International Journal of Hospitality Management 30 (2011) 141–149

Contents lists available at ScienceDirect

International Journal of Hospitality Management

journal homepage: www.elsevier.com/locate/ijhosman

Mergers and acquisitions and firm growth: Investigating restaurant firms

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ARTICLE INFO

Keywords:
M&A
Sales growth
Firm growth strategy
Firm size
Restaurant industry

ABSTRACT

Merger and acquisition (M&A) has been viewed as an efficient strategy for firm growth because M&As allow firms to quickly achieve their ideal size. However, whether consistent growth can be maintained after an M&A is questionable because post-M&A integration is a difficult process. In order to identify whether M&A is really an effective tool for producing consistent growth in restaurant firms, this study examined post-M&A firm growth in comparison to non-M&A firm growth. Using financial data from 1980 to 2007, this study analyzed the sales growth of restaurant firms up to five years after an M&A. This study found that post-M&A growth patterns varied across firm sizes and time periods (from one to five years after an M&A). This study also revealed that both small and large acquirers experienced positive sales growth in the year following M&A. However, this positive effect completely disappeared during or after the third year post-M&A. M&A firms showed the same growth patterns as non-M&A firms three to five years after an M&A. This study provides useful post-M&A growth information regarding restaurant firms, which can be practically useful for firms considering M&A.

1. Introduction

Merger and acquisition (M&A) is often considered an effective growth tool for hospitality firms (Hsu and Jang, 2007). The J.H. Chapman Group (2008) reported that 78 M&As of restaurant firms were announced in 2003. That number increased to 112 in 2007, which suggests that M&A has been increasingly used in the restaurant industry.

Traditionally, scholars have recognized that there are two types of firm growth strategies: internal (organic) and external (M&A) (Dickerson et al., 1997). Internal growth (organic growth) means that firm growth is realized through the firm's own strengths and resources. Internal growth usually requires a long time because sudden jumps in the internal growth process are difficult to achieve. On the other hand, external growth (growth through M&A) signifies a strategy that is achieved by buying another firm or business. External growth is usually perceived as a faster strategy than internal growth (Ikeda and Doi, 1983; Scherer and Ross, 1990; Trautwein, 1990). According to Hay and Liu (1998), faster growth may occur even after an M&A because firms executing M&A experience lower costs due to their larger size. These lower costs put the firms in a better price position, and consequently the firms have more growth potential.

However, there are often huge obstacles that must be overcome in order to actualize faster growth. Post-M&A integration is a time-consuming process and the real chemical integration required to achieve synergy is difficult to accomplish (David and Singh, 1994). Besides, it also takes time to restructure the acquired firm. Some sectors of the business might overlap with an acquired firm and, occasionally, some sectors may not be exactly what the acquirer wanted. Given these factors, whether or not M&A is a really an effective tool for promoting consistent long-term firm growth has not been clearly verified.

Prior M&A studies have generally examined post-M&A performance in order to understand whether M&A is useful in terms of improving financial performance (Hsu and Jang, 2007). Thus, these studies tended to focus on investment returns to examine changes in shareholder value. Nevertheless, since the majority of the studies used the event window approach, their results were too limited to fully understand the various effects of M&A on firm performance. In order to further identify post-M&A performance, it is necessary to use more general methods. Because M&A executions are directly related to firm growth, an investigation of post-M&A firm growth could be very important in terms of expanding practical knowledge and contributing to the M&A literature. Besides, despite the increasing importance of M&A for restaurant firms, little research has focused on the effects of M&A on firm growth. Hence, whether M&A can actually produce and sustain firm growth remains unanswered. To fill in this the research gap, this study investigated post-M&A growth patterns in comparison to non-M&A growth patterns using restaurant firms. The outcomes of this study contribute to both industry and academic discussions in that it provides useful

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doi:10.1016/j.ijhm.2010.04.002

information as to what actually occurs in terms of firm growth after M&As in the restaurant industry.

2. Literature review

2.1. Effects of M&A

To understand the effects of M&A, previous studies have examined whether M&A influences financial performance and firm growth. Zollo and Meier (2008) reported that the majority of M&A studies have focused on short-term and long-term performance using the event window approach to analyze abnormal stock returns. As Oler et al. (2008) explained, however, event studies with short-term windows have serious limitations in that positive initial market responses to M&A are usually contradicted by negative long-run post-M&A returns. This suggests that the initial market response may have been incorrect and the error was later rectified. Accordingly, event studies using a short-term window may not accurately capture the economic impacts of M&A, but instead reflect only stock market expectations for the event. Also, Kothari and Warner (1997) and Barber and Lyon (1997) questioned the validity of standard parametric tests for long-term financial performance using abnormal returns. Barber and Lyon (1997) pointed out that long-term (one- to five-year) abnormal returns could be biased without an appropriate consideration of firm size. Thus, Scherer (1988) suggested the use of accounting data to examine the effects of M&A on financial performance. Empirical studies, including Dickerson et al. (1997) and Ravenscraft and Scherer (1987), reported on post-M&A profitability using accounting data from many industries. In addition, Ikeda and Doi (1983) added that the profitability five years after M&A could be better than three years after M&A.

In terms of the effect of M&A on firm growth, several studies found that M&A had a negative influence on firm growth. Cosh et al. (1989), Mueller (1985), and Kumar (1985) used the event study method and suggested that M&A had a significant negative impact on firm growth. Odagiri and Hase (1989) also concluded that M&A did not improve the growth rate three years after M&A. However, two studies examining the M&A of Japanese companies (Hoshino, 1982; Taketoshi, 1984) reported positive growths after M&A. Consequently, except for the two studies of Japanese companies, most prior studies have claimed that M&A has a negative effect on firm growth. Even though there seems to be a consensus regarding the negative effects of M&A on firm growth, past studies have all used the event study method. Given this, estimations of the effects of M&A could have a time dependent problem because performances prior to and following M&A performance are estimated under different business situations (Neumann et al., 1983). Accordingly, in order to clarify the effects of M&A on firm growth it is necessary to examine the effect from a different perspective, one that deals with the time dependency problem. Thus, it may be more meaningful to compare firm growth between M&A firms and non-M&A firms for particular time periods.

2.2. Post-M&A integration

Among the various advantages of M&A, firm growth is seen as one of the primary advantages (Ikeda and Doi, 1983; Scherer and Ross, 1990; Trautwein, 1990). In other words, the outcomes of M&A are likely to be visible more quickly than internal growth. Thus, growth through M&A allows the firm to acquire ready-made tangible and intangible assets and alleviates the managerial constraints on reaching rapid growth (Penrose, 1959).

However, Dickerson et al. (1997) argued that M&A might not provide exactly what firms would prefer because they are purchasing an already existing business or company. Consequently, this could actually lead to a reduction in firm performance. Also, there may be difficulties in integrating the acquired firm into the acquiring firm. Thus, costs are incurred in association with M&A, and these costs can sometimes dominate the benefits of M&A. One major cost is related to cultural differences between the acquiring and acquired businesses (David and Singh, 1994). Prior studies have acknowledged that post-M&A integration is a time-consuming process, and companies should not expect synergy right after an M&A. Based on a simulation study, Miczka and Großler (2004) claimed that cultural integration is usually completed in the first three years after M&A, but actual synergy may take even longer. Therefore, based on the above notion that post-M&A integration tends to take time, this study attempted to examine the effects of M&A up to five years after an M&A.

2.3. Firm size effect on post-M&A firm growth

Traditional industry organization studies have examined the relationship between firm size and firm growth. Past studies have shown a negative relationship between firm size and firm growth, indicating that small firms usually grow faster than larger firms (Kumar, 1985; Evans, 1987; Hall, 1987; Dunne and Hughes, 1994). Further, the negative relationship between firm size and growth is non-linear (Jovanovic, 1982; Rodriguez et al., 2003). The theoretical underpinning for this non-linear relationship comes from the concept of the long-run average cost curve. Traditional microeconomic references argue that an “L-shaped” long-run average cost curve exists as firm size increases (Laidler, 1981; Stettner, 1982). Consequently, small firms experience rapidly decreasing costs due to the “L-shaped” curve, which in turn has a large positive effect on firm growth. On the other hand, because large firms exist under almost unchanging cost curves, their growth potential from the cost curve does not improve much. This results in less positive effects from firm growth. Thus, it was necessary to consider the potential non-linear relationship between firm size and growth in this study as well.

Another important issue in relation to M&A and firm size is in the different behaviors of small size and large size acquirers. According to Moeller et al. (2004), small acquirers tend to have positive abnormal returns but large acquirers tend to show negative abnormal returns. They explained that the difference may be due to the fact that small acquirers generally acquire relatively large target firms, but large acquirers tend to acquire relatively small target firms. Earlier studies also examined relative size (the ratio of acquired firm size to acquiring firm size) and found that relative size could be a critical factor for M&A performance (Asquith et al., 1983). Along similar lines, Seth (1990) found that acquisitions involving relatively large target firms generate more synergy than those involving relatively small target firms. Thus, it is logical to consider relative size in M&A as related to growth, because a relatively large M&A could mean more rapid growth. In other words, an M&A would contribute more to a small acquirers’ growth than it would to a large acquirers’ growth.

Theoretically, however, post-M&A integration would be faster for large acquirers who merge with relatively small target firms because the larger acquirers have the capability to sufficiently absorb the relatively small target firms. In general, the managerial capacity and experience of small acquirers would not be sufficient enough to realize immediate M&A synergy as compared to large acquirers. Thus, it could be generally understood that post-M&A integration for small acquirers will typically be slower than for larger acquirers. Nevertheless, small acquirers would be expected to show greater synergy in terms of firm growth because of the larger relative size of the deal, but the integration speed would be slower. In contrast, large acquirers would be expected to have