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Citation: Vitkova, V. and Koh, K. Y. Q. (2016). Does the Early Bird Always get the Worm?. London, UK: M&A Research Centre, Cass Business School, City, University of London.

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Cass Business School
CITY UNIVERSITY LONDON

Does the Early Bird Always get the Worm?

M&A Research Centre – MARC

MARC Working Paper Series - 2016

MARC – Mergers & Acquisitions Research Centre

MARC is the Mergers and Acquisitions Research Centre at Cass Business School, City University London – the first research centre at a major business school to pursue focussed leading-edge research into the global mergers and acquisitions industry.

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Overview

M&A can be motivated by many different things and it is not unnatural to believe that these motivations could be dependent on where we are in the M&A cycle. By extension if we believe that different motivations lead to different 'success' rates then there could be different success rates at different points in the cycle. This is the topic of this report.

First movers have historically been feted for their strategic motivations in pursuing M&A and the advantages gained from moving early, such as the availability of attractive targets. In contrast, late followers have been characterised as firms that exemplify irrational behaviour as they are compelled by competitive pressures to mimic the actions of their rivals without a logical rationale for the motivations underlying the M&A announcement.

We set out to test this simplistic view and in this report we tested the difference in performance between first movers and late followers using a sample of global M&A deals for two periods, Wave 1 (1990-2002) and Wave 2 (2003-2009).

We found considerable evidence that this simplistic view may not be correct, with our so called 'late followers' at least as successful as the 'first movers'.

Before we highlight some relevant practical findings for practitioners we will also show that there may be something different about the latest M&A wave. There are certain features of this second wave (notably the prevalence of cross-border M&A) that may make first mover advantage less prevalent. In addition, insight from literature in other fields may be casting those first movers in a less unreservedly flattering light, which should give managements pause in their attempts to be the first to acquire.

We conclude:

- It's not too late

  If you find a compelling M&A opportunity but you feel others have invested in that area already, it's not necessarily a bad thing.

- Something's changed in the latest wave

  The M&A market is becoming more about new geographies and opportunities, deals where the more you know before you proceed, the better.

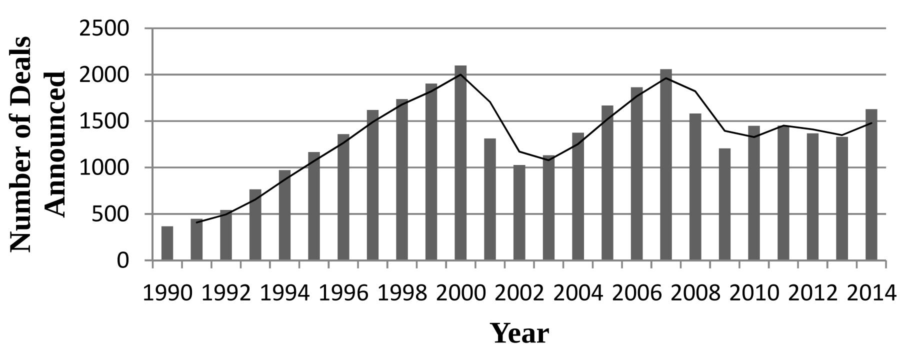
- M&A can and does add value

  Unavoidably, we looked at the data and saw a generally positive reaction to acquisitions, regardless of which end of the 'wave' we are at.

And perhaps, judging by the positive reception given by the market to both our first movers and late followers, we must conclude that you don't want to be caught in the middle.

In M&A, unlike nature, the early bird may not always get the worm!

Figure 1: M&A deals announced 1990-2014 (Source: ThomsonONE)



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A history of M&A waves

In 1993, Golbe and White[1] first formalised the tendency of M&A activity to occur in 'waves'. M&A rarely occurs in isolation, a low level of activity is often followed by a surge in M&A volume before subsiding again to lower levels of activity. This wave pattern suggests interdependent and competitive behaviour as firms compete to merge and acquire one another.

The accepted view is that industry shocks instigate merger waves, where collective reaction is such that assets are reallocated and reorganised through M&A. Behavioural hypotheses attribute it to overvaluation and periods of high stock returns, which spurs those with highly valued stocks to acquire assets of undervalued targets. Ultimately, both explanations attribute waves to the state of, and changes in, the macroeconomic environment, which induces firms to engage in M&A.

The authors mentioned above identified four waves that occurred principally in the U.S., to which can be added two global waves that have followed. As already mentioned periods begin with low levels of M&A activity, which sharply increase before reaching a peak, followed by a fall.

Most literature contended that first movers lead in an M&A wave, whilst late followers are compelled by competitive pressures to react to the moves of competitors. The veracity of this view is the focus of the rest of this report.

Figure 2: The six waves of M&A (York University)

Waves	Period	Dominant characterisation
First Wave	1893 – 1904	Horizontal mergers, creation of the principal steel, telephone, oil and manufacturing giants of the U.S.
Second Wave	1919 – 1929	Vertical mergers. Consolidation along the value chain. Rise of auto manufacturers.
Third Wave	1955 – 1970	Diversified conglomerate mergers. Expansion and diversification into once non-core products.
Fourth Wave	1974 – 1989	Hostile takeovers, corporate raiders and highly leveraged transactions.
Fifth Wave	1993 – 2000	Mega mergers: TMT and in oil, banks, autos, etc… Belief in size as an absolute virtue. Massive value destruction in some deals, e.g; AOL-Time Warner.
Sixth Wave	2003 – 2008	Globalisation, private equity, shareholder activism led by hedge funds

[1] Golbe, D. and White, L. Review of Economics and Statistics, 1993

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The accepted view - First mover advantage

In 2004, Carow et al[2] suggested that first movers lead in an M&A wave by pursuing intentional and strategic M&A. They develop first-mover advantage by moving early: they have access to a wider pool of targets and hence are more likely to acquire targets with a higher potential for high returns. This explains prominent empirical studies conducted by authors such as Haleblian[3] that demonstrated first movers perform better than late followers.

As an example, exploring a sample of completed acquisitions involving public-traded U.S. companies between 1979 and 1998, Carow found that combined announcement returns during the event window (-1, +1) were 1.24% higher for acquisitions at the beginning of the industry merger wave, supporting the belief that first-mover M&A transactions experience larger announcement returns. Furthermore, in the same piece 'strategic pioneers' were found to outperform the remaining acquirers within an M&A wave.

And follower disadvantage

Conversely, this theory would suggest that late followers are inclined to take action only when significant competitive tension is encountered. Based on a sample of 1,316 companies in the U.S. software industry, another study[4] reported a significant negative direct effect of intra-segment acquisitions on firm performance. This supported their hypothesis that acquisitions undertaken as a response to competitive pressures are negatively related to firm performance.

The logic would be as follows. As first movers pre-empt the best targets, high potential targets become scarce which renders them to be in greater demand. This demand causes the price to acquire them to increase, which prevents late followers from capturing the full benefits of their acquisition. Whilst first movers' acquisitions are backed by strategic intent, later acquisitions may occur simply as a mimic of earlier acquirers, conducted without an understanding of the underlying rationale of their competitor's M&A action. Hence, in comparing the underlying motivation of first movers and late followers, the former is intentional and strategic whilst the latter often occurs at random in response to competitive pressure.

Academic research limitations

As an aside we would highlight the fact that the literature on this topic makes use of the widely used academic technique by which the efficient market hypotheses assumes that the 'success' of any transaction can be determined by looking at short term movements in the acquirer share price, rather than longer term studies (whether of a stock price or operating metrics). One of the obvious counterpoints to this assumption is the prevalence of merger arbitrage funds who, regardless of their view of an acquisition's 'quality', will buy the target and short the acquirer, in a stock for stock deal. We try to compensate for this by looking at multiple performance periods but it is an inexact science.

Note also that these studies do not incorporate the latest merger wave as their longer term performance periods are not available.

However, the arguments aren't all on one side. Competitive dynamics literature contends that following the actions of competitors is a legitimate and rational defence strategy to protect one's relative competitive position. Late followers can hence be distinguished between those who have irrational motivations and those, like first movers, who are strategically motivated. In the former, first movers would perform better than late followers. The latter

[2] Carow et al, Strategic Management Journal, 2004
[3] Haleblian et al, Strategic Management Journal, 2012
[4] Keil, T and Laamanen, T, HBR, 2011

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proposes an alternate situation where late followers actually perform better than first movers.

Stepping outside M&A

The notion of late followers' advantage is prominent in the area of product innovation, where the research explores advantages derived from moving last and how this is exploited when a strategic approach is adopted. One [5] analysis of drug launches in the pharmaceutical industry revealed first mover advantage remained prominent, accounting for 10% of the market share in 2000-2012. However, their study revealed more than 40% of winners in the drug launches were late entrants. This study is limited to the activity of product launches. However, the results suggest a trend favouring the performance of late followers, which may provide insight into their parallel performance in the M&A field. Strategic imitators don't simply copy but are capable of developing a better version of an idea. This was highlighted in a study that discovered imitators captured approximately 98% of value generated from innovations. By moving last, late followers derive the advantage of being able to observe the successes and failures of the actions of first movers and therefore formulate an optimal strategy accordingly. Therefore, late followers may be strategically motivated and hence perform better than first movers[6].

Behavioural change was recognised in another study[7] which proposed that late followers have strategic motives and capabilities to innovate beyond simply replicating the actions of competitors. Note that their study was based on emerging markets, something that may hint as to one explanation for the performance change we observed.

Clearly there will be intentional differences in the timing of participation in an M&A wave and also the underlying motivations between first movers and late followers. These are unlikely to be static over time and hence worthy of update post each new merger wave, as we shall see.

[5] Cha, M. and Yu, F. McKinsey, 2015
[6] Yang, M. and Hyland, M. Journal of Management, 2006
[7] Li, J. and Kozhidoke, K. Asia Pacific Journal of Management, 2008

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Our findings

Our analysis was based on a database of 1,496 global M&A deals between the periods 1990-2009, where two wave periods were identified, Wave 1 (1990-2002) and Wave 2 (2002-2009). Note the latter wave was not covered by the published research summarised in the previous section of this report, and thus our study does provide up-to-date and more relevant analysis based on the most recent data.

We took the first 25 movers and the 25 last for both waves one and two, giving a total group of 100 M&A deals. We then looked at returns versus the stock market over varying event periods around the M&A announcement.

Below we show the average cumulative abnormal return (CAR) by stock over each period.

In the data for Wave 1, 1990-2002, we see that the first movers outperformed the market to a statistically significant level, on all four event study periods. The late followers didn't generally do so well but did deals that were still well received, particularly if we measure using the two shortest event intervals. Looking at the data for Wave 2 we see quite a different pattern. We see outperformance by the late followers that is statistically significant, while the first movers' performance was mixed (and statistically speaking) not significant.

In Wave 1 there is some suggestion of first mover outperformance of late followers and interestingly no suggestion of underperformance versus the market in any period.

In Wave 2 something does seem to have changed versus Wave 1 and compared to the existing accepted literature around M&A first mover advantage, literature that does not include the latest wave. So what has changed? And why?

Figure 3: Performance relative to the market in days around deal announcement in Wave 1

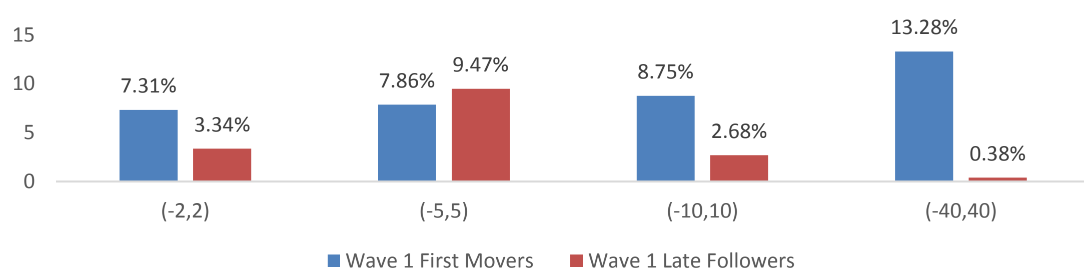
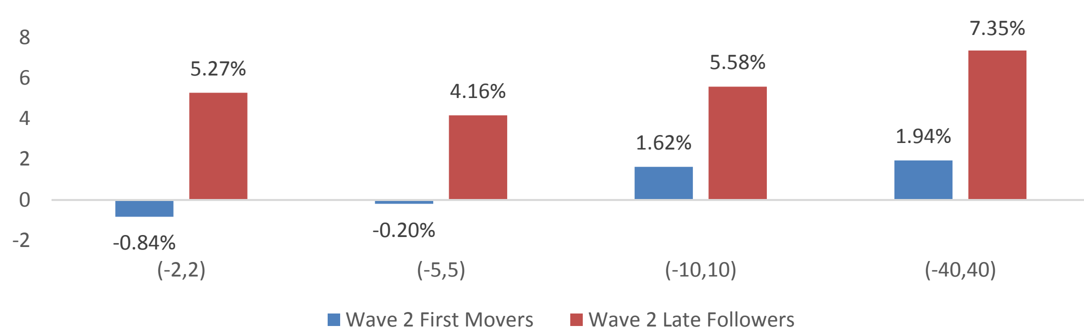


Figure 4: Performance relative to the market in days around deal announcement in Wave 2



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What could have changed?

Does what we are seeing indicate a shift in late followers' underlying motivation in pursuing M&A towards a more strategic rather than irrational, copy-cat approach?

Or is this M&A wave intrinsically different?

If we look in more detail at the fifth and sixth global M&A waves mentioned above (which correspond in time nicely to our studies Wave 1 and Wave 2) there are some characteristics of each that may hint at a reason for the improving relative performance of late followers that we have observed.

In the fifth wave there seemed to be a belief in size as an absolute virtue, with deals within the oil, technology and auto sectors in particular. With these types of deal the best targets are likely to go first. And moving 'last' may well be a 'me-too' step, with a less attractive partner, or, even worse, just undertaking the acquisition to make yourself too big to be acquired.

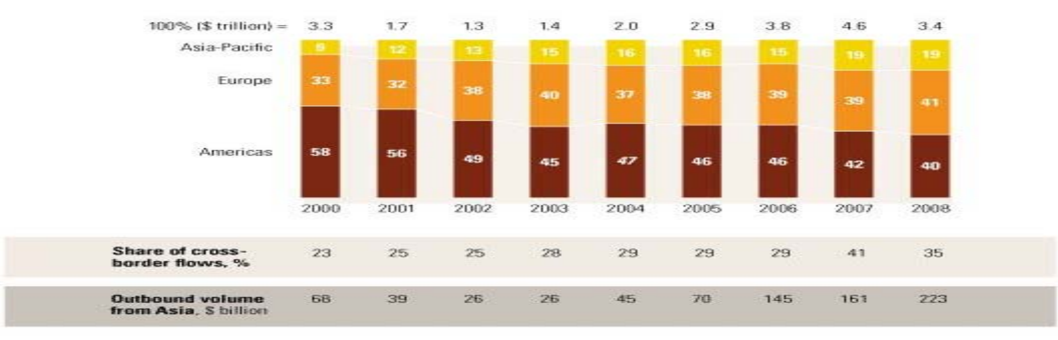
Turning to the latest, sixth, wave

The first obvious defining characteristic of the latest wave is the prominence of cross border activity. As the figure below shows cross border M&A, as a percentage of the total, reached 41% in 2007, versus just 23% as recently as 2000. These deals are typically about gaining access to new markets. This is not about innovation and indeed, it is often best not to be the first to enter a new geography, but to learn from those that came before. There is very rarely only one way into a country.

In addition, the rise of private equity has given corporates more competition for those early mover, counter cyclical, deep value acquisitions that often presage the start of an M&A wave. And lastly, the lowering of deal premiums observed in this wave suggests a less 'frenzied' market with less of a late cycle rush.

So taken together there is some evidence that on a macro scale this recent M&A wave may be different and hence on a micro scale the behaviours and motivations of participants themselves are different. This offers a possible explanation for our results.

Figure 5: Cross border flows (Source: Dealogic, McKinsey)



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What it means for M&A practitioners

These findings support the theory of competitive dynamics, where, contrary to criticisms of mimicking behaviour, attempts to match the moves of competitors are regarded as a viable defence strategy. Late followers achieving higher returns than first movers may be explained by the timing advantage of their participation. By moving later, late followers have an ability to observe the performance and the outcome of M&A decisions of first movers. In light of the successes and failures of first movers, late followers are able to reassess their own M&A decisions and strategy to proceed accordingly.

M&A practitioners can also learn from outside their own field, observing the late movers' advantage which has been prominent in studies outside of M&A literature, such as those mentioned above about new product launches, who revealed late entrants or imitators were able to generate more value than first movers.

Taken together with the changing nature of M&A waves we suggest first mover advantage is no longer a given.

In practical terms:

- It's not too late

  If you find a compelling M&A opportunity but you feel others invested in that area have already taken advantage of the situation, learn from their mistakes. At the same time you may benefit from waning valuations at the end of the 'wave'.

- Something's changed in the last wave

  As the prevalence of mega mergers potentially recedes, whether due to their historic lack of success, increasing anti-trust regulation or simply a lack of opportunity, the M&A market is becoming more about new geographies and opportunities. While deals such as this may appear riskier, they are also deals where the more you know before you proceed, the better. Wait before you jump.

- M&A is a valuable tool

  While this report has focussed on the specific subject of M&A timing within 'waves', it is unavoidable to also look at the data and see the generally positive reaction to acquisitions regardless of which end of the 'wave' we are at. As such this data adds to the growing weight of literature that has moved beyond the simplistic 'M&A destroys value' assumption, an assumption that is now being challenged when studies are refined by considering such areas as serial acquirers, private acquisitions and the value of the 'bolt-on' versus the mega-merger.

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Data and Methodology:

An event study and univariate analysis involving a two-group mean comparison test was performed. These methods were performed on a sample of 1,496 global M&A deals between the periods 1990-2009, where two wave periods were identified.

To obtain the sample of M&A deals, data was primarily sourced from the Thomson Reuters Securities Data Company (SDC) Platinum Database, a widely used database for M&A studies. To obtain financial information, such as company daily share prices and index level data, the Datastream database was utilized.

To further narrow the sample, the deal value criteria was included only those deals above USD$500m. Consistent with past studies, deals with acquiring firms from the financial services industry were excluded due to their distinct asset structure compared to other industries.

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Cass Business School
In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation
Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.