December 2001

Dot-Com Deals: An Empirical Investigation of Value Creation in Internet Related Acquisitions

C. Ranganathan  
University of Illinois at Chicago

Peter Dadalt  
Georgia State University

Follow this and additional works at: http://aisel.aisnet.org/icis2001

Recommended Citation
http://aisel.aisnet.org/icis2001/46
DOT-COM DEALS: AN EMPIRICAL INVESTIGATION OF VALUE CREATION IN INTERNET RELATED ACQUISITIONS

C Ranganathan
University of Illinois at Chicago
ranga@uic.edu

Peter Dadalt
Georgia State University
fncpjd@langate.gsu.edu

Extended Abstract

Several traditional brick and mortar firms as well as pure Internet firms are increasingly using acquisitions as a key mechanism for their online business growth. Although the number of internet-related acquisitions have increased in the last few years, there is little understanding of this phenomenon. This study addresses this gap by examining acquisitions involving traditional brick and mortar firms as well as Internet firms that are primarily aimed at improving online business activities. We specifically study the effectiveness of internet-related acquisitions by examining the value created by these acquisitions.

Studying the value created by web-related acquisitions is important from at least two perspectives. First, acquisitions have become a popular strategy for corporate growth for firms engaged in e-commerce initiatives. Surprisingly, there is little empirical research examining the viability of acquisitions as a mode of corporate growth. A second reason for studying the linkages between acquisitions and firm value comes from the growing literature on the resource-based theory of firm. According to this view, acquisitions lead to redeployment of resources across the firm, leading to more productive uses of resources and capabilities of the firm. Firm-specific assets and capabilities residing in one organization are merged and combined with those in another organization in an effort to improve the overall productivity of combined resources. This is all the more important in the context of firms engaged in e-commerce initiatives as they are under pressure to gain resources and capabilities before their competitors. For traditional brick and mortar firms as well as Internet firms trying to establish an online presence, acquisitions offer an opportunity to gain quicker access to resources and technological expertise that would accelerate their plans for online expansion. For Internet firms facing intense competition and resource constraints, acquisitions also provide a viable exit strategy, simultaneously satisfying the wealth maximizing objectives of their entrepreneurs. Acquisitions also help in meeting the critical resource requirements faced by several Internet firms that are in the early stages of business development. Evaluating the value created through acquisitions will throw light on the resource synergies that are expected to be generated through the acquisitions.

Two principle questions guide our study:

1. Do Internet-related acquisitions result in the creation of economic value?
   a. Are there any significant differences between the economic value created for acquiring firms and target firms?
   b. Are different kinds of acquisitions associated with different degrees of value creation?

2. Do the findings from strategic management and financial economics generalize to the context of Internet-related acquisitions?
   For example, are the investor expectations different for Internet-related acquisitions?

We investigate the above questions with a data set of Internet-related acquisitions in the U.S. in 1999. A sample of over 150 acquisitions were assembled and examined. The shareholder wealth effects associated with different kinds of acquisitions were measured and examined using the traditional event study methodology.

Our first hypotheses tested the change in stock holder value following an acquisition announcement. In all three event window periods, i.e., (-1,+1), (0,+1) and (-5,+5), we found significant and positive cumulative abnormal returns. The findings imply that

1Keywords: Internet acquisitions, mergers, event study, market value, electronic commerce.
the investors view acquisitions as a viable mode of corporate growth for enhancing online activities. Our second and third hypotheses examined the stock value returns for acquirer and target firms respectively. We found significant and positive increase in stock value for both acquirers and targets. While the findings about target firms are consistent with similar research studies in strategy and financial economics research, our analysis on acquiring firms present some contrasting results. Contrary to earlier findings that acquiring firms do not accrue any significant gains from an acquisition, our results indicate that acquiring firms make positive and statistically significant wealth gains from acquisitions.

Our fourth hypothesis examined if there are any differences in the stock holder value between related and unrelated acquisitions. We classified acquisitions as related or unrelated depending on the type of firms involved in the acquisitions. Acquisitions where both acquiring and target firms are of same type (both are traditional firms, or both are Internet firms) were treated as related acquisitions, whereas cases where a traditional firm acquires an Internet firm or vice versa were classified as unrelated. Our analysis revealed positive and significant cumulative abnormal returns for related acquisitions, but the returns for unrelated acquisitions were insignificant.

In summary, our results indicate that:

1. Stock markets react favorably to Internet acquisition announcements, leading to positive and significant enhancements to the market value of firms involved in the acquisitions.
2. While both the acquiring and target firms derive significant and positive gains in their market value, the target firms experience larger gains as compared to the acquiring firms.
3. The cumulative abnormal returns for related acquisitions are significant, positive, and higher than those for unrelated acquisitions.

A major contribution of this study is that it provides interesting insights into a contemporary industry phenomenon. From a practitioner standpoint, we can draw several lessons. First, for pure play Internet firms, acquisitions can serve as an effective way to accumulate valuable resources and capabilities. Second, the wealth impacts of acquisitions on target firms also provide support for using acquisition as an exit strategy for Internet firms. Third, for traditional firms seeking to boost their online activities, acquisitions could bring in valuable assets and expertise that could give them an edge over their rivals. Fourth, managers planning acquisitions should pay careful attention to the nature of their partner firm as this is a key determinant of the market value.

Although this is one of the early empirical studies in this area, this study has several limitations. For example, the relative size of the participating firms was not included as a variable in our study. Also, the financial amount involved in an acquisition is likely to influence the stock market reaction. This variable was also not considered in our study. We adopted a rather simplified scheme to categorize acquisitions as related and unrelated. A useful line of future enquiry would be to adopt a more rigorous classification procedure that would take into account the primary operating industries of the firms. Finally, our results are also limited by the time period of the data collection when there was a general boom in the stock market for Internet related firms.