

A Case Study of Acquisition of Avon Organics Limited by Arch Pharmalabs Limited

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ABSTRACT

The corporate sector all over the world is restructuring its operations through various types of consolidation strategies in order to face the challenges posed by globalisation and liberalisation, which have led to the greater integration of national and international markets. In order to cope up with the constantly changing environment and increasing competition, constant growth of business organisations has become imperative. The Indian corporate sector has experienced a boom in mergers and acquisition led restructuring strategies especially after liberalisation. Banking and Finance, Drugs and Pharmaceutical, Textiles, Telecommunication, Cement, Computer Software, FMCG etc. are the major sectors in which it has occurred. The present study is an attempt to bring out the effectiveness of such strategies in realizing the desired objectives in the case of Drugs and Pharmaceutical sector, by analysing a case study of acquisition of Avon Organics Limited by Arch Pharmalabs Limited. Ratio analysis has been conducted to measure the overall performance of the acquiring firm. Besides, t-test has been used to check for any statistical significant difference between the means post the acquisition. Overall, it was concluded that the acquisition failed led to create a positive impact on the operating performance, financial performance and shareholders' wealth of the acquiring entity.

Keywords: *Mergers and Acquisitions, Operating Performance, Financial Performance, Shareholders' Wealth*

INTRODUCTION:

The corporate sector all over the world is restructuring its operations through various consolidation strategies like mergers and acquisitions in order to face challenges posed by the new pattern of globalization and liberalisation, which has led to the greater integration of national and international markets. M&A is an important strategic option that companies can leverage to make necessary leaps in the competitive marketplace. Mergers and acquisitions is a path businesses take to obtain a higher market share, a broader customer base, and gain access to new technology, products and distribution channels. Yet, at the same time, M&A is very risky and many deals fail, sometimes bringing companies to the brink of failure. Overpayment, cultural mismatch, poor integration etc. are some of the reasons which can be attributed to the same. For many companies, mergers and acquisitions are irregular events for which they lack capabilities and processes. How well a merger or an acquisition fits into a company's strategy and complements its growth depends very much on the industry the company operates in, its market position and its strategy for value creation.

Despite this, mergers and acquisitions have increasingly become an important part of the corporate strategy of many companies since decades. Mergers and acquisitions can help companies take to achieve exponential and not just linear growth, and therefore continues to generate interest. The Indian market is no different. M&A's have become an integral part of the Indian economy as well. Based on macroeconomic indicators,

India is on a growth trajectory, with the M&A trend likely to continue. Thus, for any business, inorganic growth through M&A's continues to be an attractive option. The Indian corporate enterprises are refocusing in the lines of core competence, market share, global competitiveness and consolidation. This process of restructuring has further been hastened by the arrival of foreign competitors. In this backdrop, Indian corporate enterprises have undergone mergers and acquisitions to create a formidable presence and expand in their core areas of interest.

There are two broad theories explaining why firms get acquired or merged with other firms. The monopoly theory postulates that the firms use this route to raise their market power (Steiner, 1975), whereas, according to the efficiency theory, M&A's are planned and executed to reduce costs by achieving economies of scale (Friedrich Trautwein, 1990). Either way, firms are expected to have better financial performance following M&A's. Many of the existing studies done by (Healy et al. 1992; Switzer, 1996), empirically support the proposition that M&A lead to better corporate performance of the firms. Contrary to this, there are several studies (Mueller, 1985; Ghosh, 2001; Ikeda and Doi, 1983) that report results at odds with the view that M&A improve corporate performance. However as stated already, despite mixed results, the intensity of mergers and acquisitions has increased in India especially with the de-regulation of various government policies. The reforms process initiated by the Indian government since 1991 have opened up a whole lot of challenges both in the domestic and international spheres, which in turn has influenced the functioning and governance of Indian firms, resulting in adoption of different growth and expansion strategies, particularly mergers and acquisitions. In particular, since 1991 there has been a significant increase in the overall number of M&A's in the Indian corporate sector (e.g., Khanna, 1997; Basant, 2000; Agarwal, 2002; Agarwal and Bhattacharya, 2006; Mantravadi and Reddy, 2008). Historically, M&A's have shown a cyclical pattern. There have been six waves of M&A's for the past 100 years; these are those of the early 1900s, 1920s, 1960s, 1980s, 1990s, and 2000s. The trends of mergers and acquisitions in India have changed over the years. The immediate effects of the mergers and acquisitions have also been diverse across the various sectors of the Indian economy. The broad industry groups that experienced a large number of M&A include financial and other services, chemicals including drugs and pharmaceuticals, electrical machinery, electronics and beverages including spirits and vinegars, etc. (Basant, 2000; Das, 2000; Agarwal, 2002) with majority of the deals being horizontal in nature (Khanna, 1997), followed by vertical and conglomerate deals (Basant, 2000).

LITERATURE REVIEW:

Gallet (1996), investigated the relationship between mergers in the U.S. steel industry and the market power. The study employed New Empirical Industrial Organization (NEIO) approach which estimates the degree of market power from a system of demand and supply equations. The study analyzed yearly observations over the period between 1950 and 1988. The results revealed that in the period of 1968 to 1971, merges did not have a significant effect on market power in the steel industry, whereas mergers in 1978 and 1983 did slightly boost market power in the steel industry.

Heron and Lie (2002), examined the relation between method of payment, earnings management and operating performance. They took a sample of 959 cases (mergers & tender offers) announced and completed between January 1985 and December 1997, where current and long term accruals have been separately used to detect any earnings management. The operating income over sales ratio was used to examine the operating performance. This ratio considers the effects of the accounting method and the method of payment on the operating performance. The operating performance of the sample was compared with two benchmarks to isolate the factors beyond the transaction that may affect the performance. First, the study compared the pre-merger performance of the merged firms with similar industry counterparts. Second, it compared the post-merger performance with industry-adjusted performance. The results revealed that merging firms exhibit superior operating performance relative to their industry counterparts prior to the deal and continue to exhibit performance levels in excess of their respective industries. No evidence was found on earnings management effects. No difference was found in the operating performance across different methods of payment.

Majumdar et al. (2007), studied the effect of mergers of local exchange firms in the U.S., which took place between 1988 and 2001, on the financial performance and efficiency level. For measuring financial performance cash flows and sales growth was used. In evaluating synergy and operating efficiency, operator

system expense ratio, ratio of total cable and wire facilities expense to total operating revenues, and information transfer ratio were used. The results indicated that relative cash flows decreased after mergers, and for sales growth, the pattern was ambiguous and driven by increased market presence. The impact of mergers on the measures of efficiency and synergy was found to be negative.

Groff et al. (2007), used Data Envelopment Analysis to test whether there were changes in efficiency associated with hospital mergers in the U.S. The sample included hospitals that had undergone merger activity in the years 1994 and 1995 as well as a matched control group. The sample included 166 hospitals (77 in 1994 and 89 in 1995) that were involved in mergers. Hospital mergers led to an efficiency gain if the coefficient of the merger status variable showed a positive association between efficiency scores and mergers. The findings revealed that there were no detectible improvements in efficiency in the first year after the merger but that efficiency improved significantly in the second year after the merger.

Maquieira, Megginson, and Nail (1998), examined 260 mergers in the US between 1963 and 1996. The study recorded significant net synergistic gains in non-conglomerate mergers and insignificant net gains in conglomerate mergers.

Surjit Kaur (2002), compared the pre and post-takeover performance for a sample of 20 acquiring companies during 1997-2000, using a set of eight financial ratios, during a 3-year period before and after merger, using t-test. The study concluded that both profitability and efficiency of targeted companies declined in post-takeover period, but the change in post-takeover performance was statistically not significant.

Cybo-Ottone and Murgia (2000), conducted an event study analysis of 54 mergers and acquisitions deals covering 13 European banking markets of the European Union and the Swiss market for the period 1988 to 1997 and found positive and significant increase in the shareholder value of bidder and target banks at the time of the announcement of the deals. Ismail and Davidson (2005), analysis of 102 merger announcements in the European financial services industry between 1987 and 1999 found positive returns for target bank shareholders in different event windows.

Avkiran (1999), employed DEA and financial ratios to a small sample of 16 to 19 Australian banks during the period of 1986-1995, examined the effects of four mergers on efficiency and the benefits to public. The results found that the merging banks do not always maintain their pre-merger efficiency, but that, during the deregulated period, technical efficiency, employees' productivity and return on assets improved. There were mixed evidence from the four cases on the extent to which the benefits of efficiency gains from mergers were passed on to the public.

Marina Martynova, Sjoerd Oosting and Luc Renneboog (2007), evaluated the long-term profitability of corporate takeovers in Europe, and found that both acquiring and target companies significantly outperformed the median peers in their industry prior to the takeovers, but the profitability of the combined firm decreased significantly following the takeover. However, the decrease became insignificant after controlling for the performance of the control sample of peer companies.

Deo and Shah (2011), examined the financial implications on the acquirer and target shareholders wealth in the Indian Information Technology Industry (IT) that have taken place from January 2000 to June 2010 taking a sample of 28 exchanges in India. The study revealed that the acquisition announcements in the IT sector have no significant impact on the bidder portfolio, while as it been found that acquisition has generated significant positive abnormal returns for target shareholders only.

Brief Profile about Drugs and Pharmaceutical Sector of India:

The Indian pharmaceutical industry tops the chart amongst India's science based industries with wide ranging capabilities in the field of drug manufacture and technology. It not only caters to the domestic market in fulfilling the country's demands but also exports high quality, low cost drugs to more than 200 countries including USA, Russia, South Africa, Kenya, Malaysia, Singapore, Nigeria, Ukraine, Vietnam and many more. It ranks very high amongst all the third world countries, in terms of technology, quality and the vast range of medicines that are being manufactured. The Pharmaceutical Industry in India is one of the largest and most advanced among the developing countries. It is ranked 3rd in terms of volume and 14th in terms of value globally as per a report by Equity Master. The Indian pharmaceutical sector is highly fragmented with more than 20,000 registered units. The Indian Market is projected to witness a huge growth of US\$ 55 billion by the year 2020, making it incipient of sixth largest upcoming pharmaceutical hub

globally, in context of absolute size. The sector is expected to generate 58,000 additional job opportunities by the end of 2025.

The healthcare sector in India has experienced a paradigm shift due to emerging trends in globalization, industry dynamics, developing markets and increasing regulatory and competitive pressures. Indian companies have to devise newer strategies continuously to survive in the this highly competitive global market that is characterised by high capital requirement, high process skills, high technical requirement, high value addition prospects, high export volumes and high market sophistication. A rise in merger and acquisition (M&A) deals has been witnessed in recent past as a result of increasing health care costs, mounting research and development budgetary requirements, liberalization, and globalization. The Indian drugs and pharmaceutical sector is not untouched by these M&A waves. The Indian pharmaceutical sector has undergone a drastic change since the past two decades. In the 1970's, the Government of India implemented a series of policy measures to achieve self-sufficiency in production pharmaceutical sector including legislation of the Indian Patent Act, 1970, Drug Price Control Order, Foreign Exchange Regulation Act and increasing the import tariff to enable the industry to meet the requirements of the Indian population. The M&A have helped the Indian pharmaceutical industry to improve global competitiveness, expand product range, gain access to approved facilities outside India, gain access to distribution channels gain advantage of tax concessions, geographical expansion thus overcoming barriers to entry and compensate for continued sluggishness in their home market.

The Indian pharmaceutical industry is at present the most aggressive overseas investors of all Indian industries. However, adverse financial effects, antitrust action delaying or preventing of proposed merger, limited flexibility and sophisticated structure, and time-consuming process is something which cannot be overlooked. In spite of this, the drive to enhance the size and thereby attaining higher economies of scale has motivated many companies to adopt this path to survive and grow. The future holds a lot as the trend is likely to continue with many companies from developing countries, particularly India.

Brief Profile about Arch Pharmalabs Ltd.:

Arch Pharmalabs Limited is a pharmaceutical company incorporated on 02 April 1993. Ajit Kamath, promoter of Arch, is also managing director of the company. The Company is engaged in products and services business. Its business comprises of manufacture and sale of active pharmaceutical ingredients (API's) to generic pharmaceutical companies and intermediates in India and worldwide. The company offers API's across various therapeutic segments. It offers Contract Research and Manufacturing Services as well (CRAMS). Its products include Atorvastatin calcium, which is a lipid lowering agent; Amlodipine besylate, which is a calcium channel blocker; Clopidogrel bisulphate which is an anti-platelet agent, and Isosorbide-5-mononitrate, which is an anti anginal agent, among others. The Company provides a range of CRAMS starting from route selection/process development/optimization, analytical development, stability studies, safety studies, scale-up to technology transfer/clinical-trial manufacturing to commercial manufacturing to suit the United States/Europe regulatory requirements.

Brief Profile about Avon Organics Ltd.:

Avon Organics Limited, a public limited company was incorporated in 1993 and promoted by Mr. P R Agarwal, Mr. Rajesh Agarwal and late Dr. G S Sidhu. It is a manufacturer of bulk drugs and chemicals with manufacturing facilities in Maharashtra and Andhra Pradesh and provides contract manufacturing services. Its products range in diketene derivatives which includes monomethyl aceto acetamide, methyl aceto acetic ester, diethyl aceto acetamide and other diketene derivatives. Avon's exports constitute of 31.1% of sales. Avon has two manufacturing plants, one in Medak District, Andhra Pradesh and other in Solapur, Maharashtra.

Key Financials and Benefits Expected From the Acquisition:

- In November 2007, the board of directors of Arch Pharmalabs limited approved issue of 9.8 million (43.6%) equity shares of Avon Organics Ltd. to Arch Pharmalabs limited for Rs 22.4 cr.

- As Arch Pharmalabs Ltd. (APL) acquired more than 15%, it made another public offer to acquire 4.5 million (20%) equity shares on a preferential basis at a price of Rs.21.85 per share. As a result, stake of Arch Pharmalabs Ltd. increased to 63.6%.
- Avon's Sholapur site had USFDA status (United States Food and Drug Administration), while its Hyderabad site was a specialized facility for production of intermediates. The company had reported losses owing to intense competition from China for one of its main product groups resulting in financial stress. The acquisition would help Arch Pharmalabs Ltd. in backward integration strategy. For APL, the acquisition made sense owing to the USFDA status at one of the sites and also the possibility to sweat the assets at the intermediates sites. The USFDA status would help Arch Pharmalabs Ltd. to fast forward a few product launches in the US and the intermediates plant will serve as a key sourcing base for a couple of the products, which are currently market leaders in their category.
- The entry of APL's management in Avon Organics Ltd. would facilitate latter's various product group sales.
- The acquisition would facilitate Arch Pharmalabs Ltd. to restructure their operations, invest in assets and achieve a huge turnaround.
- The positioning of both the companies will help unleash synergy across all functions.

RESULTS AND DISCUSSIONS:

The acquisition of Avon Organics Ltd. By Arch Pharmalabs Ltd. was expected to have produced positive impact on operating and financial parameters of the acquiring entity which in turn would have created more wealth for shareholders of the new entity. In order to conclude whether the acquisition led to a statistical change in the operating performance, financial performance and shareholders' wealth, the average industry adjusted post- merger variables have been compared with the industry adjusted pre- merger variables, using ratio analysis and paired sample t-test at significance level of 5%, the details of which have been presented in below table:

| ARCH PHARMALABS LTD. (ACQUIRING) AVON ORGANICS LTD. (TARGET) | | | | | | | | | | | | | |
|--|---|--------|--------|--------|---------------|-----------|--|--------|-------|-------|--------------|-----------|------------------|
| RATIOS | INDUSTRY-ADJUSTED PRE-ACQUISITION PERFORMANCE | | | | | | INDUSTRY-ADJUSTED POST-ACQUISITION PERFORMANCE | | | | | | T-TEST (P-VALUE) |
| | 03-04 | 04-05 | 05-06 | 06-07 | MEAN | STD. DEV. | 08-09 | 09-10 | 10-11 | 11-12 | MEAN | STD. DEV. | |
| OPM (%) | 2.33 | 3.86 | 3.17 | 2.39 | 2.94 | 0.72 | -3.99 | -2.83 | 0.10 | 2.73 | -1.00 | 3.02 | 0.10 |
| | 2.43 | 1.51 | -5.62 | 0.68 | -0.25 | 3.65 | | | | | | | |
| OER (%) | -2.54 | -4.15 | -0.01 | -0.08 | -1.69 | 2.02 | 4.03 | 8.13 | 5.52 | 3.17 | 5.21 | 2.17 | 0.04* |
| | -11.71 | -12.04 | -2.95 | -12.76 | -9.86 | 4.63 | | | | | | | |
| GPM (%) | -2.44 | -3.74 | -9.90 | -10.34 | -6.61 | 4.10 | -7.02 | -10.30 | -7.94 | -3.97 | -7.31 | 2.62 | 0.83 |
| | 7.69 | 7.18 | -3.50 | 5.76 | 4.28 | 5.25 | | | | | | | |
| NPM (%) | -0.67 | 0.89 | -1.52 | -1.64 | -0.74 | 1.17 | -4.58 | -5.71 | -5.87 | -4.40 | -5.14 | 0.76 | 0.01* |
| | -3.61 | -4.48 | -9.30 | -4.40 | -5.45 | 2.60 | | | | | | | |
| ROA (%) | -0.25 | -1.93 | -7.79 | -8.68 | -4.66 | 4.20 | -4.24 | -5.90 | -6.07 | -5.14 | -5.34 | 0.84 | 0.75 |
| | -9.96 | -11.45 | -15.46 | -11.65 | -12.13 | 2.34 | | | | | | | |
| ROE (%) | 45.91 | 10.06 | -10.54 | -11.84 | 8.40 | 26.95 | -6.14 | -8.90 | -6.98 | -4.35 | -6.59 | 1.89 | 0.35 |
| | -17.09 | -22.81 | -37.53 | -24.95 | -25.60 | 8.62 | | | | | | | |
| EPS (Rs) | -10.90 | -8.96 | -10.35 | -3.13 | -8.34 | 3.56 | -13.64 | -11.85 | -5.21 | -3.69 | -8.60 | 4.88 | 0.90 |
| | -13.63 | -13.99 | -18.44 | -14.50 | -15.14 | 2.23 | | | | | | | |
| Book Value per Share (Rs) | -115.26 | -86.46 | -62.94 | -5.62 | -67.57 | 46.51 | 12.70 | 30.01 | 53.98 | 78.31 | 43.75 | 28.59 | 0.00* |
| | -83.78 | -80.51 | -81.06 | -73.66 | -79.75 | 4.31 | | | | | | | |
| DY (%) | -0.59 | -0.59 | -0.59 | -0.59 | -0.59 | 0.00 | -0.97 | -0.97 | -0.97 | -0.97 | -0.97 | 0.00 | - |
| | 2.77 | -0.59 | -0.59 | -0.59 | 0.25 | 1.68 | | | | | | | |

Note: (*) Statistically Significant at 5% Level of Significance

(-) T-Test, Cannot be Calculated Because the Standard Error of the Difference is Zero Source: CMIE

Impact on Operating Performance:

Perusal of the data detailed out in the above table reveals a negative impact of the acquisition on the operating performance across all operating measures. It can be seen that the mean operating profit margin ratio of the acquiring firm has registered a decline from 2.94% to -1.00% post-acquisition. The decline in operating profit may be attributed to increase in operating expense ratio which has increased from -1.69% to 5.21%. Out of the two operating variables, the mean difference of operating expense ratio was found to be statistically significant ($p=0.04$) while as the mean difference for operating profit margin ratio had p-value greater than 5%.

Impact on Financial Performance:

The analysis of the impact of the acquisition under study has revealed a negative impact on the operating performance variables, which is expected to get reflected in the profitability of the acquiring entity. Similar picture emerged about the gross profit margin and net profit margin ratio which declined post-acquisition from -6.61% to -7.31% and -0.74% to -5.14% with insignificant p-values of 0.83 for gross profit margin ratio & significant p-value of 0.01 for net profit margin ratio respectively. This reflects the ability of the acquiring firm to effectively control its expenses, interest and taxes. Similar picture emerges with regard to ROA & ROE, they have declined post-acquisition though insignificantly. ROA has declined from -4.66% to -5.32% and ROE from 8.40% to -6.59% respectively. Overall, it can be concluded that all the financial performance parameters showed drastic decline post-acquisition with only net profit margin ratio being statistically significant.

Impact on Shareholders' Wealth:

The declining operating and financial performance is also reflected in the returns for the shareowners. Perusal of the data presented in the referred table reveals negative impact on the wealth of the shareholders of the entities under study across all measures except book value per share. It can be seen from the table that the EPS of Arch Pharmed Labs Ltd. has declined from Rs -8.34 to Rs -8.60. Similar results were found with respect to dividend yield which had declined from -0.59% to -0.97%. The mean difference of book value per share was found to be statistically significant ($p=0.00$) while as the mean difference for earnings per share had p-value greater than 5%.

CONCLUSION:

Overall, it was seen that the acquisition had a negative impact across all the operating performance parameters with only OPM being statistically significant. All the financial performance parameters also revealed a negative change post-acquisition. Out of these, only NPM was found to be statistically significant. With respect to shareholders' wealth, except book value per share, all the ratios recorded a negative change post the deal. As such, it could be concluded that the acquisition had a negative impact on the overall performance of the acquiring firm with majority of variables being statistically insignificant.

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