Seventh Annual Mergers and Acquisitions Research Centre Conference Report

19th June 2023

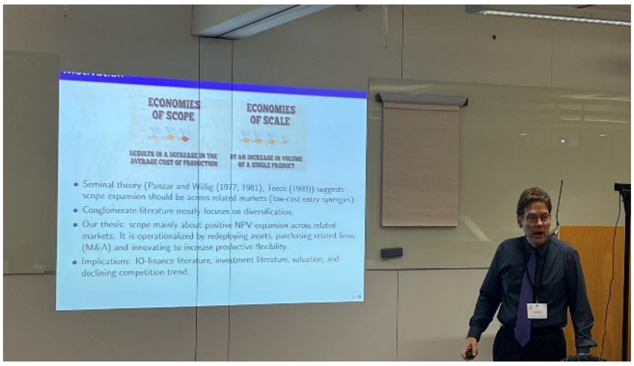
Bayes Business School

City, University of London

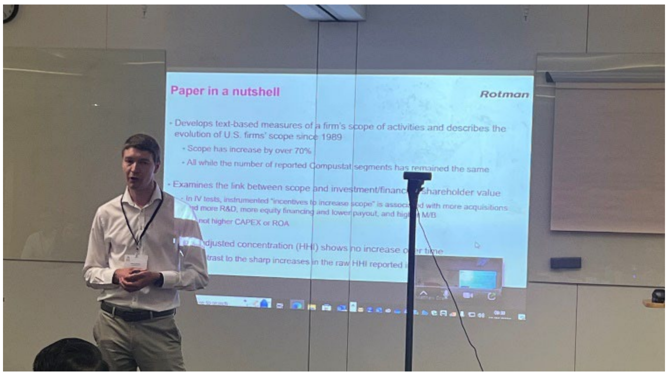
Conference organisers:
Prof Scott Moeller, Prof Anh Tran, and Prof Paolo Volpin

Session 1:

Gordon M. Philips: *"Scope, Scale, and Concentration: The 21st century firm"* (with **Gerard Hoberg**)



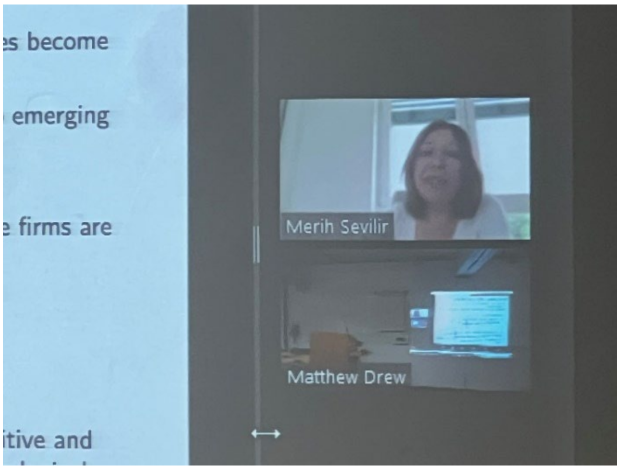
The interplay between scope, scale and competition has been the focus of numerous authors including both business historians and economists. A principle focus of authors has been defining firms by the basket of products firms produce and the industries to which these products belong. Recent papers have also documented the rise in firm size, a rise in traditional industry concentration measures, and a drop in the number of U.S. listed firms. **Gordon M. Philips** presented a paper which shows that over the past 30 years, U.S. firms have expanded their scope of operations. Increases in scope and scale were achieved largely without increasing traditional operating segments. Scope expansion significantly increases valuation and is primarily realized through acquisitions and investment in R&D, but not through capital expenditures. The paper shows that traditional concentration ratios do not capture this expansion of scope. Their findings point to a new type of firm that increases scope through related expansion, which is highly valued by the market.



In his discussion, **Andrey Golubov** first commented on the temporal trends. He considered the time-series evidence to be inherently valuable, yet expressed interest in gaining a deeper understanding of how the entire distribution evolves over time. He recommended providing further clarification on the disparities between the TNIC-based and NAICS-based measures after 2007. He suggested offering more comprehensive explanations for the reasons behind the endogenous shifts in optimal scope and its consequences for both firms and shareholders. Furthermore. He offered advice to the authors to address concerns regarding instrumental variables. Finally, the authors could provide more explanations on the results on market-to-book ratio

Matthew Denes: *"Merger Waves and Innovation Cycles: Evidence from Patent Expirations"* (with **Ran Duchin** and **Jarrad Harford**)

It is well known that mergers and acquisitions are clustered by industry and through time, that is, that industry merger waves exist. **Matthew Denes** presented a paper which studies the role of innovative activity in the clustering of merger activity, often called merger waves. The results show evidence that waves of patent expirations can set off industry merger waves. The deals in patent expiration merger waves notably differ from those occurring in other merger waves. The paper reports that these deals tend to have lower announcement returns and higher target premiums, and are further followed by declines in the performance and investment opportunities for acquirers. They also find that acquirers in patent expiration merger waves experience declining profit margins, profitability and cash holdings, as they simultaneously cut costs to mitigate the impact of the approaching patent expirations. Taken together, they offer novel evidence on the role of patenting activity, and in particular their expirations, as a determinant of mergers and their clustering within an industry



In her discussion, **Merih Sevilir** who unfortunately had a flight cancellation which meant that she needed to attend by Zoom, suggested distinguishing between the difference of a patent creation wave and a patent expiration wave. To the extent that patent expirations are observable and common knowledge, the economy would respond by generating new patents – hence, patent expirations would coincide with patent creations. She also suggested investigating whether target companies hold patents. Secondly, the authors should provide further clarification on the concept of technology obsolescence. In Table 7, it is shown that industries experiencing patent expiration waves tend to become more consolidated. These could be declining industries. In addition, acquirers expand into emerging industries by acquiring innovation. Merih proposed that the results in Table 7 are consistent with the interpretation that the merger wave is driven by a new wave of patents that are replacing existing ones. When considering deals during an innovation wave, acquirer's deal announcement returns tend to be positive but lower. She suggested that it is possible for some firms with expiring patents to acquire private innovative firms, while others may acquire (and potentially overpay for) large publicly traded firms in order to reduce competition during the wave. This may generate heterogeneity in ex post ROA (return on assets) and market-to-book ratios after the deal and explain why ex post performance measures are poor. Finally, the evidence in the paper could also be related to the timing and industry waves of entrepreneurial activity and venture capital investment.

Session 2:

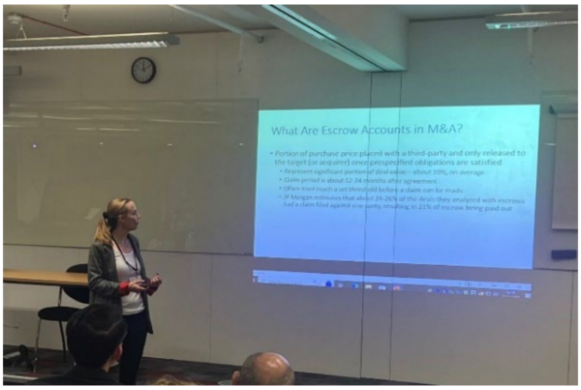
Antonio Macias: *"Solving Serial Acquirer Puzzles"* (with **P. Raghavendra Rau** and **Aris Stouraitis**)

A huge body of literature documents several findings about serial acquirers that pose puzzles if serial acquisition dynamics are not properly taken into consideration. Using a novel typology of serial acquirers, **Antonio Macias** presented a paper which examines several puzzles documented in prior literature. First, the paper uses cluster analysis, based on the total number of acquisitions, the number of acquisition blocks, and acquisition intensity within the block, to identify four distinct groups of acquirers. These acquirer types can be reliably classified using a relatively stable classification based on ex ante information. Second, acquisition activity is driven by different factors for different types of acquirers, and these acquirers appear to acquire targets with different sizes and listing status. Ex ante information on serial acquirer types enables the paper to predict acquisition activity vastly more accurately compared to previous studies. Additionally, some acquirer types appear to benefit from consistently conducting acquisitions of many small deals and accumulate large dollar gains in the process. They find little evidence of declining returns for the most frequent serial acquirers after adjusting for market anticipation. Finally, evidence shows that extraordinary acquirers appear to persist because they are not easily predictable by the market. The most frequent and easily predicted acquirers are not extraordinary.

In his discussion, **Frederik Schlingemann** agreed that the comprehensive approach to assessing the M&A landscape is important and the improvements of classifying bidders and ex-ante predictability are important contributions. However, it's important to clearly show readers what these improvement yield. The authors should offer further clarification on whether the identified puzzles are truly puzzling and provide insight into potential answers for these puzzles. The paper should address the fundamental question of acquisition quality rather than focusing on deal announcement return adjustments. The authors could also offer additional evidence regarding learning.

Lubomir Litov: *"The use of escrow contracts in acquisition agreements"* (with **Sanjai Bhagat** and **Sandy Klasa**)

The majority of acquisitions conducted by publicly traded firms involve purchasing standalone private companies or subsidiaries of other firms. However, the existing body of empirical evidence on acquisitions involving unlisted targets is limited. This constraint restricts our understanding of these types of acquisitions. **Lubomir Litov** presented a paper which studies the escrow contracts included in acquisition agreements. Firstly, they find that escrow agreements are more common when transaction risk is high, such as for stand-alone private targets, targets with dominant shareholders, and larger targets relative to the acquirer. The use of escrow contracts shortens the time-to-complete the transaction by 35.5-51.0%. Secondly, escrow agreements are more common when information asymmetry risk is high. This is observed for targets in cross-industry acquisitions, targets with high accruals, targets in industries with high earnings volatility or low analyst coverage, and targets that are financially constrained. Additionally, escrow agreements are more common when other risks may be present, such as when there is no reverse insurance in the form of liability cap limitations (or caps) included. Furthermore, the paper provides evidence that escrow contracts are associated with a significantly smaller target discount. The adoption of an escrow agreement increases the valuation of a private target by 3.5-6.1%. Finally, escrow contracts benefit the bidder. For every dollar in an escrow contract deposit, the market capitalization for bidder shareholders increases by 89 cents. The bidder benefits from reduced losses, lowered information gathering (due diligence) costs, and decreased litigation expenses.



In her discussion, **Audra Boone** first pointed out that firms could opt to purchase Representation and Warranty (R&W) insurance as an alternative. The paper by Even-Tov, Ryans, and Davidoff Solomon (RAST, 2022) conducts an extensive investigation into R&W insurance. Both demand and cost for insurance is higher when there is greater valuation uncertainty and weaker internal controls in target's industry (similar to when earnouts are more likely to be used). One advantage of R&W insurance is that the target could receive more of the proceeds upfront rather than waiting until the escrow expiration. These two remedies are also often used in conjunction with each other. Secondly, Audra suggested providing reasons not to use an escrow. She was curious about why firms would choose not to take this route if escrows could help mitigate risks. The authors should also present potential drawbacks of using escrows. Additionally, she suggested including more information on coverage. This could involve details such as what factors determine the size of the escrow, which issues are commonly covered, and so on. Finally, the results show that the time between signing and closing is lower due to reduced due diligence costs. Audra would expect the use of escrows to be particularly helpful in reducing negotiations during the private phase.

Session 3:

Keynote Speech

Amanda Scott, Global Mergers & Acquisitions Leader – WTW *"What's 'the Deal': What's happened, what's happening and what may happen - Market insights from the WTW M&A Barometer Survey"*

In her keynote address, **Amanda Scott**, the Global M&A Leader at WTW, presented a comprehensive overview of the M&A landscape, seamlessly weaving together historical trends, present-day scenarios, and anticipated future developments. Drawing from WTW's recent corporate M&A Barometer Survey, which garners insights from M&A practitioners globally—38% from North America, 30% from Europe, and 18% from the UK—Scott highlighted several pivotal issues in the realm of M&A.

Firstly, she noted that economic volatility has prompted half of the surveyed organizations to re-evaluate their M&A strategies. Joint ventures and partnerships have emerged as fundamental components of these strategies. Furthermore, two thirds of organizations measure the success of their M&A transactions through their business unit financial performance. Scott also emphasized the human dynamics inherent in M&A activities. As organizations undergo takeover, the challenges of team integration, talent management, and cultural assimilation become increasingly salient. There is a growing trend among organizations to implement formal change leadership training and support initiatives. Another salient topic Scott touched upon was "Target Assessment". In the intricate and high-risk domain of M&A, the meticulous evaluation of potential targets—considering their strategic alignment, financial robustness, and synergy potential—is imperative. It is noteworthy that many organizations are now integrating Diversity, Equity, and Inclusion (DEI) metrics into their assessment criteria. During the subsequent Q&A session, the audience exhibited a keen interest in the human dimensions of M&A.

Tom Nohel: *"Paper: The incentive of SPAC sponsor"* (with **Felix Feng**, **Xuan Tian**, **Wenyu Wang**, and **Yufeng Wu**)

In his presentation, **Tom Nohel**, provided an in-depth analysis of the key players in SPAC (Special Purpose Acquisition Companies) transactions, with a primary focus on SPAC sponsors. These sponsors, as the founders of SPACs, put significant capital at risk but can reap substantial rewards from both successful and unsuccessful deals. The challenge for SPAC sponsors lies in striking a balance in the proposed valuation to appease all stakeholders involved.

Nohel paper introduces a model framework that centres on the interactions between SPAC sponsors and IPO investors. This model highlights the informational asymmetry between the two parties, especially when determining the value of a deal based on announced terms. A significant concern addressed is the agency problem in SPACs. The misalignment of incentives between sponsors and investors is evident, particularly in unfavourable deals. While good deals benefit all parties, the interests diverge considerably in bad deals. The authors used a comprehensive sample of SPAC business combos, calibrate the model and find the model fits the data well. Nohel showed that agency costs are pervasive and severe: agency costs uniformly distributed; deals brought by low agency cost sponsors outperform their high agency cost counterparts by 19%.

Lakshmi Naaraayanan provided commentary on the paper from a variety of perspectives. The discussant first pointed out some missing assumptions in the paper, such as the reputational effects disciplining SPAC sponsors and potential frictions between sponsors and targets. Naaraayanan also suggested the paper can go one step further in terms of source of information asymmetry. Additionally, he suggested using policy counterfactual analysis to analyse welfare. Overall, Naaraayanan emphasized the need to highlight the paper's unique strengths and its connection to existing literature as well as a need to further unpack the nature of agency frictions and expand on counterfactual policy exercise.

Session 4:

Jean-Marie Meier: *"Tax Avoidance through Cross-Border Mergers and Acquisitions"* **(with Jake Smith)**

The intersection of tax havens and cross-border M&A is often considered a niche topic associated only with the so-called (M&A) inversions. **Jean-Marie Meier** presented a paper which investigates 13,307 cross-border, tax-haven mergers and acquisitions (M&A) from 1990 to 2017, totalling $4.1 trillion in deal value, or about 30% of total cross-border M&A volume. Using a gravity model research design, the paper shows that tax havens have $2.4 trillion more deal value than predicted based on their economic fundamentals. Tax avoidance through tax havens is a significant determinant of cross-border M&A. Moreover, cross-border, haven M&A results in $30.7 billion in tax savings. The evidence shows that $1.0 trillion in small-haven M&A results in $8.3 billion in annual savings. $3.1 trillion in large-haven M&A results in $22.4 billion in annual savings. The tax avoidance resulting from haven M&A is substantial.

In her discussion, **Jennifer Blouin** first stated that there is an extensive body of work on M&A and tax synergies, M&A and patent, intangibles, profit shifting, and inversions. She suggested considering how to position the paper within the context of the large literature that demonstrates the role of taxes in M&A. She advised including an illustration of how tax residency impacts M&A in the absence of an additional sale. Furthermore, she indicated that the paper implies that firms engage in M&A to generate tax benefits. However, the authors should explain the rationale behind this perspective. She recommended that the authors provide more explanations to help readers understand the relative significance of tax synergies compared to other attributes of the deals.

Micah Officer: *"Beyond Culture: How does international migration affect cross-border mergers and acquisitions?"* (with **Ning Gong** and **Hong Feng Zhang**)

A successful merger of two companies involves a complex combination of physical assets and human capital to achieve potential synergies. Relative to deals involving same-country participants, cross-border mergers and acquisitions (M&As) are further challenged by additional barriers, such as diverse regulatory environments, different languages and religions, and distinctive national cultures. **Micah Officer** presented a paper which conducted a comprehensive study of the impact of international migration on cross-border M&As based on a large, cross-country sample. The paper finds that a higher inbound migrant stock can lead to a significantly higher frequency, dollar value, and synergy gains after controlling for the differences between acquiring and target countries in economic and financial development, regulatory environments, stock market and currency valuations, and cultural distance. The paper supports the arguments that migration impacts cross-border deal activity by ameliorating the effect of cultural distance, facilitating post-merger integration, and mitigating information asymmetry between acquiring and target countries The results are robust to a variety of subsample tests, alternative regression specifications and endogeneity concerns.

In his discussion, **Nickolay Gantchev** first expressed his concern about disentangling the effects of migration and ancestry. Burchardi, Chaney, and Hassan (2019) demonstrates that the (common) ancestry of US counties has a causal effect on foreign direct investment (FDI), and the ancestry is instrumentalized by migrant flows dating back to 1880. Secondly, concerning cross-border M&A results, the findings reveal more pronounced effects of migration on M&A activities for targets in labour-intensive industries, acquirers with a high intensity of organizational capital, and targets that are private or situated in complex industries distinct from those of the acquirers. He suggested focusing cross-sectional tests on M&A-specific measures, such as completion probabilities, time to completion, and friendly/hostile distinctions. Finally, he mentioned his concerns on the instrumental variables strategy.