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Term Paper

Perspectives on mergers

Written by: Martin Kronenberger, Constantin Ulmer and
Lucas Volberg

Professor: Mario Jametti

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1. Introduction

Mergers and Acquisitions have had a long tradition in Economics and so does academic research on the phenomena associated with mergers.¹ Mergers may occur in several different industries and may have various different effects on firm structures and their environment. M&A activities may encompass firms that operate in the same industry, a big corporation acquiring a small competitor, companies merging with upstream or downstream firms and many other compositions.

Although the work on hand does not solely deal with mergers from an Industrial Organization point of view, it shall give an Industrial Organization approach to mergers, focusing on the question whether mergers create or destroy value. The latter question will be embedded into two other guiding questions along which this paper is structured. The first guiding question, “*how do mergers occur?*” will provide a brief overview of past merger waves and their main characteristics (cp. Section 2). Section three addresses the core of the paper at hand, the question of how mergers can be evaluated. Three different studies on merger evaluation are presented together with their empirical findings. The fourth section touches on the question “why do mergers occur?”. The work is rounded off with some concluding remarks and the posting of two questions that point at promising fields of further research (cp. Section 5).

¹ This paper does not make a distinction between mergers and acquisitions. In the following both terms are used as well as other terms to describe activities related to mergers and acquisitions

2. How do mergers occur?

As mentioned in the introduction, this paper is structured along three main questions. The following section will cope with the matter of how mergers have occurred over time.

Mergers can certainly not be considered a new phenomenon. Although one can observe merger activities throughout economic history, it is eye-catching that mergers mainly occur in waves. In retrospect five big merger waves can be identified over the last roughly 100 years.² Specific characteristics for each of these five merger waves can be found and shall be looked at in the following.

The first merger wave lasted from 1897 - 1904³. This period was characterized by large changes and significant improvement in industrial production. Due to enhanced production capacities supply provided by industrial companies exceeded demand of the market. Big firms and corporations saw a chance in merging activities when they were trying to influence market production levels and disarm competitive pressure. Another reason for this first merger wave was the promise of (quasi-) monopoly power for growing corporations. The merging activities during this first wave were mainly of horizontal nature, i.e. companies that have been competing in the same market would merge.

Starting in 1920 the second merger wave was dominated by vertical M&A activities. After the US-American government had decided to exercise control over horizontal mergers firms were now seeking after completion of the value chain. Most of these vertical mergers in the decade before the World Economic Crisis of the 1930s fostered oligopolistic structures. Another feature of this second merger wave was the emergence of network firms, which e.g. transformed Energy suppliers into Utility providers. The World Economic Crisis that started in 1929 put an abrupt end to the second merger wave.

The third merger wave commenced in 1965 and lasted until 1969. Following Harry M. Markowitz' Portfolio Theory, corporations aimed at diversifying their portfolios in order to achieve risk-diversification and more independent, uninterrupted cash flows. The Celler-Kefauver Act of 1950, which redesigned the Clayton Act, played a big part in the conglomerate trend of the 1960s. The Celler-Kefauver Act prohibited competitors' asset acquisition if the result lead to reduced competition in the market. It seems however worth mentioning that the diversifying mergers of the 60s were often perceived as second best solutions.⁴

The fourth wave in the second half of the 1980s (1984-1989) had corporations turning away from diversifying mergers in favor of (re-)concentration on the core business idea. This wave however showed other significant differences compared to the preceding merger wave of the '60s. The large transaction

² Cp. e.g. Kleinert/Klodt (2002) or Martynova/Renneboog (2008)

³ Although literature on merger waves agrees more or less on the time periods of the merger waves the exact yearly dates describing the merger waves vary across academic literature

⁴ cp. Jansen et al. (2004)

volumes, the enhanced number of hostile takeover-bids and a trend back towards cash over stock as the preferred payment method clearly set the '80s merger movement apart from the preceding wave.

In addition, American companies started to reach out for European and other foreign businesses in order to grow. The developments of the financial markets and tax benefits for borrowed capital fostered the takeover activities of the '80s additionally. As seen with earlier waves a stock market crash, this time in 1987, played a major role in the decline of M&A activities.

The fifth merger wave is closely linked to the surge of the catchwords *globalization* and *deregulation*. Its beginning is dated around 1995. For the end of the fifth wave academic literature has not reached consensus.⁵ It is widely agreed upon though that deregulation of formerly national monopoly or strongly regulated markets, such as the utility market, displayed not only the possibility to enter new markets, but also to set a foot into foreign markets. Intensifying merger activity can also be explained with growing international competition that is a result of globalizing markets in general.

It remains very questionable if the merging activities from 2003 to 2007 can be seen as a new wave. The beginning of the current economic crisis brought most M&A activities to a halt. The takeovers within the financial sector that have occurred and might still continue even during this economic downturn are mainly done from necessity. A detailed discussion of and whether we can observe a sixth merger wave is certainly a worthwhile topic, though it would exceed the limits of this paper by far.

3. Do mergers create or destroy value?

Having had a brief look at the modalities of past merger waves we will now address the topic of evaluating merger activities by approaching the question of “do mergers create value or not?”.

3.1 Measuring merger profitability

One way of going at merger evaluation is examining the profitability of the firms involved in the merger. In their 1989 paper “The profitability of mergers” Ravenscraft and Scherer analyze the pre- and the post-merger profitability of several hundred US firms.⁶

The authors test two main hypotheses. First, the market for corporate control hypothesis is tested which states that firms that are not run in a profit-maximizing way will be taken over.⁷ Put differently, acquired businesses should show a lower pre-merger profitability. The second hypothesis says that post-merger profits should be higher than pre-merger profitability and/or industry average of comparable firms due to economies of scale and scope.

⁵ Opinions about the termination of this fifth wave differ remarkably. Martynova/Renneboog (2008) or Jansen et al. (2004) date it around 2000, while e.g. Kleinert/Klodt (2002) come to a different conclusion

⁶ The following section focuses on the paper “The profitability of mergers” by Ravenscraft/Scherer (1989)

⁷ The hypothesis of the market for corporate control can be traced back to Manne (1965)

The data sample used in their study was taken from US Federal Trade Commission surveys between 1975 and 1977. The data covers more than 450 firms in the manufacturing and mining businesses. It is pointed out by the authors that their data set also includes a large amount of non publicly listed companies involved in mergers, a feature of their study that has been considered a shortcoming of previous studies examining the profitability of mergers.⁸ Using these data, an overview of pre-merger profitability and of acquired companies and post-merger operating results is provided.

Trying to derive meaningful and comparable results, the authors distinguish between two different types of accounting methods that are used by acquiring firms in order to record the acquired assets into their financial statements. The so-called pooling of interest accounting method records the acquired assets at their book value. The possible difference between the purchase price and the book value is booked to owners' equity of the acquiring firm. In contrast, if the purchase accounting method is used the acquired assets are recorded at the price that the acquirer actually paid for them. When computing ratios it is obvious that the choice of accounting method can have significant influence on the outcome of ratios.

Ravenscraft and Scherer decided to measure pre-merger profitability of acquired companies by computing operating income over end-of-period assets. By subtracting the resulting ratios from an afore created peer industry average ratio the authors receive a remaining percentage that expresses an above peer group index (SUPRA).

By examining this SUPRA index of acquired firms the authors observe that pre-merger profitability of acquired companies was not, as stated by the before mentioned hypothesis, lower than the peer group's profitability, but rather higher.⁹ This lets the authors conclude that "...there is no broad-gauged support for the 'inefficient management displacement' hypothesis..."¹⁰.

The study classifies the performed mergers along four categories in order to create higher informative value of their post-merger profitability examination. The four categories which the authors used are *horizontal mergers*, *vertical mergers*, *related mergers* and *conglomerate megers*.¹¹

Furthermore, to account for the above mentioned differences in accounting Ravenscraft and Scherer decided to employ three different percentage ratios when investigating post-merger profitability: Operating income/end-of-year assets, Operating income/sales and Cash flow/sales. The effects of the chosen accounting methods affect each of these ratios differently.

After running a regression model, the findings do not support the hypothesis that post-merger profits should rise as a result of the merger. While pre-merger returns do not differ significantly from post-merger returns

⁸ The main benefit of having data available of so called private businesses is that this study can also include smaller companies, as the state of being listed on a stock exchange is normally linked to the size of the firm.

⁹ Closer examination of the SUPRA index showed that the smaller the acquired company was in size the more exceeded its profitability the corresponding peer group.

¹⁰ Ravenscraft/Scherer (1989), p. 105

¹¹ For further explanation on how these classifications took place, please see Ravenscraft/Scherer (1989), pp. 105 et seq.

in the purchase accounting cases, the empirical evidence for the cases in which pooling of interest accounting was applied, oppose even more to the idea of profitability gains through mergers. Only mergers between firms of equal size show limited support for merger-induced profit gains, but these positive effects are considered statistically insignificant by the authors.¹²

Trying to find explanations for declining post-merger profitability Ravenscraft and Scherer consider four options.¹³ First, it might be possible that the high pre-merger profitability of acquired companies had already reached a peak and would have regressed over time to normal levels. Second, they take Williamson's 'control loss' explanation into consideration. Third, they see the possibility of acquiring companies treating their acquisitions as cash cows, i.e. not investing sufficiently into modernization and expansion. The fourth possible explanation goes in opposite directions as the cash cow explanation and states that parent companies might have provided too much money for investments for the formerly privately owned companies so that *all* attractive investment opportunities could be pursued and marginal returns decreased.

Ravenscraft and Scherer conclude that the average profit decline following mergers must be due to control loss of management, i.e. higher complexity in organizational structures and lessened managerial competence.¹⁴

3.2 Stock market reactions to unsuccessful merger attempts

Within the preceding pages, pre- and post-merger profitability measures were presented as a possibility of measuring merger performance. A second approach to merger evaluation can be taken from "Do mergers create or destroy value?" by Cole, Fatemi and Vu.¹⁵

The authors identified 220 pairs of firms during the years 1991 and 2000. In contrast to other analyses the work focuses only on unsuccessful merger attempts. All mergers tested were announced but experienced a termination later on.

The study considers the stock prices of acquirer and acquiree for its analysis of mergers. Following the efficient market hypothesis changes in value resulting from the announcement of a planned merger will immediately be factored into stock prices. The investigated time is three days around the announcement- and three days around the termination-date of the merger attempt. The efficient stock market implies that future value creation is constantly discounted to the present. Of utmost importance for merger evaluation are the immediate reactions to the merger announcement and the respective reactions to the termination of the merger attempt.

¹² cp. Ravenscraft/Scherer (1989), p. 111

¹³ For further explanation on these aspects see *ibid.*

¹⁴ This approach is also consistent with a large number of divestitures following the M&A activities.

¹⁵ Cole/Fatemi/Vu (2006)

In order to calculate these reactions to mergers and to differentiate between them the authors formed portfolios of mergers classified as horizontal, vertical and conglomerate. Afterwards portfolio cumulative abnormal returns are calculated (named CAR in the paper) by summing up the portfolio abnormal returns over the mentioned three-day event window. For a concluding evaluation base there is the test for significant differences in these portfolios CARs.

Based on the agents of calculation the enhancement in “Do merger create or destroy value” is to test three upstream theories, which try to explain and predict the reactions to mergers announcements. Testing these theories, the authors put in front the general assumption that mergers do create value. Again, the common types horizontal, vertical and conglomerate mergers are used for classifying reasons. In theory horizontal and vertical mergers (focusing mergers) create economies of scale and scope while conglomerate mergers (diversifying mergers) provide the advantage of risk diversification.

In the following the three above mentioned theories are illustrated. The “*Agency Theory*” describes the Principal-Agent conflict between stockholders and managers. It implies that managers may engage in takeovers to maximize personal utility rather than shareholder value, as “firm size is a fundamental determinant of executive compensation”.¹⁶ According to the agency theory mergers are most likely to destroy value.

The “*Synergistic Theory*” is based on the economic assumption that vertical and horizontal mergers create value due to economies of scale and scope and efficiency reasons. It is expected that investors anticipate this with stock price increase / increase firm value. Furthermore it is implemented that conglomerate mergers create considerably less value as synergy effects are less common.

The “*Signalling Theory*” suggests that mergers attempts signal the quality of management. The study argues that the announcement of termination of a merger deal indicates bad quality management, as the management cannot implement the merger successfully. Stock prices decrease due to a loss of confidence in management.

The authors found “*that bid announcement returns are partially, but not completely reversed by termination announcement returns, evidence that the merger proposal itself contains information about the value of the bidding firm.*”¹⁷ These signals feature expectations of the markets and indicate weaknesses as well as strengths.

After providing the basic assumptions and instruments the authors observe a different effect than expected. Geared to the theories and expectations the measurable market reactions support the theories only in some ways. After the merger announcement the average stock price fell and even after the termination announcement there is only little reversal for diversifying firms. A greater, but still not complete reversal for

¹⁶ Cole/Fatemi/Vu (2006), p. 6

¹⁷ Cole/Fatemi/Vu (2006), p. 4

focused firms can be found, but also in this case the stock price does not reach its initial level. The smaller reversal for diversifying firms is explained with less expected economic value in terms of economies of scale and scope. A price decrease of the bidder is observed. Both, scale and scope economies can be assessed as support for the Synergistic Theory. According to the latter, the reversal of the stock price should equalize the previous loss.

The Agency Theory only holds in some ways. The stock prices, as mentioned before, decrease around the announcement and increase around the termination date. Nevertheless, the price after the reversal is much smaller than the price level before the announcement which cannot be reached again as it is predicted by the model.

As observed, the Signalling Theory gains the greatest support and is the only one which is valid without exceptions. The prediction that reversal around the termination date will be smaller due to loss of investors' confidence receives empirical support.

Another time we face the importance of psychological and trust matters in the stock and investment market. Bhattacharya e.g. already contributed to the questions on how stock prices react to dividend changes and are interpreted as being consistent with the signalling argument.¹⁸

The paper certainly contributes to the literature by giving empirical evidence which can be used for the valuation of mergers. It points out and measures how takeover attempts signal investors about the quality of the acquirer firm's management. The unsuccessful merger attempt seems to destroy value, the market punishes management by lowering the valuation of the firm. Beyond, the authors point out that different types of mergers are evaluated differently by investors. The results might not only be important to investors but also to stakeholders like government regulators, employees and labour unions who might find an orientation in what to expect from strategic merger plans.

3.3 Stock market reactions to implemented mergers

Another approach with a different perspective on the evaluation of success or failure of mergers can be derived from the article "New Evidence and Perspectives on Mergers" by Andrade, Mitchell and Stafford.¹⁹

The authors evaluate mergers which were accomplished, meaning they have been performed and took place. The observation of mergers started in 1973 and ended in 1998; in 25 years, 3688 mergers were examined.

However, for the evaluation of mergers only publicly listed companies were taken into consideration. Both companies, the acquiring firm and the target firm needed to be listed at the stock exchange. As already seen above, the assumption is that stock market reactions are an indicator for success or failure of a merger. If investors see any value creation due to the announced merger, stock prices increase. This relates to the fact

¹⁸ Cp. Bhattacharya, (1979)

¹⁹ Andrade/Mitchell/Stafford (2001)

that any change in value creation is immediately incorporated. The change of future value creation is discounted to the present and has an impact on the stock price accordingly. As previously presented in the study, the assumption of a stock market that is efficient with regard to public information is a necessary prerequisite. Following this assumption of an efficient stock market, changes in the stock prices are caused by a change in expectations of investors regarding companies' future performance. If the stock market is efficient, we can use it in its function of an informative instrument. Hence the stock price can be used as a gauge for value creation or value destruction.

The design of the study is divided into a short term and long term perspective. The short term event window looks at a three day window of stock market reaction surrounding the merger announcement: From one day before to one day after the announcement. The long term event window observes stock prices from 20 days before the announcement until the merger has been closed. The reason for this is that the entire wealth effect should be incorporated when uncertainty is resolved. This is the case when the merger is completed.

The results to their conducted study are presented as follows.

On average, target firm shares show significant positive abnormal returns, in the short term as well as in the long term. Abnormal return is defined as the difference between stock return and return of the market. Hence, when abnormal return is positive, the stock increased more than the market. Between 1973 and 1998 short term abnormal return for the target firms amounts to 16.0%. Even if the decades are observed independently we observe twice 16.0% and 15.9%.²⁰

If we expand the event window to the long term perspective we observe abnormal returns which are even higher than in the short term window. Between 1973 and 1998 abnormal returns amounted to 23.8% on average. And if we only look at the data for the single decades (73-79; 80-89; 90-98), abnormal returns for each decade do not differ more than 1% from each other. It is remarkable that abnormal returns for target firms are so stable across decades. As we have previously seen, mergers occur in waves and each decade is driven by merger activities in different industries. We can interpret that abnormal returns for target firms do not depend on industry but are independent of it. We observe similar abnormal returns across different industries.

However, it is not sufficient to look only at returns for acquired firms. We also need to look at acquirers' abnormal return in both, short and long term window. In the short term event window acquiring firms show an abnormal return of -0.7% on average between 1973 and 1998. For all decades in which the data was subdivided we observe slight negative returns. None of them differs more than 0.4% from the data between 73-98 though.

²⁰ Andrade/ Mitchell/Stafford (2001), p. 110

If we expand the event window to the long term perspective we observe abnormal returns which are worse than in the short term window. The negative return amounts to around 4%, again with only slight differences across the decades.

Hence, acquiring firm shares reactions do not demonstrate such extreme and clear evidence as target firm shares. We can say that shareholders of acquiring firms are for sure not winners in the merger, but we cannot say that they are clearly the losers either.²¹

In order to evaluate if mergers create or destroy value we need to consider the average of combined return of shares from the acquirer and acquired firm. More specifically, market capitalization gives a hint of how value changed. In the short term perspective a value increase of 1.8% on average between 1973 and 1998 has been created. Also in the above mentioned decades a value creation can be observed, ranging from 1.4 to 2.6%.

When we have a look at the abnormal returns in the long term window there is no significant change in stock price levels to be observed. Between 1973 and 1998 cumulative market capitalization of both firms involved in the merger grew 1.9% more than market capitalization of the market. Also each decade generated a small increase in value creation, ranging from 0.1% to 3.2%.

The authors interpret the positive combined average abnormal returns over both event windows, as a small increase in value caused by mergers. Hence, this model suggests that on average mergers do create value. For the target firm as well as for the value of both firms aggregated we do not find evidence that value declined on average. Following that, we can say that this study supports the traditional view that mergers enhance efficiency. In addition to that, we have to underline the assumption that stock price reactions are caused by real value creation and are not simply a redistribution of wealth from other stakeholders. The observed economic gains can therefore be explained by the efficient rearrangement of resources following the merger.²²

As every model, also this study bears weaknesses. First of all, it only relies on stock market reactions. Even if a short and long term perspective is considered, the study does not look at fundamental data of respective firms. Stock prices only incorporate expectations of future revenues and earnings. However, expectations oftentimes do not come true due to several reasons: unexpected problems within firms, integration problems of acquired firms, less than expected economies of scale & scope, unforeseen market and customer reactions, etc. Expectations do not correlate perfectly with real economic development. Additionally, when expectations are revised as a reaction to e.g. ad hoc announcements of firms, stock prices will incorporate these changes again. Until investors realize that expectations might not be achieved it may take some months or even years. Therefore, it might take years until we can evaluate the “true” effects of mergers. Managers are often said to be blinded by possible synergies and other possible benefits, while challenges and risks

²¹ Cp. Andrade/Mitchell/Stafford (2001), p. 111

²² Cp. Jarrell/Brickley/Netter (1988)

oftentimes seem to be underestimated. The merger between Daimler-Benz and Chrysler is often referred to as an example of an unsuccessful M&A. It took nine years until Daimler decided to spin-off Chrysler.

The Top-Management was suspected to have failed the challenge of integrating both companies and becoming one single firm with regard to common values, views and norms.

The model also lacks a real long term window. The observations of abnormal returns stop at the time when the merger is closed. It could be useful to expand the long term window to one year or five years after the closing of the merger. When evaluating these suggested data, we could then even better interpret whether the merger created value or not.

4 Why do mergers occur?

Academic literature offers both, support for value creation through mergers as well as value destruction through mergers. From the studies we took into consideration in the course of this paper we found more support for the hypothesis that mergers destroy rather than create value. The question which now arises is why we still observe so many mergers? If the majority of mergers really destroys value, what are possible reasons for managers to still engage in M&A activity? This leads us to our third guiding question: Why do mergers occur?

Next to the probably most common publicly communicated goals of achieving synergy effects, academic literature lists various other possible reasons and motives for mergers. One approach to classify these different motives is the classification along main categories: Economic, Strategic and Personal motives.²³

When Economic motives are presented, mergers are undertaken to enhance the economic performance of the firm. The most common and cited reason is to generate economies of scale and scope for horizontal and vertical mergers. They are supposed to lead to an increase in profitability. Arguments adduced for mergers of conglomerate nature are oftentimes risk diversification through e.g more business or product lines. Cash Flow and income is more likely to be smoothed (no big cycles) and less dependent on single products. These factors should lead to increased shareholder value in theory.

Then, also strategic motives are considered to be an important element which needs to be mentioned. There are a variety of issues which motivate merger activities such as building up barriers to entry. The market in which the merged companies operate becomes less attractive to competitors or those firms which intend to enter the market. The merged firm becomes stronger and competitors might reject to face competition. In addition, through a common acquisition of raw materials and resources the merged firm can exploit their increased buying power and put pressure on their suppliers or customers. Hence, market power of the firm can be increased through merger. The competitiveness in the economic environment can improve

²³ Cp. Brouters/Hastenburger/van den Ven (1998)

substantially, thus likely to lead to higher efficiency and/or profitability and increasing firm and shareholder value.

Personal Motives can be considered as a third category of motives for mergers. Managers might strive for the achievement of personal goals through mergers. With managers' remuneration often being linked to sales or pure firm size, mergers can help managers to achieve their very own personal goals disregarded whether the merger creates value for the firm or not. Personal motives also include non-pecuniary benefits, such as managerial prestige, media popularity or the satisfaction that arises from the challenge of integrating a newly bought firm.

5. Concluding remarks and outlook

As we have already mentioned scholars have done a lot of research in explaining why and how mergers occur. We have had a look at the past appearance of merger activities. We saw that they mainly occur in concentrated phases throughout history, widely known as merger waves. We also gave a short overview what the reasons were for merger waves in the past (e.g. external and industry specific pressure, economic reasons, strategic reasons, etc). Each merger wave so far has been of its very own nature and featured predominantly one specific type of merger (e.g. horizontal, vertical, conglomerate). Moreover, there are numerous empirical studies on value creation and destruction resulting from M&A activities. Whether mergers create or destroy value depends on the point of view one argues. More particular, it depends on the method(s) used, on the size of the sample, and many other criteria.

In spite of the large amount of studies on mergers we find that some important questions remain under-represented in the merger research universe. "What, for example, are the causes for successful and unsuccessful mergers?" and "how can managers make mergers become a success?" could attract more attention in academic research. Contributions to answers to these questions could help managers in the decision making process for or against mergers and might make M&A activities more transparent in general. Findings could be used by managers to allocate their resources in a more promising way when trying to implement mergers successfully. In this way the rate of unsuccessful mergers could be reduced at best. It would however still be up to managers to take the findings into consideration.

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