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Gaining a competitive edge through acquisitions: Evidence from the telecommunications industry ☆

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ABSTRACT

I study the announcement effects of all acquisitions in the recent telecom wave on both the acquirers and their industry competitors. I find evidence of negative rival returns (−0.55%, *t*-stat = 2.47) by focusing on non-horizontal acquisitions where rivals are less susceptible to experience positive returns due to increased market power or expectation that some will become future targets themselves. I find that this effect is worse for closer rivals defined as having similar size and being in the same primary service area as the acquirer. Competitor returns are positively correlated with those of the acquirers suggesting that the negative impact experienced by competitors is driven by acquisitions in which the acquirer itself is earning negative abnormal returns. Results are broadly consistent with the Competitive Advantage Hypothesis that posits acquisitions are a means of corporate restructuring in a changing environment, awarding the acquirer a competitive edge and thereby making these acquisitions costly for their non-merging competitors.

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1. Introduction

A recent trend in the empirical takeover literature ties M&A activity to industry-wide shocks, finding evidence consistent with the notion that acquisitions may be an efficient reaction to economic change (Andrade and Stafford, 2004; Mitchell and Mulherin, 1996; Mulherin and Boone 2000; Weston et al., 2004; and Harford 2005). Implied is the possibility that acquisitions may be strategic investments and restructuring tools that arise in response to an industry shock. The very nature of a merger wave and its possible role as a response to an industry-wide shock emphasizes the need to focus on an industry as a whole in order to understand the overall impact of and possible motives behind acquisitions, particularly those that occur during a merger wave. The primary goal of this paper is to study rival returns as a guide to causes and effects of takeovers, particularly to those that come after an industry shock and during a high period of M&A activity.

A body of analysis studies rivals as a means to address the causes and effects of takeovers with no direct link to industry shocks. Starting with Eckbo (1983) and Stillman (1983), several studies test the collusion theory by examining the impact of an acquisition announcement on the industry counterparts of the acquirer in horizontal acquisitions. They find mixed results. By studying the impact to the rivals of the *target* firm, Song and Walkling (2000) show that targets' rivals experience positive returns both in horizontal and non-horizontal acquisitions due to the expectation of them becoming future targets themselves. More recently, Song and Walkling (2005) investigate bidder rivals' returns at the announcement of the first acquisition within an industry that experienced a long period of M&A inactivity ("dormant" period). They find that rivals earn small returns that are positively correlated with that of the acquirer, finding support for anticipation effects at such acquisition announcements.

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A variety of theories are proposed for observed rival returns at the announcement of acquisitions. One such theory suggests that merging of two firms in an already concentrated industry can be beneficial for the rival firms through increased market power for all parties, resulting in positive returns for both the acquirer and the rivals (Eckbo, 1983; Eckbo and Wier, 1985). Alternatively, the target firm might give the acquirer a competitive advantage resulting in negative abnormal returns for its competitors whether that occurs when the acquirer is earning positive returns (Eckbo, 1983; Eckbo and Wier, 1985) or negative returns itself (Akdoğu, 2008; Molnar, 2000). Information spillovers can also affect rival firms. An acquirer may earn negative returns since that signals a weaker competitor (McCardle and Viswanathan, 1994) or poor internal growth opportunities for the acquirer (Braguinsky and Jovanovic, 2004). If the latter is extended to the acquirer's industry as a whole, that results in a negative reaction for its rivals as well. Anticipation of some of the rivals becoming future targets (Song and Walkling, 2000) or future acquirers (Song and Walkling, 2005) themselves can also be the cause of non-zero rival returns.

I study acquisitions in the Telecommunications industry after the Telecom Act of 1996 investigating primarily the effects on the acquirer's rivals. Instead of multiple industries, I choose to focus on a specific one in order to engage in an in-depth study of all firms belonging to that particular industry. The primary benefit of this approach is that it allows me to choose an industry that has experienced an easily identifiable exogenous shock which precedes a high period of M&A activity. The telecommunications industry, particularly after 1996, provides a unique platform to investigate the impact of acquisitions on rivals after an industry shock; Acquisitions were a response to an exogenous shock that came in the form of deregulation and were perceived to be a survival mechanism in these changing conditions. The severity of the conditions are best iterated by a practitioner describing the competitive environment in the telecommunications post-Telecom Act as largely consisting of two options: To merge or die ("Telcos merge for survival", 1998).[1]

My main findings are threefold. First, I show that acquisitions have an adverse impact on the industry competitors by focusing on non-horizontal acquisitions. Second, those rivals that are more direct competitors of the acquirer defined as having similar size or providing primarily the same service as the acquirer experience a worse impact than an average competitor. This evidence is consistent with these acquisitions having the worst impact on the closer competitors of the acquirer. Third, this negative effect is attenuated for competitors that made prior acquisitions. In addition, competitors that become future acquirers are significantly better off than those that remain unmerged at the announcement of their rivals' acquisitions. Combined, these results suggest that in this environment being an acquirer was considered to be a more viable alternative than staying unmerged.

The rest of the paper is structured as follows. Section 2 delineates the hypotheses. Section 3 summarizes the research design. Section 4 describes the data selection process and the methodology. Section 5 documents basic summary statistics of the sample and reports univariate statistics. Section 6 reports multivariate results, discusses possible theories for the initial results and attempts to identify the driving theory(ies) behind them. Section 7 concludes.

2. Hypotheses

Several theories have implications on rival returns at the announcement of mergers. In the next two sections, I discuss the various predictions resulting from these theories and the specific tests designed to differentiate between various reasons behind rival returns. I summarize these under three main headings: market power, information-based and competitive advantage hypotheses.

2.1. The market power hypotheses

As initially argued by Eckbo (1983, 1985) and Eckbo and Wier (1985), the market power hypothesis suggests that a horizontal merger can result in a more concentrated industry and increased monopoly power for firms within the industry. The rivals of the merging firms benefit from the merger because successful collusion among rivals limits output and possibly raise prices. This collusion would result in positive abnormal returns for both the bidder and rival firms in horizontal mergers but not be a strong factor in non-horizontal acquisitions.

A vertical merger can similarly have effects on rivals due to increased market power of the combined firm. A vertically integrated firm might engineer an increase in rivals' costs by driving up the price of a scarce input (Riordan, 1998) or through vertical foreclosure, i.e. by increasing market power at the upstream market (Ordover et al., 1990). This outcome can lead to negative returns for the rivals at the downstream market and can be a factor in acquisitions that are classified (based purely on SIC codes) as either horizontal or non-horizontal depending on the particular target industry, i.e., if the target firm is a supplier of the telecom industry.

2.2. The information-based hypotheses

Informational stories suggest that the rival or bidder returns at merger announcements do not necessarily represent the value impact of that particular acquisition but the impact of the information revealed by it. A merger announcement may reveal extra information about the bidder itself, its industry as a whole or the prospects of future acquisitions within the industry. I consider two versions of such stories: signalling and anticipation.

[1] Another article published in Business Week, entitled "It's merge, buy or die in Telecom", emphasizes this point. Several other industries, including Internet, Pharmaceuticals and Petroleum, exhibit similar characteristics with respect to their competitive environment and perceived survival strategies in this environment. The article published in April 2002 in *Wireless Week* entitled "Smaller Players in 'Merge-Or-Die' Frenzy" describes the internet industry conditions. The 2003 article in *Graduating Engineer* (Industry Focus: Petroleum), claims that "at first glance, the motto of the petroleum industry would appear to be 'merge or die'".

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