The history and mystery of merger waves: A UK and US perspective

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Merger waves are an enduring mystery and the search for a single explanation for their existence, growth and size continues. The history of US and UK merger waves shows that each wave has had a different motivator, including regulatory and economic factors. The nature of the waves also changed with differences in the type of deals, the behaviour of the involved companies and the methods of payment. Why then should there be a single explanation for the existence of merger waves? Considering their history there is no reason to believe that a single model exists to explain this phenomenon.

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What causes a merger wave? Why do they grow to such excessive heights? Is it possible to create a single model that will explain this behaviour? The analysis of the relationship between merger and acquisition activity and the condition of the economy in the preceding periods is the subject of a substantial body of work in which several models have been developed. The overriding problem with these models is that none of them work very well outside the market or timeframe over which they were created. This has resulted in the development of a second strand of research considering the level of merger and acquisition activity over time, but a discussion of that particular area of the literature is outside the remit of this paper. Instead by concentrating on the history and nature of merger waves throughout the last century it is possible to posit the hypothesis that there is no one reason for the development of merger waves, nor is there any great mystery concerning their existence. Furthermore, there will never be a single explanation for these events as they change fundamentally over time and, whilst some characteristics seem to be consistent, many others are not. In short, merger waves are simply the result of a combination of economic and legal conditions that make activity of this sort appealing to companies at certain times.

I

A company is an entity which must respond continually to both internal and external pressures. Biological analogies are no longer a particularly fashionable way of viewing a firm but a certain resemblance exists nonetheless and can work well to illustrate the general life-cycle of a firm. A company is born, struggles to survive, grows through adolescence and then reaches maturity. Eventually, it will die, either through natural causes and a slow deterioration into old age or it may be absorbed into another, more predatory, firm. Merger and acquisition activity represents the second of these options and provides a way for company assets to be transferred from one set of owners to another. The literature that attempts to connect merger and acquisition activity to economic factors presumes that companies are reacting to external conditions rather than internal ones and also presumes that changes in the performance of the economy can impact on the firm in such a manner that the company is inspired to enter the market for corporate control.

This strand of the existing literature begins with the economic disturbance theory[i] which suggests that changing economic conditions result in differences of opinion concerning the value of companies. These differences of opinion, in turn, result in increased levels of merger and acquisition activity. This theory works particularly well as a general statement but in order to be truly applicable, it is necessary to identify precisely which economic conditions are important in this relationship.

The level of the stock markets is one factor that appears to be important in the majority of existing literature on this topic. Rising share prices are very often an indicator that a country's economy is strengthening and this is followed by increased profits for many firms. Naturally, this, in turn, can trigger increased levels of merger and acquisition activity[ii]. Another advantage of a rising stock market is that it facilitates merger and acquisition activity either by allowing companies to raise finance through the issue of new shares or allowing them to use new shares as the medium of exchange in the deal. If this is coupled with falling interest rates then finance becomes particularly easy to raise and a major constraint to merger and acquisition activity is removed[iii]. It is interesting to note that these advantages seem to completely overweigh the fact that rising share prices will also elevate the target firm's market price.

Another important factor in determining the level of merger and acquisition activity is the overall size of the economy. It is much easier to attempt deals of this sort in a large economy rather than in a small one[iv]. When a firm is considering entering the market for corporate control, it is far easier to find a suitable partner for a merger or a target for an acquisition when there are a lot of companies to choose from.

When considering the behaviour of the market for corporate control there are also considerable differences between levels of activity in different industries. It is also well-known that the timing of merger and acquisition activity is industry specific. These patterns are determined by shocks to the industry which can result from changes in economic and regulatory conditions[v]. When a substantial shock is received by an industry, it often becomes necessary for the firms within that industry to make some major changes in response. Under these circumstances, merger and acquisition activity is often the fastest form of response and, in some situations, may even be cheaper than the alternatives.

An important caveat to all of the theories connecting economic factors and the level of merger and acquisition activity is that they all presume that external factors are able to drive decision making within the firm and, if necessary, override internal concerns. This may, indeed, be the case but there will always be instances in which internal factors will either encourage or prohibit a firm's entry into the market for corporate control. More problematically, whilst these theories are all effective within the data set used in their construction, they do not demonstrate the same accuracy when used on other data. Furthermore, whilst there are many similarities in the variables that are considered significant, there are also many differences and the interrelationships between variables change from one paper to another.

II

The history of merger waves spans the twentieth century during which time there have been several merger waves in the US, each of which has been distinctly different from the others.

The first US merger wave began at the end of the nineteenth century and lasted until 1905. It is generally thought to have been triggered by the combination of a rising stock market and the introduction of the Sherman Antitrust Act (1890) which was designed to prohibit any contract that would limit trade between different states and countries, but was not designed specifically to deal with the growing phenomenon of merger and acquisition activity. It was also unable to prohibit any merger or acquisition that was organized using a stock for stock exchange. Worse yet, the Sherman Act made it possible for companies to form near monopolies without any regulatory interference. Naturally, many companies sought to take advantage of this situation and the first US merger wave began as a result. During this time 1800 firms disappeared in this merger wave and approximately 71 formerly competitive industries were converted into virtual monopolies during this wave; a massive reorganization of the industrial landscape of the United States[vi].

Twenty years later there was another merger wave, this time reflecting the fact that the regulatory framework was changing again. The US courts now made it clear that they were prepared to forcibly take apart companies that had a monopolistic hold on their industries, as the 1911 break-up of Standard Oil so clearly demonstrated. John D Rockefeller had created Standard Oil in 1868 in Pittsburgh, Pennsylvania and it then spread rapidly throughout the United States gaining more and more subsidiaries as it went. This one company represented all the power and wealth of the Rockefeller business empire and Standard Oil was well known for savage business practices that drove many of its competitors out of business. In 1911, however, the US Supreme Court decided to act and accused Standard Oil of discriminatory practices, abuse of power and excessive control of its market. All of these had been acceptable under the Sherman Act but the regulatory framework of the United States was changing and monopolistic behaviour was no longer acceptable. Standard Oil lost the ensuing court battle and was forced to dismantle thirty-three of its most important subsidiaries and distribute the shares to its existing shareholders. The company was also forbidden from creating a new trust to be the recipient of the shares effectively making it impossible for Rockefeller to maintain control of the subsidiaries. The break-up of Standard Oil represented the first step towards the new merger legislation that was to be introduced in 1914, the Clayton Act. This Act was put in place specifically to redress the weaknesses of the previous legislation and it actively encouraged companies to form oligopolies instead of monopolies. Once again companies were eager to take advantage of the change and the second US merger wave was the result. As with the previous wave, the stock market was rising and companies were able to issue equity as a way of financing mergers and acquisitions with relative ease. The wave was brought to a very abrupt end however with the advent of the Great Depression (1929) which caused the collapse of the US stock market and halted merger and acquisition activity almost overnight.

The level of merger and acquisition activity fluctuated throughout the 1940s and 1950s without ever rising to the extreme levels that characterize a wave. In 1950 the Celler-Kefauver Act was introduced which extended the Clayton Act and prohibited any merger or acquisition that was designed to give one firm a substantial degree of market power. As a result the number of horizontal deals was reduced to the bare minimum. This Act marked the first step towards merger regulations as they exist worldwide today with the emphasis on maintaining consumer choice in the market place.

The next US wave activity began at the end of the 1950s and lasted until the middle of the 1970s as the US economy underwent a strong period and the stock market again rose markedly. This resulted in the third US merger wave of the last century as profitable companies found themselves with large cash flows which they were unwilling to pay out to shareholders in the form of dividends and so turned to the market for corporate control as a way of utilizing these funds. Throughout this period, the majority of deals were friendly arrangements and stock was the primary medium of exchange[vii]. The most notable feature of this merger wave was the preponderance of conglomerate deals as companies actively sought to expand into new markets and areas. The strength of this trend is illustrated by the fact that the number of conglomerate firms increased from 8.3% of Fortune 500 firms in 1959 to 18.7% in 1969[viii]. This change is almost certainly due to the provisions of the Celler-Kefauver Act, which made horizontal mergers unpopular. The oil crisis of 1973 resulted in a sharp increase in inflation and a world-wide economic downturn which marked the end of this merger wave.

The fourth US merger wave took place in the 1980s and exceeded all of the proceeding waves in both the volume of transactions and in the size of the deals. Another notable characteristic of this wave was the much higher degree of hostility as companies that were previously considered untouchable, as their sheer size would make them safe, became the targets of unwelcome acquisition bids and fought vigorously to defend themselves. Almost half of all major US companies were the recipients of an unsolicited takeover bid in the 1980s[ix] which is a clear indicator of the volume of transactions taking place during this particular wave. This merger wave is also the one that has generated the greatest volume of academic analysis and a plethora of different reasons have been put forward for its taking place. One possible reason is that the US government relaxed some of the restrictions on takeover activity that the earlier law had put in place[x]. An alternative explanation is that it represented a return to specialization after the excessive diversification and expansion of the 1960s wave. Many of the companies that were most active during the earlier merger wave found that there were incredible difficulties inherent in managing a company spread over many different markets and countries. Many conglomerates failed entirely or were forced to divest considerably in order to survive after the 1960s merger wave and the 1980s wave saw the return of horizontal takeovers as firms elected to concentrate on areas in which they were most profitable and effective. It is also worth noting that the 1980s was a period in which companies had to respond to a series of shocks that impacted on just about every type of company. These included the growth of industrial deregulation, severe changes in the costs of inputs, such as oil, and the rapid developments in technology that took place throughout this period. This tallies with the economic disturbance theory that was propounded by Gort[xi] which says that changes in external conditions result in differences of opinion concerning the value of companies and this, in turn, leads to increased levels of merger and acquisition activity. Another alternative arises from the fact that mergers and acquisitions, whilst expensive and risky for the involved firms, may nonetheless be the most effective way for an entire industry to restructure in the wake of some form of economic shock[xii].

A more traditional approach to the 1980s merger wave takes the line that it was caused by the proliferation of managerial inefficiency. Ineffective corporate governance mechanisms, coupled with equally poor managerial incentive schemes, allowed corporate mismanagement to flourish throughout the 1970s and into the 1980s. If stock markets were truly efficient, any company with an ineffective management team would be identified, the share price would drop and, ultimately, the firm would go bankrupt. Stock markets are not, however, fully efficient and so the market for corporate control steps in to fill the gap. Companies with inefficient managers will be somewhat undervalued thus making them an appealing target for acquisition. After the purchase is complete, the ineffective managers will be removed and the overall efficiency of the market is improved[xiii].

The merger wave of the 1980s was also prompted by the popularity of debt financed transactions during this period. The use of debt in mergers and acquisitions was not a new innovation but became considerably more widespread during this period than at any other time as leveraged buy-outs became popular forms of takeover. The use of junk bonds had the advantage of making it possible for very large companies to be considered potential takeover targets which added to the hostility of many transactions at that time.

The most recent merger wave, in the 1990's, was the biggest one of all, vastly exceeding all of the previous waves in both number of transactions and value. Whilst the trend towards horizontal deals continued, in every other respect the 1990s merger wave was very different to its predecessor. This wave was almost entirely friendly with just 4% of deals being denoted as hostile[xiv] and the popularity of stock as the medium of exchange increased by approximately 50% compared to the previous merger wave. One potential explanation for the change in nature of deals from the hostility of the 1980s to the more restrained activity of the 1990s is due to improvements in corporate governance. With the level and effectiveness of monitoring increasing greatly, it became much more difficult for managers to enter into highly risky deals and forced them to consider more carefully whether to enter the market for corporate control at all and, in the event that they decided to proceed, how they would enter the market[xv]. Faced with these sorts of constraints, many managers would think very carefully before attempting a merger or acquisition.

III

Merger waves in the UK have a far shorter history than those occurring in the US. Nothing akin to a substantial merger wave transpired before the 1960s although there was a small wave in the 1920s which was inspired by the widespread introduction of mass production technologies in the UK following the end of the First World War. These new technologies resulted in a sharp increase in productivity, and a matching increase in share prices. This sudden burst of productivity and profitability generated a spate of mergers that resulted in substantial increases in concentration in many manufacturing industries.

In 1948 the first step in the development of UK merger policy was taken with the passing of the Monopolies and Restrictive Practices Act which created a Commission to look into deals that might be adverse to the public good. The terms of reference for the Commission, however, were vague and the criteria to be used in determining the public good were equally indistinct. Not surprisingly, this had no noticeable effect on the level of merger and acquisition activity which continued to fluctuate gently over time but with no sign of a merger wave for more than a decade. The first real merger wave in the UK was in the 1960s and coincided with the internationalization of the World economy. The British government decided that large firms were needed to compete effectively on the international stage and to achieve this goal the Industrial Reorganization Corporation (IRC) was created with a brief to encourage the development of such companies through horizontal mergers which made up the majority of mergers in this wave. Amongst the top 200 manufacturing companies in 1964, 39 (19.5%) were involved in merger or acquisition activity within the next five years[xvi]. Given the low levels of merger and acquisition activity prior to this time, this was a major increase in activity. During the same period, the Monopolies and Mergers Act (1965) was passed which prohibited any merger or acquisition that was contrary to the public good, and created the Mergers and Monopolies Commission (MMC) to rule on contentious cases. This law focused predominantly on horizontal mergers as the public good was generally associated with market share and consumer choice and, as a result, the popularity of this type of deal should have been limited to a considerable degree but any deal backed by the IRC was exempt from the legislation which allowed the merger wave to occur, irrespective of its deleterious impact on competition in many markets. This wave experienced a partial drop after 1968 but then grew to another peak in 1972. Throughout this latter period, the proportion of horizontal deals dropped, although they were still by far the most popular type of purchase, and conglomerate deals grew correspondingly[xvii], reflecting the growing impact of the earlier legislation. The legal framework was further reinforced in 1973 with the Fair Trading Act which formalized the procedures for regulating merger and acquisition activity in the UK and created the Office of Fair Trading (OFT). The OFT examines each deal and decides whether it should be referred to the Mergers and Monopolies Commission (now know as the Competition Commission) for a detailed analysis of its potential impact.

The next period of excessive merger and acquisition activity took place in the 1980s and marked a change in emphasis when compared to the previous waves. Prior to this time the waves had been mostly about increasing the size of companies but in the 1980s the emphasis changed to the control of corporate assets as a commodity. During this period, the most recent development in merger and acquisition policy took place with a comment written in an internal memo by the then Secretary of State for Trade and Industry, Normal Tebbit, who wrote that he considered the primary grounds for a referral to the MMC would be an adverse impact on competition. However, the actual criteria for making a referral are somewhat unclear. As a result, the OFT has historically referred only a very small proportion of qualifying bids. Between the introduction of the Mergers and Monopolies Act in 1965 and 1985 there were 3540 mergers and acquisitions which met the criteria for a referral to the MMC. Of these only 107 were actually referred and in 31 of these cases the bidding company elected to withdraw the bid before any judgement was handed down[xviii]. This is echoed by more recent data which shows that of

915 deals that qualified for investigation between 1998 and 2001; only 42 were referred for a full investigation[xix]. This provides a compelling reason why the numbers of horizontal mergers have not been limited by the prevailing legal framework, despite the often quoted "Tebbit Guidelines". Throughout the early part of the 1980s the stock market was rising sharply reflecting growing profits and business confidence. The financial services industry had just been deregulated which further contributed to the growth of the wave. This period of excessive restructuring also incorporated some features of merger and acquisition activity previously unseen in the UK and imported from the US; increased hostility, the use of leverage and a large number of buy-outs all of which took place in this wave but had not previously been notable features of the market for corporate control in the UK. The London Stock Exchange suffered a major crash in 1987 but this was not enough to stop the wave, however, which had sufficient momentum to keep going until 1989.

The most recent merger wave in the UK took place in the 1990s and was again spurred on by deregulation of more British industries coupled with the policy of privatizing Government owned assets which took place through the last years of the 1980s and the early 1990s, as typified by the sales of British Telecom (1984), British Gas (1986) and British Rail (1993). These changes resulted in the need for extensive restructuring on many difference levels of British industry and prompted the merger wave. Unlike the 1980s there was relatively little hostility during this period and many companies changed their perspective on mergers and acquisitions to take a more balanced approach when compared to the excesses of the previous decade. This change in perspective was prompted by the findings of the Cadbury Report (1992) which was commissioned by the London Stock Exchange to investigate the state of corporate governance in the UK. The Cadbury Report made a large number of recommendations that increased the level of monitoring to which Boards of Directors were subjected and also increased the degree of transparency in company decision making. These recommendations, coupled with proposals decreasing the power of individual Board members and increasing the independence of Non-executive directors, made managers much more accountable for their actions and far less able to make the type of large, hostile, possibly unwise, acquisition attempts that characterised much of the 1980s.

IV

This article illustrates that there is no mystery to merger waves. Quite simply, they cannot be modelled because some of their characteristics change over time. The clear implication of this is that whilst some of the motivating factors remain consistently important, there are always other factors that are unique to one particular wave and do not apply to any other. In general terms, merger waves are prompted when finance becomes readily available at a time when the regulatory framework allows companies to enter into merger or acquisition activity. However, shocks to the economy such as deregulation are not constant and only impact on certain industries at certain times. Thus the search for a single explanation for merger waves will never be satisfied, but taking into account the history of this phenomenon, this should not be unexpected.

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