Inter-firm linkages and M&A returns

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This study investigates the value of customer/supplier relationships in mergers and acquisitions. The findings indicate that targets (suppliers) with strong customer/supplier relationships obtain higher abnormal returns and higher merger premiums when compared to targets with weak customer/supplier relationships. However, targets with a strong connection to a customer have a lower chance of being acquired. Acquirers that purchase targets with strong customer/supplier relationships have negative long run abnormal returns suggesting that the acquirers may have overpaid for these targets. The implications of customer/supplier relationships on customers, rivals, and competing rivals are presented.

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1. Introduction

Extensive literature has examined M&A activity where firms acquire other firms for traditional motives, such as to improve efficiency and to promote growth. In this paper, we study an unconventional reason for takeovers, presumably to benefit from the supplier’s relationships with major customers. A major customer/supplier relationship exists when a supplier sells a significant portion of its output to a customer. An example of this type of relationship involves Target and its major supplier, Mossimo, Inc., which was acquired by Iconix Brand in April 2006. On March 2000, Mossimo, Inc. announced a major, multi-product licensing agreement with Target under which Mossimo, Inc. would brand items sold exclusively at Target. In the acquisition of Mossimo, Inc. by Iconix Brand, the CEO of Iconix stated, “Mossimo is one of the largest apparel brands in the United States distributed exclusively through one of the biggest and most exciting retailers in the world (Target) and we are thrilled to be in a position to add it to our growing portfolio of strong consumer brands...”. In this example, Iconix did not have a major relationship with Target prior to the merger and, as such, could benefit from Mossimo’s existing relationship with Target.

Strong customer/supplier relationships are often considered harmful for supplier performance. This view can be related to research conducted by Galbraith (1952), Scherer (1970), and Porter (1974), who note that major customers may bully their suppliers by pushing for lower prices. A case in point is Wal-Mart and its history of “squeezing out every penny from suppliers” (PBS Frontline, 2004). In particular, Porter (1974) argues that “where retailer power is high, the manufacturer’s rate of return will be bargained down, certeris paribus.” Stern and El-Ansary (1988) and O’Neal and Bertrand (1991) find that suppliers in strong customer relationships face higher inventory costs as often they are the ones responsible for holding the inventory. If this is the case, firms with strong customer/supplier relationships may be less attractive as targets as these relationships may be less valuable to potential acquirers.

An alternative theory is provided by Jackson (1985) who demonstrates that stronger ties improve efficiencies. Kalwani and
Narayandas (1995) and Kinney and Wempe (2002) argue that relationships foster information sharing. Kinney and Wempe (2002) find that firms that adopt just-in-time production management are associated with improved return on assets relative to non-adopters, and partnerships between suppliers and their trusted major customers accelerate the just-in-time process. Kalwani and Narayandas (1995) report higher levels of return on investment for a sample of 76 manufacturers in a long-term relationship with major customers. Jackson (1985) suggests that increased customer-base concentration provides supplier firms with benefits, such as decreased marketing and administrative expenses. He argues that suppliers may be able to exploit their major customers’ reputations and brand names and use them as showcase accounts to attract other customers. Furthermore, Cowley (1988) examines a sample of strategic business units in the Profit Impact of Market Strategy (PIMS) database from 1973 to 1976 and finds that selling and advertising costs tend to be lower when there are fewer major customers to service. These reasons, namely improved efficiencies generated by information sharing and lower marketing expenses, would make suppliers with strong customer/supplier relationships more attractive as potential takeover targets.

To investigate whether strong customer/supplier relationships are valuable in takeovers, we examine how these relationships influence the shareholder wealth gains for targets. We focus on takeovers of suppliers with large customers for several reasons. First, large customers account for a substantial portion of a supplier’s revenue. In addition, U.S. disclosure rules make the study of large customers more reliable since suppliers must disclose the identities of major customers, but customers are not required to share similar information about their major suppliers. The findings indicate that stronger ties between the target and the customer are associated with higher three-day cumulative abnormal returns (CARs) (30.5% vs. 19.5%) for the target. Stronger ties are also associated with a 21% higher merger premium. Furthermore, the benefits that targets receive from strong customer relationships are apparent after controlling for other relevant factors in the multivariate analysis. The findings suggest that acquirers value strong ties, consistent with Papatoukas (2012), who finds that customer-base concentration has a net positive impact on supplier firm performance.

Upon initial observation, a supplier with a strong customer/supplier relationship would appear to be a good takeover target based on the relatively high premium paid for these targets. However, an examination of the post-merger performance of acquirers that have purchased targets with strong customer/supplier relationships indicates that these acquirers perform poorly in the long run. In particular, the buy-and-hold returns on both the style-adjusted and market-adjusted basis are negative. An examination of the post-merger period reveals that most of the customer/supplier ties are terminated after the merger. After investigating deals in LexisNexis, we attribute the termination of ties to the change in dynamics of the merged entity which distorts the supply chain process.

To gain further insight into merger transactions involving strong customer/supplier relationships, we examine the effects of these deals on customers, rivals, and competing rivals (rivals with significant sales to the target customer). We find that customers associated with suppliers that deem them important report significant returns of −1.49% around the merger announcement date. These results suggest that customers lose bargaining power when an acquirer announces the takeover of an important supplier. Rivals of suppliers with strong customer ties experience positive abnormal returns of 0.62% around the merger announcement date, while competing rivals (rival firms that sell to the target customer prior to the merger) experience returns of −1.64% around the same time window. The positive returns to rivals may reflect their increased probability of a takeover. The fall in returns to competing rivals may signal the perceived increased competitive threat from the merged firm.

This paper contributes to the literature in the following ways. First, we determine that acquirers value targets (suppliers) with strong customer/supplier ties. Acquirers pay a higher premium for targets with stronger ties, and these target firms experience better stock announcement returns around the time of the merger. This finding broadens our understanding of target ties in acquisitions.

While Fee and Thomas (2004) examine targets that may or may not be customers of supplier firms, in our sample, the targets are always suppliers. Thus, the focus of our target firms is different. Further, we make an important distinction between targets with strong customer ties and those without, which Fee and Thomas (2004) do not. In addition, while Fee and Thomas (2004) focus on customers associated with bidders, our results provide new evidence as to how the acquisition of supplier targets impact rival, customer, and competing rival firms of the target firm. Moreover, the findings indicate that acquirer ties with the customer are seldom maintained after the merger and that the acquirer fails to benefit from the merger resulting in poor long run performance. This finding suggests that acquirers overestimate the value of such ties prior to the merger. Finally, we demonstrate that the odds of being acquired fall as customer/supplier ties increase. The targets that have strong ties are acquired by acquirers with high market-to-book ratios suggesting that the merger may be driven by overconfidence on the part of the CEO.

2. Hypothesis development and related literature

Several studies investigate the influence of major customer/supplier relationships on various corporate policies including capital structure (Maksimovic & Titman, 1991; Titman, 1984), corporate governance (Cremers, Nair, & Peyer, 2008), and bankruptcy (Hertzel, Li, & Officer, 2008). Fee and Thomas (2004) and Shahrur (2005) focus on customer/supplier relationships in mergers and acquisitions. In examining takeovers of target with strong customer ties, our study takes a new perspective by investigating how large customer/supplier relationships affect target (supplier) shareholders.

Relationships between individual suppliers and customers are major fixtures in business practice. These relationships are known to create operating interdependence across firms (Banerjee, Dasgupta, & Kim, 2008; Cremers et al., 2008). Our focus is to examine customer/supplier relationships in a merger framework. Previous studies provide some limited evidence as to how mergers affect customer/supplier relationships in industry-specific case studies relating to antitrust. Mullin, Mullin, and Mullin (1995) examine the market reaction of customers to various events associated with the unsuccessful dissolution of U.S. Steel that began in 1911. They find that dissolution of U.S. Steel would have lowered steel prices and raised output. The welfare consequences of the expanded output would have been substantial. Mullin and Mullin (1997) examine the reaction of customers to the U.S. Steel 1906 acquisition of Great Northern Railway iron ore properties. They find efficiency gains passed onto customers associated with the merger. Bittingmayer and Hazlett (2000) study the effects of antitrust actions against Microsoft on firms that produce complements or substitutes for Microsoft products. Government action against Microsoft appears to inflict capital losses on the computer sector as a whole. Hertzel et al. (2008) examine the extent to which bankruptcy has intra-industry consequences. Distress related to bankruptcy filing is associated with negative and significant effects for suppliers. Aerni and Harford (2014) investigate how inter-industry relations affect merger waves. They find that there are more inter-industry mergers between two industries when they

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