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The Extended Merger and Acquisition Process: Understanding the Rôle of IPOs in Corporate Strategy

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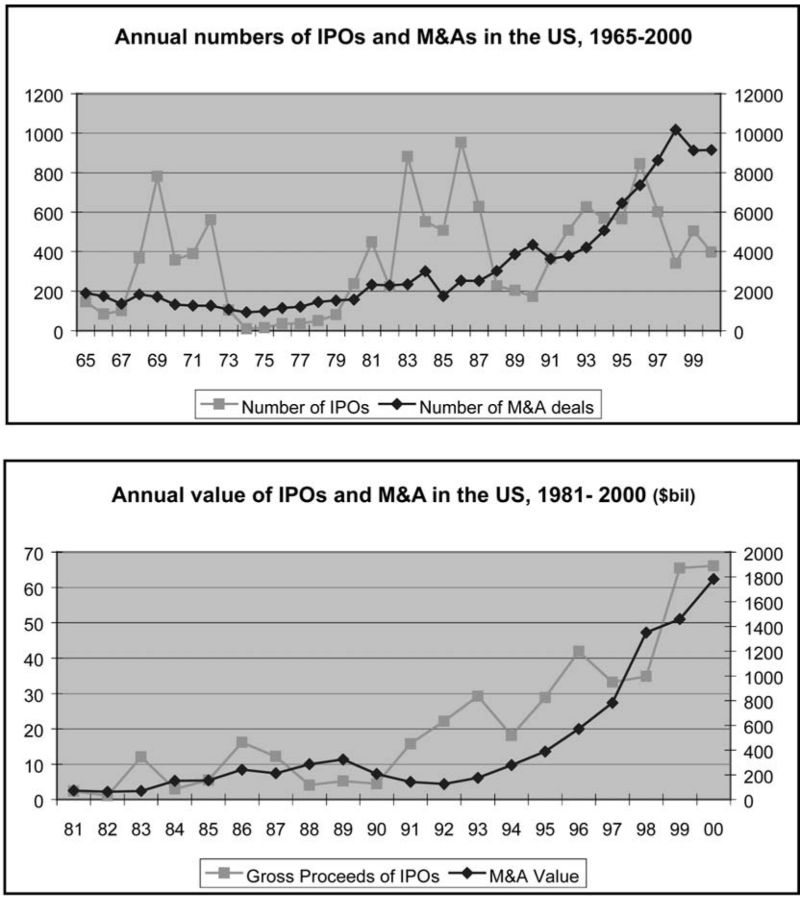
Corporate strategy research has largely ignored initial public offerings. We discuss possible reasons why this is the case and then present evidence suggesting why this may be problematic. In contrast to prior M&A research, we take the perspective of the sell-side and investigate a private firm's decision to sell itself outright versus engage in alliances or undertake an IPO beforehand. We develop the argument that sequential divestiture via IPOs can serve to mitigate *ex ante* transaction costs in the M&A market under two general conditions: (1) when search costs are non-trivial because potential acquirers' understanding of the identity and availability of exchange partners is incomplete, and (2) when information asymmetries pose valuation challenges. Consistent with these arguments, the empirical results of our research suggest that sequential divestiture via IPOs is more likely in industries with spatially-dispersed firms and for firms with significant intangible resources. Investments in strategic alliances are shown to be alternative signaling mechanisms that lessen the effects of asymmetric information accompanying intangible assets. The evidence indicates a place for IPOs on the corporate strategy research agenda as well as a need to understand sell-side processes in M&A. We suggest that IPOs can be seen as part of a more extended M&A process.

Keywords: M&As, Corporate strategy, Initial public offerings, Private firms, Divestitures

Introduction

Both initial public offering (IPO) markets and merger and acquisition (M&A) markets experienced unprecedented surges in the last decade. Figure 1 displays the annual volumes and values of IPOs and M&A activities in the US. During the 1990s, more than 5000 US companies went public, compared with fewer than 3000 firms from the EU and fewer than 1000 Japanese firms. The number is also higher than the 4866 US IPOs in the 1980s, a period which had been characterized as IPO mania. This trend is even more significant for M&A transactions. There were over fifty thousand M&A deals completed in the 1990s, roughly twice as many compared to the 1980s. And the transaction value during the 1990s was more than three times the value during the 1980s.

The going public boom has been attributed to factors as diverse as tax changes, deregulation of investments by institutional and foreign investors, the emergence of entrepreneurial firms and venture capitalists, relaxation of listing requirements, improvements in legal protection of minority shareholders, and, in Latin America, continental Europe and Asia, the advent of large-scale government privatization programs (Jenkinson and Ljungqvist, 2001). Equally significant, more than a dozen different political and economic factors have been suggested to be responsible for creating a business environment leading to the restructuring of corporate assets. These factors include the relaxation of restrictions on mergers imposed by anti-trust authorities, improvements in takeover technology and financing technology, withdrawal of resources from industries that are growing



* Gross (nominal) proceeds of IPOs data exclude IPOs with an offer price of less than $5.00 and overallotment options but include the international tranche, if any.

Source: IPO data are from Jay Ritter, available at http://bear.cba.ufl.edu/ritter/ipoall.htm M&A data are from *Merges and Acquisitions*, which includes data from *The Thomson Financial Securities Data Mergers & Corporate Transactions Database*.

Figure 1 Annual Volume and Value of IPOs and M&As in the US

more slowly or that must shrink, and, notably, deregulation in the financial services, gas, transportation, broadcasting, and telecommunications sectors (e.g., Andrade *et al.*, 2001). However, despite the increasing importance of IPO and M&A activities and the concurrence of IPOs proceeds and M&A values (the correlation is as high as 0.87 over the past two decades), little research has examined the interplay between these two markets.

Viewing IPO and M&A markets in a separable fashion may reflect a conventional view that IPO markets and the market for corporate control are largely independent. Specifically, it is often assumed that going public is mainly undertaken as a purely financial choice or the natural outcome of an entrepreneurial firm's efforts to develop a new business. Under traditional finance theory, IPOs might be assessed based on the tradeoffs between the benefits arising from relaxing an owner-manager's liquidity constraints and the costs associated with the agency hazards stemming from the separation of ownership and control in corporations (Jensen and Meckling, 1976). Although such an agency theory perspective has also inspired theories accounting for M&A activities based on conflicts of shareholders and managers over the payout of free cash flow (Jensen, 1986), the link between the decision to go public and subsequent divestiture activities has largely been ignored.

However, recent descriptive findings indicate that IPOs are often part of a larger process of transferring control rights in organizations. For instance, in newly-public Italian firms the controlling stake is sold to an outsider 13.6 per cent of the time, which is roughly twice the rate for the Italian economy in general (Pagano *et al.*, 1998). Not only are control changes more likely to happen for IPO firms than private firms, but newly-public firms also experience a greater rate of acquisition than established public firms (Field and Mulherin, 1999). Practitioner accounts of merger and acquisition patterns suggest that a firm can use an IPO as a way of 'teeing up' a company for sale, or as a first step in a sequential divestiture strategy (Rock, 1994). Taken together,