A L T E R N A T I V E   I N V E S T I N G

# Investigating the Economic Role of Mergers

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A growing body of empirical evidence documents that mergers may be an efficient way to reallocate assets within the economy. Ample evidence on post-merger stock returns and operating performance suggests that mergers on average increase value, and lead to improved profitability. This paper adds to that literature by suggesting how mergers can help firms and industries grow and restructure, particularly in response to shocks.

Overall, our analysis indicates that mergers play a dual economic role. On one hand, mergers, like internal investments, are a means for companies to increase their capital base, in response to good growth prospects. Both merger and non-merger investment are positively related to the firm's sales growth and its Tobin's q — the ratio of its market value to its replacement cost.

On the other hand, mergers appear to facilitate industry contraction. The clustering of mergers by industry suggests that mergers are often a response to industry shocks. We find that mergers within a single industry are negatively related to capacity utilization during the 1970s and 1980s; that is consistent with the view that mergers are an effective means for industries with excess capacity to rationalize and induce exit.

In addition, we find that within these contracting industries, acquiring companies tend to be the firms with better performance, perhaps even better management, and lower leverage and capacity utilization. This all suggests that this industry rationalization and asset reallocation results in improved efficiency.

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