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Change your thinking about M&As

With the failure of some high-profile mergers, the concept itself has been questioned. But IESE's Stefano Sacchetto has built a model to better measure the effects of an active merger market on productivity, the economy and entrepreneurship.

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AOL and Time Warner. Daimler Benz and Chrysler. Quaker Oats and Snapple. Some mergers are complete failures, cautionary tales, pouring billions of dollars down the drain.

So, on the whole, do mergers tend to be successful or not? Do they tend to boost efficiency and productivity or divert it? Counting up the time and money spent on the search, on the legal consultations, on the actual implementation, integration and more, who comes out

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ahead?

Good news: Research by Theodosios Dimopoulos and IESE's **Stefano Sacchetto** concludes that M&A activity adds to productivity on aggregate. The economy as a whole benefits, not just the investment bankers hired. The model they build to show this includes a novel feature: It looks at the *incentive effect* of M&A activity in a market, in addition to firms' direct benefits (or losses).

In other words, mergers don't just affect the merging partners. For example, when Google spends billions on a series of acquisitions, it encourages more startup activity, as entrepreneurs hope they will be next. And new entrants tend to be positive for productivity overall. Yet, on the other hand, industry laggards may decide *not* to throw in the towel amidst a merger frenzy in the hopes that they too will be bought up. These firms tend to be negative for productivity overall.

So, crunching all the numbers, the co-authors find that an active merger market boosts overall productive efficiency. Specifically, there's a 0.7 percent gain as a result of increasing the number of firms who enter and exit the markets. Then there's a more significant 4.1 percent that comes through direct productivity gains to individual companies, resulting in a 4.8 percent gain overall.

In sickness and in health

Firms merge in both good and bad times. But their motives are very different — and so are their productivity gains.

During difficult periods, with little demand, many firms will look to mergers as a way to cut costs and hang on in the market (where the only other alternative may be to exit). Their productivity increases primarily by limiting expenses. This is *counter*cyclical, running contrary to the economic cycle and decreasing the impact of a struggling economy.

When times are good, with high demand, firms are less concerned with cutting costs through mergers. Instead they focus on productivity gains, which have even more impact in an abundant market. These gains include improvements in marginal productivity, synergy and efficiency. This is *pro*cyclical: here, mergers further increase good economic performance.

Yet direct gains to firms are only one part of the impact of the merger market. The authors show that mergers *indirectly* increase productivity by changing the composition of firms in the industry. They do this by affecting the number — and type — of companies who enter

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and exit.

In other words, M&A activity is good for productivity and thus for the economy on aggregate. Decision-makers and policymakers, take note.

Methodology, very briefly

To predict firms' entry, exit and merger decisions, the authors develop a dynamic industry-equilibrium model of a competitive industry populated by many different types of firms. This model takes merger costs, post-merger production costs and many other factors into consideration. They also test their predictions empirically through a regression analysis of merger and exit rates in a sample that tracks public financial data on U.S. companies between 1981 and 2010.

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