A BRIEF REVIEW OF MOTIVES OF MERGERS AND ACQUISITIONS FOR CONSTRUCTION INDUSTRY FIRMS

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ABSTRACT

In the changing of construction industry, mergers and acquisitions (M&As) activities taking place in construction industry firms have been increasing sharply in the recent decades. While the majority of studies in construction management are focused on the management of construction projects, there are few researches have conducted on the construction firms' expansion strategy through M&A. Actually, M&A is an important growth strategy for construction industry firms, since it allows firms to quickly achieve their ideal size and raise managerial efficiency. However, the high ratios of poor operational performance of post-merger firms raise the attention to its potential risk. Motives of M&A are one of the important factors to study the risk of M&A deals. Different motives of M&A may lead to absolutely opposite performance of M&A transactions. Therefore, the paper makes a brief review of the motives of M&A for construction industry firms based on aim extensive review of motivation theory of M&A study. The review is conducted from three different perspectives such as efficiency theory, redistribution theory and behaviour theory.

KEYWORDS

Mergers and acquisitions, motives theory, strategy management.

INTRODUCTION

With the change of the social, economic and technical environment, the construction industry has progressed a lot and been very different from its conventional features. The most important driving forces behind the change are globalization of the market for construction and technological progress in communication technology (G. Runeson and G. d. Valence, 2009). The outstanding feature of the changes is that the construction industry is becoming an oligopolistic industry. Under this trend, a large parts of the global construction market are dominated by a small number of very large firms. Take the 2009's ENR 225 Ranking for example, the total international revenue of the top 20 firms takes up over 55% of the whole of ENR 225's revenue. These large construction firms are becoming larger and larger, as well as more and more diversified and integrated. By continually growing in scale, the firms can exploit economies of scale and, by diversifying, they provide not only more service and integration solutions for their clients but they can also apply new technologies over a range of their products, These changes will make the construction industry more like modern manufacturing than the traditional, fragmented, small-scale and low-technology construction industry. The two most important strategies for firm growth in scale and diversification are through establishing new entity and acquiring existing firms by takeovers or mergers (Runeson, 2000). Compared with establishing new businesses and firms, growth through mergers and acquisitions is an easier way, since it reduces risks and save resources and effort through taking over the existing firms as well as an existing market. Therefore, merger and acquisition of an existing firm is the most attractive expansion strategy. The same story is also happening in the construction industry. The activities of M&A conducted by construction industry firms are increasing sharply in recent decades as shown in figure 1. The figure provides the distribution of deals of M&A conducted by construction industry firms in the global market, which transaction value are above 10 Million US Dollars according to the SDC database. The number of M&A deals had increased sharply since the 2001, which leap from less than 3 deals each year before 2000 to more than 30 deals after 2001.

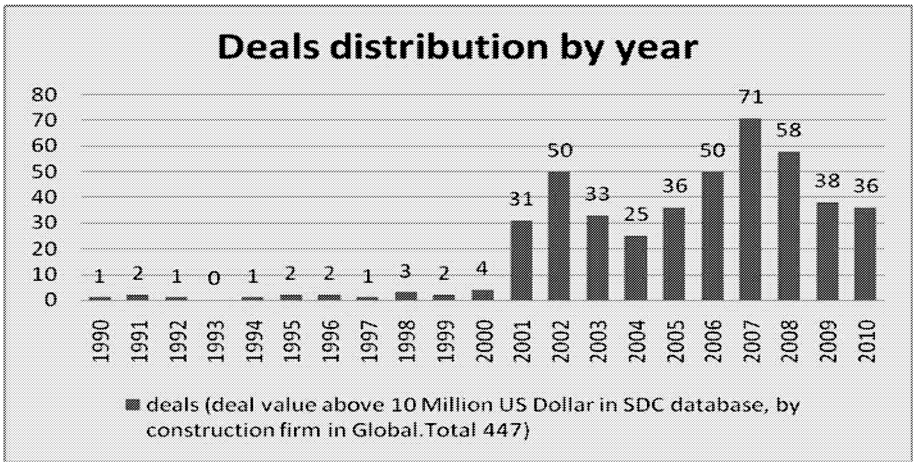

Figure 1 M&A deals conducted in construction industry in Global market (Source: SDC database)

However, there is no doubt to say that the majority of the research on construction management is on the management of construction projects, rather than on the firms that execute those projects (Winch 1989). However, while effective management of construction projects is of critical importance to construction firms, that aim depends first upon effective management of the firms which implement these projects. The project-oriented management concentration may be partly owing to project demands such as budgets, schedules, and quality issues and thus the long-term objectives, hence, with the result that organisation issues receive far less attention (Abraham 2003).

According to Langford and Male (2001), strategic management involves the manners in which strategic decision makers determine the objectives of the firm and make decision to achieve those objectives within the limitation of available resources. Mergers and acquisitions (M&A) have been viewed as an efficient strategy for corporate growth because M&As allow firms to quickly achieve their ideal size and raise managerial efficiency. However, the high ratios of poor operational performance of post-merger firms illustrate that corporate which want to grow through M&As also need to pay more attention to the potential risks (Hunt, 1990; Business Week, 1995). Different motives of M&A may be leads to absolutely opposite performance of post-merger. While applying the M&A strategy under suitable motives can realize the win-win performance for both target and acquirer, blind use of M&A strategy to purchase a firm without any reasonable motives for expansion might be lead to a nightmare or disaster in finance or organization for the acquirer, as well as target. Owing to this reason, many studies are conducted from all sorts of different perspectives to detect the relationship between M&A motives and performance of post-merger firms. Some representative theories of these motives explanation issues are summarized from different perspectives by various researchers. Haspeslagh and Jemison (1991) categorized these into four types: capital markets school, strategy school, organizational behavior school and the process perspective; and Larsson and Finkelstein (1999) identified five themes including strategic management, economics, finance, organizational research, human resource management. However, fragmentation of the research has resulted in barriers to the development of more integrated research on M&A. In particular, studies from the economics perspective identified good overall performance and efficiency for M&A, while other studies from finance perspectives reported just the inconsistent results or even reverse conclusion. Similar barriers exist among the other perspectives such as strategic versus finance, organizational versus human resource management, etc.

Therefore, each type of theory can only explain a rare phenomenon from each situation upon which is based. Due to the lack of a general theory or principle which can solve all of motive problems, the bulk of studies are carried out to figure out the issues of motive, performance and the relationship between them based on different kinds of industries with specific features such as financial industry, banking industry, service industry etc. In the case of the construction industry, obviously different from the above mentioned industry, there is little research found focusing on this topic. Hence, this review intends to analyze the motives of M&A deals carried out by construction industry enterprises, which based on the extensive literature review of general theory in the M&A study.

The remaining sections will provide a brief review of the motives of M&A from the following three perspectives for construction industry firms.

MOTIVES THEORY OF MERGERS AND ACQUISITION

M&A deals can be deemed as an equity investment on enterprises, while other investments mainly focus on projects or specific businesses, all of which usually compete with each other and comprise firm's investment strategy together. Since each investment has its specific motives and objectives regarding to firm, so does the M&A deals. The motives and aims for making an M&A deal from the bidding firm's perspective are different across the various industries and the emphases are also placed very differently (e.g. Walter and Barney, 1990). The motives of M&A presented by scholars could be classified into various types from different perspectives. Based on the economic, market and finance perspectives, the motives of M&A can be categorized into the following three types: namely, the efficiency theory (realization of synergy potential), redistribution theory (value transfer), and behaviour theory (managers or decision-maker's behavior) (Roll, 1986; Trautwein, 1990; Berkovitch and Narayanan, 1993). Herein, the review of each of these motives will be presented in the following.

Efficiency theory

From efficiency perspective, the intention of M&A is to enhance the competitiveness of organization and ultimately achieve value growth for the shareholders. The efficiency theory can be interpreted that making M&A deals can improve the production and managerial efficiency of corporate via synergy brought by a combination of entities. In other words, the consolidation entity created by an acquirer and its target can yield greater value than the sum of the acquirer and target separately. A great many of scholars, like Friedman and Gibson (1988); Bradley, Desai, and Kim (1988); and Trautwein (1990), suggest that firms making M&A deals to achieve synergies benefit from combining operations and activities such as marketing, research and development, procurement, and other cost components that were operated by separate firms. Synergistic gain can be achieved from different sources of value gains such as increasing the targets' value, economies of scale and scope, increasing market share and power, and taking advantage of tax and exchange rate differentials between countries.

Increasing the target's value

Synergistic gains can be achieved when target's value are increased through M&A by acquirers. In another words, the value of entity by combining acquirer and target will greater than the sum of them separately. Actually, increasing the target's value can occur mainly in two ways: to reduce an agency problem in the target and to decrease the target's management inefficiencies.

Correcting the agency problem of the target

In the case of an agency problem, it happens when an agent (the manager) is motivated by self-interest and acts at the expense of the shareholders (Baiman. 1990). Despite managers are supposed to maximize shareholder wealth through all sorts of effective management, conflict in the objectives of the managers and the shareholders are very common problem. For example, the more dividends are paid to shareholders, the less resource will be controlled by managers, which reduce the power of manager, and the more likely for firms to finance from outside. Hence, the acquirer can increase the target's value and create synergistic gains by reducing existing agency problem in the target.

Reducing the target's management inefficiency

Another way to increase the target's value and achieve synergy is to reduce its managerial inefficiencies. Acquirer can solve the target's managerial inefficiency problems to enlarge its value and realize the synergic gain. The largest synergistic gains might be realized when an efficient firm acquires a relatively inefficient firm (Servaes, 1991). Hence, it is important to detect the target's existing inefficiency management problem which can be improved afterward prior to make M&A deal. Palepu(1986) assert that the target's return on equity (ROE) prior to deals can be utilized as an index for measuring the target's management efficiency. Alternatively, Delong (2002) suggest that a firm's management efficiency can also be evaluated by the firm's return on asset (ROA).

Economies of scale and scope

Another important synergic gain can arise from economies of scale and scope. Operating synergies theory assumes that economies of scale exist in an industry, and that the levels of production in both acquirer and target prior to M&A do not exert their full potential of economies of scale. For example, some economies of scale can be realized in manufacturing operations or in research and development if the acquirer and target belong to the same industry (weston et.al, 2001). Furthermore, economies of scale can also be achieved by vertical integration within the same industry, which enhances the coordination at different stages of production and reduces transaction cost and bargaining (Arrow, 1975 and Klein, Crawford, and Alchian, 1978). M&A deals in which the acquirer and target belong to the same industry are more likely to be motivated by economics of scale synergy (Slusky and Caves, 1991).

Financial synergy

Financial synergy can be obtained by reducing the costs of internal financing (Weston et al., 2001). For example, acquirer firms can lower their cost of capital by acquiring firms with high levels of cash. Therefore, M&A deals involving targets with high levels of cash are motivated further by a desire for financial synergy. Another method to identify possible financial synergies is to calculate financial slack, which are considered as the difference between the target and acquirer's financial leverage (Slusky and Caves, 1991). Differences of financial leverages means differences in the firms' costs of capital, which imply that financial synergies may arise in the M&A deal.

The efficiency motivated acquisitions imply that the incentives of managers of the acquiring firms and their shareholders are of coincident, and the acquisition is aimed at increasing the acquiring firm's value.

Redistribution theory

Being different from the efficiency theory, redistribution theories consider that the M&A do not produce efficiency gains but only enable wealth transfers from the other parts of involved entities to the bidders. The redistribution theories generally consist of tax saving theory and monopoly theory.

Tax savings

Tax savings can be an additional source of synergy since they represent a case of redistribution of wealth from the government or public to the firm (Weston. et at, 2001). In additional, synergic gains can also be achieved by taking advantage of exchange-rate differentials (Kish & Vasconcellos, 1993) and tax differentials between the host and home countries in cross-border M&A deals (Servaes & Zenner,1994). However, the existing literature has not found the synergies resulting from tax savings sufficiently significant to motivate an acquisition (Auerbach and Reishus, 1988, Hayn, 1989, Ghosh and Jain, 2000, Weston, et at, 2001).

Monopoly theory

The monopoly theory regards M&A as a route to achieve market power. Conglomerate M&A may have advantages in the following ways: The firm can cross-subsidize products. For example, profits from the position in one market are used to sustain a fight for market share in another market. The firm can simultaneously limit competition in more than one market. The firm can also prevent potential entrants from its markets. One possible way to realize this is concentric acquisition by a market leader. These kinds of advantages have been regarded as collusive synergies (Chatterjee, 1986) or competitor interrelationships (Porter, 1985). Being different from the efficiency theory, collusive synergies based on monopoly do not produce efficiency gains but only wealth transfers from the firm's customers. As the construction industry is a segment market with many participants, even the leader of which has only a little market share compared with other high market concentration industries, it is hard to establish a monopoly market in construction industry. Therefore, the motive for achieving conglomerate may not be one of main motives for conducting M&A deals by construction firms.

Behaviour theory

The efficiency motivated acquisitions imply that the incentives of managers of the acquiring firms and their shareholders are coincident, and the acquisition is aimed at increasing the acquiring firm's value. However, when manager conduct the M&A transaction based on their own benefit rather than taking into account the interest of shareholders, these kinds of motives of M&A deal can only be explained by behavior theory generally including agency problem and hubris theory.

Agency problem of acquirer

Similar agency problem will also happen in acquirer, it happens when an agent (the manager) is motivated by self-interest and acts at the expense of the shareholders (Baiman. 1990). Despite managers are supposed to maximize shareholder wealth though all sorts of effective management, conflict in the objectives of the managers and the shareholders are very common problems. Hence, the manger of a acquirer would conduct a M&A deal for improving their own benefit (like bonus from firm's growing or more power of control) but disregard the interest of shareholders or even on the basis of cutting down the earning of shareholders.

Hubris theory

Some authors, such as Roll (1986) proposed a "hubris motive" and suggest that the acquirer's managers inflating their sense of confidence about their ability to extract value from targets will often motivate M&A deals. Actually, "Hubris" is not a real indirect motive for an M&A, since managers do not acquire another company for the sake of overpaying for it. M&A deals that can be explained by hubris may be motivated by either synergy or agency, but whenever the acquirer over-pays. The over-pays under hubris can happen in the two kinds of situations either when it is very difficult to evaluate the target's true value or when there are other factors affecting the bidding price such as competition for the control of the target.

Difficulties in the valuation of the target

Difficulties in evaluating the target when making M&A deals may lead to hubris. Ambrose and Megginson (1992) extended the Palepu (1986) model to predict the likelihood of acquisition by using tangible and intangible assets structure, managerial ownership, and takeover defenses. Ambrose and Megginson (1992) asserted that fixed assets are easier to assess than growth opportunities since the realization of growth opportunities depends on a variety of environment factors like managers' capability, market fluctuation etc. Thus the higher proportion of intangible assets the target has, the more inaccurate valuation and poor decision acquirer will make. In addition, if the target has high levels of research and development (R&D) expenses, then making precise valuation on it will also become more difficult, which is because the R&D expenses , like other intangible assets, are difficult to value since their outcome is uncertain.

Multiple bidders Competition

Bidding competition for acquiring the target might also cause a case of hubris. Varaiya (1988) detects factors associated with cases of overestimation of targets in corporate takeovers. The factors identified to be related to overestimation were the pre-acquisition profitability of the acquirer (consistent with Hayward and Hambrick. 1997) and the degree of competition for acquiring the target firm. Based on the theory of order statistics, Varaiya explains that the larger the number of bidders, the greater the expected value of winning the bid. Therefore, the likelihood that the acquirer will overvalue the target, which contributes to a case of hubris, increases along with the degree of competition.

CONCLUSION

The M&A is an important growth strategy for construction industry firms in global market. Understanding the motives behind the M&A deals can increase the chance of success for M&A deals, as well as mitigate the risk of poor performance of post-merger firms. This paper reviews the motive theory of M&As from three different perspectives, say, efficient theory, redistribution theory and behaviour theory, which provide a foundation for analyzing the motives of conducting M&A deals in the construction industry. Based on the summarized motive theories, the construction industry firms could make decision-making more effectively when conducting M&A deals on reasonable motives, and simultaneously, could avoid the risk of conducting M&A deals on the unreasonable motives as mentioned in behaviour theory.

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