses. When a company pursues additional operational benefits after M&A, it will lay off far more basic staff to save money on compensation. One of the explanations for the low successful rate of M&A cases is the negative reaction of employees including high employee mobility. In Cartwright and Schoenberg's study (2006), 25% of senior managers choose to depart the company before M&A [5]. Moreover, Kim (2020) found that in the first year after the company was acquired, 33% of the acquired personnel leaved, regular employees with equivalent abilities and work experience occupied 12% among the whole group [6]. When the study is conducted over a three-year period, the likelihood of employee turnover is 15% higher than that of new hires. At the same time, around half of employees who do not feel they fit into the business culture after M&A will quit. The reason behind these data is that the M&A process will increase the risk of breaking the implicit psychological contract and earlier agreements, resulting in decreased commitment and causes employee turnover. Another factor is that employees will reevaluate their identities as a result of M&A, and they will determine if they are still suited for the new organization. Therefore, the significance of guaranteeing employee turnover rate is that it will have a direct impact on business performance, particularly the loss of high-tech talent, which will erode the company's distinctive competitive advantage and, in certain cases, cause operations to be disrupted. Plus that, volatile staff turnover rate affecting not only the morale of the remaining employees, but also the company's reputation, making future recruitment difficult.

3 Financial Effects

3.1 Profitability

According to neoclassical economics, profit maximization is the result of mergers and acquisitions. Successful M&A can assist the business achieve synergy effects. Gugler and Siebert (2007) put forward the point that M&A positively improve the company's profitability in terms of economies of scale, financial resource reorganization, post-adjustment, cost reductions and knowledge spillover [7]. Synergies are the outcome of integration between distinct businesses that alter the properties of business operations. Edi (2020) contends that the factors of production are shared across various firms, so that operational synergies in mergers and acquisitions aid businesses in achieving economies of scale [8]. Fundamentally, the components of production are labor, capital, land and enterprise. The integration of two or more firms estimates that the number of these components of production owned by an acquisition may increase and that the resources owned by different enterprises may complement one another. The degree of synergy depends on the similarity and complementarity between the acquired company and the acquired company. Cultural differences can provide opportunities for resource redeployment to improve corporate value.

Profitability can be measured in a cluster of aspects, including market share, revenue and return on profit margin. Take LVMH as an example, since 1987, LVMH has begun to expand its company by acquiring other luxury firms and it has progressively grown to become the world's greatest luxury conglomerate. One of the latest and most famous M&A cases of LVHM is that it bought Tiffany&Co. With approximately $16 billion in 2021. Although LVHM's watch and jewelry section only accounted for 8% of total group revenues, making it the least profitable segment, it doubled after LVMH acquired Tiffany&Co. The explanation for this is because the transaction strengthens LVMH's position in the luxury jewelry business, as Tiffany&Co. Has dominant market position. Moreover, between 2020 and 2021, the revenue earned by the whole watches and jewelry segment grown rapidly from €3,356 million to €8,964 million, which also stimulated a significant rise in profit from €302 million to €1,679. By calculating operating margin, this index increased for 9.7% which also revealed that the profitability of LVHM has been improved by acquiring Tiffany&Co.. Until 2021, the watch and jewelry department could be ascended in the top three profitable department of LVHM and from the perspective of the whole year, the overall revenue and operating margin have been improved. Therefore, from this example, a successful M&A experience can indeed improve the profitability of the company in all aspects.

3.2 Liquidity

M&A establish a larger corporation with increased assets, profitability, and debt capacity. As a result, firms gain leverage power when negotiating with banks for lower interest rates, longer payback terms, and greater loan amounts. Furthermore, if the two companies conduct typical mergers and acquisitions, their total assets will expand primarily. Second, as profitability improves, the additional profits will be transferred in the form of liquid cash flows for reinvestment in daily operations. After analyzing the operating efficiency of the 50 greatest American mergers and acquisitions from 1979 to 1984, the results demonstrate that the acquired companies' asset productivity will significantly enhance after the deal is completed, particularly the return on operating cash flow [9]. When a private equity firm replaces the management board after the acquisition, cash flow performance is also strengthened. Positive net cash flow is a portion of current assets and has various uses. For instance, businesses may decide to use it to settle debts or pay back interest to shareholders. For example, either the total assets or total equity and liabilities of LVHM have surged after acquiring Tiffany Co.

Merged business usually seeks to get tax benefits by pretending there is negative turnover. If lucrative corporations target to acquire indebted companies, the year-end profit of post-merged business will turn into loss, resulting in a lower tax burden. Palepu (1990) defined LBO as a business strategy in which investors borrow money to acquire a target company [9]. LBO has two possibilities for reducing the corporation's tax obligation: When leverage is used for purchasing business, an interest tax shield is formed during the transaction; Deductions in amortization rise while tangible assets increase after acquisition. According to Bruner (2004), prior to the acquisition, the average company's leverage ratio was at 23.7% [10]. However, these deals dramatically boosted the leverage ratio, and the sample median post-acquisition debt capital ratio was close to 70%.

On the contrast, target organizations frequently conceal negative facts, exaggerate, or overstate their advantages as a result of asymmetric knowledge, and thus these untrue claims endanger M&A's prosperity. It is likely that the debt will be past due as a result of the acquisition if the acquirer does not promptly look into the source of the target company's debt, which could result in bankruptcy. If the acquirer fails to investigate the source of the debt of the target company in time, if the acquirer fails to investigate the source of the debt of the target company in time, it is likely that the debt will be defaulted in a long-term and leads to bankruptcy. In Van de Gucht and Moore's research (1998), from 1980 to 1992, 343 leveraged buyouts were taken as the sample. After an average of 3.5 years, 27% of the companies took a turn for the worse through IPO [11]. Another 9% were sold to listed companies and 12% went bankruptcy. The bankruptcy rate of LBO companies pointed out in the 1980s was 27%, and it declined to 17% from 1990 to 2006 [12].

3.3 Stock Price

The response of stock price to mergers and acquisitions reflects the changes in company value which is related with the adjustment in debt structure. Also, the volatility of stock price implies change in several aspects: Cash flows-by providing information about future expectations; Information asymmetry-corporate managers are more likely to issue securities while the market price is overvalued; Ownership-the reallocation of command will affect stock price.

Furthermore, the impact of the announcement of mergers and acquisitions on the stock price will vary according to different types of the consolidation. When merger is conducted through stock exchange, the share exchange ratio determines whether one of the companies earns a premium (extra acquisition fee) above its share price. Basically, the stock price of target company may increase, but the amount of increase may be constrained if the stock price of the merger partner declines, which finally eroding the original premium. In order to limit the negative impact, the terms of merger may include a restriction agreement. If the shares will be exchanged at lower a level compared with a certain level, the exchange ratio will become higher. However, such a leading restriction may harm the interests of the merger partner and the shareholders of the company. In the case of acquisition, the purchasing business typically paid a premium to entice the target company. The acquirers' share price tends to decrease momentarily, whilst the target company's share price grows. The possible explanation behind this is that the acquiring company typically paid a premium and may incur liabilities. In Pop's research (2006), the average premium is 40% whereas the typical beginning premium is only 27% [13].

In a short run, share price of the target company tends to rise, because only when the purchase price exceeds the current value attracts shareholders' attention upon the transaction. According to the study of Tang and Xu (2016), from the ten trading days before the announcement, the abnormal return increases significantly day by day until reach the announcement date [14]. Within 30–20 days before the release, the growth rate was about 5.2%, and within 20 days the growth rate was 4.8%. Compared with 10.5% after the announcement, the forecast growth accounted for more than one third of the total market response to M&A. Elad and Bongbee (2016) also mentioned that the market is effective and responsive to M&A announcements, as evidenced by the abrupt change in the rate of return [15]. Nonetheless, there is still a hidden peril might be brought by consolidation. Managers of target company are refusing to publicly disclose bad news, since this news might destroy the corporate reputation and eventually lead to strike in stock price. However, they are unable to hide the fact forever, as bad news will finally be exposed to the market, which would cause a more significant decline in prices.

4 Conclusion

This paper analyzes influence of mergers and acquisitions on corporate managerial and financial performance. It also dissects how different M&A strategies amplify these influences. First, from a managerial standpoint, this paper focuses on how M&A affect employee turnover and the profitability of companies. Technology acquisitions are a means of hiring experts and increasing innovation and productivity of the acquirer when senior labor resources are scarce. However, job duplication might occur after M&A which increases employee turnover as companies lay off some employees to reduce payroll costs. Also, some of the workforce might leave the company voluntarily before the merger. When employee turnover rates increase, this will not only affect the morale of the remaining employees, but also on the company's reputation, making it difficult to recruit externally in the future. Secondly, taking the case of LVHM's acquisition of Tiffany as an example, successful M&A can help companies achieve synergies which positively affect the company's profitability. Horizontal and vertical enterprise integration can realize the complementary of resources, in order to attain a larger scale of production, or help companies to expand their market share and promote profits. From a financial perspective, after the merger of a profitable company with a debtor company, the newly formed business entity will be considered to be in a loss position, and thus the company will pay less tax at the end of the year. Moreover, based on the increased profitability, the overall cash flow of the company is more flexible, and the rise in fixed assets can help the company improve its debt capacity. Nevertheless, if a company uses leveraged buyouts with a company that is overly debt-ridden, there is a high risk of debt default that could lead to bankruptcy. Finally, when a company acquires another company, the acquirer's share price will drop due to the payment of a premium, while the acquiree's share price will soar. Yet, M&A firms often choose to conceal negative information about the firm during the M&A process, and once the bad news is disclosed to the market, the firm's share price will be crushed heavily. The findings of this paper help company to establish a critical view M&A and help them to choose the appropriate M&A approaches to maximize benefits. Unfortunately, because the study mostly utilizes secondary data from past empirical studies, the timeliness of the data may be somewhat lacking. In addition, the impact of the current epidemic on the global economic environment will also affect the M&A industry. Hence, future research needs to obtain the latest data through first-hand research and further analyze the influence of M&A in the context of the current economic environment, which will be more informative for companies.

References

1. King, D.R. (2018). Mergers and Acquisitions: A Research Overview, 2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN, Routledge.
2. Nelson, T. (2018). Mergers and Acquisitions from A to Z, New York, Amazon.
3. Statista (2021). Number of merger and acquisition transactions worldwide from 1985 to 2021. Available at: https://www.statista.com/statistics/267368/number-of-mergers-and-acquisitions-worldwide-since-2005/ (Accessed on 20 July 2021).
4. Kuvandikov, A., Pendleton, A., & Higgins, D. (2020). The effect of mergers and acquisitions on employees: wealth transfer, gain-sharing or pain-sharing?, British Journal of Management, 31(3), 547-567.
5. Cartwright, S. and Schoenberg, R. (2006). 'Thirty years of mergers and acquisitions research:Recent advances and future opportunities'. British Journal of Management, 17, S1–S5.
6. Kim, J. D. (2020). Startup acquisitions as a hiring strategy: Worker choice and turnover. Available at SSRN 3252784.
7. Gugler, K. and Siebert, R. (2007), "Market power versus efficiency effects of mergers and research joint ventures: evidence from the semiconductor industry", The Review of Economics and Statistics, Vol. 89 No. 4, pp. 645-659.
8. Edi, Basri, Y. Z., & Arafah, W. (2020). 'The effect of acquisition synergy on firm performance moderated by firm reputation', Journal of Accounting, Finance and Auditing Studies, 6(1), 16-32.
9. Bruner, R. (2004). Where M&A pays and where it strays: A survey of the research. Journal of Applied Corporate Finance, 16(4), 63-76.
10. Palepu, K. G. (1990). Consequences of leveraged buyouts. Journal of Financial Economics, 27(1), 247-262.
11. Van de Gucht, L. M. and W. T. Moore (1998). Predicting the duration and reversal probability of leveraged buyouts. Journal of Empirical Finance 5 (4), 299–315.
12. Ayash, B. and H. Schutt (2016). Does going private add value through operating improvements? Journal of Corporate Finance 40, 192–215.
13. Pop, D. (2006). M&A market in transition economies: Evidence from Romania. Emerging Markets Review, 7(3), 244-260.

14. Tang, Z., & Xu, X. (2016). What Causes the Target Stock Price Run-Up Prior to M&A Announcements?. Journal of Accounting & Finance (2158–3625), 16(6).
15. Elad, F., & Bongbee, N. (2016). Event study on the reaction of stock returns to acquisition news. Available at SSRN 2863243.