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Merger market dynamics: insights into the behavior of target and bidder firms

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Abstract

This study presents a framework deriving the demand and supply of target firm shares in merger, and tests it using event study methodology and regression analysis. Target and bidder behavior are not mirror images; instead bidders rank and pursue targets which either accept or reject bids. Merger cycles are motivated by bidder demand shifts, target quality is as important as strategic fit for bidders, and transaction type is confirmed as the most reliable predictor of variation in premiums. Target institutional investors raise the cost to the bidder. ©2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

How does the merger market operate over time? What motivates merger waves? How do supply and demand conditions impact target and bidder behavior?

The framework presented here for analyzing these and other questions involving merger dynamics is supply and demand schedules for target firm shares. The advantage of this framework is that it enables us to analyze dynamic aspects of mergers, and to determine more carefully the role of market-wide and transaction-specific factors.

Much of the previous merger research has focused on such topics as related diversification (i.e. Montgomery, 1979; Bettis, 1981; Palepu, 1985; Singh and Montgomery, 1987); what

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types of relatedness matter, and how to measure them(i.e. Shelton, 1988; Chatterjee and Wernerfelt, 1991; Markides and Williamson, 1994; Robins and Wiersma, 1995); and the division of overall gains between targets and bidders, but with little exploration of key market forces (i.e. Bradley et al., 1988; Lang et al., 1989; Stulz et al., 1990; Maloney et al., 1993; Smith and Kim, 1994). The literature also includes notable summary studies providing valuable syntheses of diverse empirical studies (i.e. Jensen and Ruback, 1983; Ramanujam and Varadarajan, 1989; Hoskisson et al., 1993), or insights gleaned from multidisciplinary or meta-analytical approaches(i.e. Lubatkin, 1983; Datta et al., 1992), but these works still shed little light on merger market dynamics.

It is surprising that most of this previous work does not consider mergers within the overall context of supply and demand because mergers occur in waves, indicating that supply and demand forces are active over time. Here, supply and demand curves for target firm shares are developed, and the impact of market-wide and transaction-specific effects on these curves is explored and key results of the literature are tested.

The following section examines the demand and supply forces in the merger market and develops testable hypotheses while the construction of the database and key variables are discussed in Section 3. Regression models and statistical results are analyzed in Section 4 and the discussion and implications are presented in Section 5.

2. Supply and demand forces in the merger market

2.1. Supply and demand curves

In this examination of merger demand and supply conditions, target firm shares are claims on target firm assets which may be purchased from shareholders of publicly held firms, or directly from target management in the case of sell-offs or privately held firms. Bradley et al. (1988) and Stulz et al. (1990) present supply curves for target firm shares that are increasing functions of the price offered by the bidder. However, all atomistic shareholders are assumed to be homogeneous, and to tender at one price, and no distinction is made between individual and aggregate supply curves. Here, shareholders have heterogeneous expectations, and Figs. 1, 2 illustrate both individual and aggregate supply curves for a target firm's shares. Sell-offs [1] and privately held firms can be assumed to be instances in which a single shareholder, target management, holds 100 percent, or a controlling percentage, of the shares. In Fig. 1, each target firm shareholder has a set of expectations regarding the future cash flows of the firm. These expectations form the reservation price, P', at which the

[1] Slovin et al. (1995) define sell-offs as privately negotiated sales of subsidiaries which differ from equity carve-outs and spin-offs, because control of the assets is transferred to a third party. Ravenscraft and Scherer (1987) note that subsidiary sales primarily increase corporate focus, or raise funds. Empirical results are mixed, with authors finding evidence supporting superior fit (i.e. Alexander et al., 1984; Hite et al., 1987; John and Ofek, 1995), and confirming the financing hypothesis (i.e. Shleifer and Vishny, 1992; Ofek, 1993; Lang et al., 1995). Target firm assets are also available because some buyers are willing to overpay (i.e. Jensen, 1986; Lang et al., 1991).

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